



The role of mandatory cost audit in enhancing trust: the case of India

The role of
mandatory
cost audit

27

Bikram Chatterjee

*School of Accountancy, Massey University, Palmerston North, New Zealand,
and*

Monir Zaman Mir

*School of Business and Government, University of Canberra, Canberra,
Australia*

Abstract

Purpose – The purpose of this paper explores whether cost audits as governance mechanism affected the trust of the users of financial statements and whether they provide the benefits intended by regulators.

Design/methodology/approach – The research method involved unstructured open-ended face-to-face interviews with cost auditors in practice, mid- to high-level accounts and finance executives of companies and investors. Twenty-three interviews were conducted over a five-week period from December 2004 to January 2005 in Kolkata city of India. The selection of respondents was purposive, to explore the attitudes of these three groups towards mandatory cost audit.

Findings – Mandatory cost audit in India has not enhanced the level of trust of investors and preparers of financial statements also have the opinion. It has not brought those benefits expected by regulators.

Research limitations/implications – It is suggested following the findings of this paper that future research should carefully consider the usefulness and cost and benefit aspects of the mandatory cost audit in India.

Originality/value – This is a pioneering study providing an in-depth analysis of mandatory cost auditing in India.

Keywords Auditing, Cost accounting, Trust, Financial reporting, India

Paper type Research paper

1. Introduction

Auditing of financial reporting status is not a new phenomenon. The function of formal auditing of financial reporting existed even before the publication of Luca Pacioli's chapter on the double entry accounting system in 1494. Whenever the advance of civilisation brought about the requirement of one person being entrusted to some extent with the property of another, some kind of check upon the fidelity of the former was advised. Auditors and auditing both have been referred to in Italy and in England in the thirteenth century (Brown, 1968). The difference between the audit functions of



The authors would like to acknowledge the contribution of the School of Accountancy, Massey University, New Zealand for funding this project. The authors would like to thank the participants of the Critical Perspectives on Accounting Conference, New York, 2005 for their valuable comments. The authors would also like to thank the two anonymous referees for their valuable comments, which have helped in further developing the paper.

Qualitative Research in Accounting &
Management
Vol. 3 No. 1, 2006
pp. 27-45
© Emerald Group Publishing Limited
1176-6093
DOI 10.1108/11766090610659733

Luca Pacioli's days and now is that the contemporary auditing function is made mandatory by the regulators of financial organisations. However, the auditing function can only be perceived as adding value when the public trusts the process, which lends credibility to published financial statements (Rezaee, 2004).

Like any other product or service, the auditing of financial statements involves the incurrance of costs by organisations. Corporate auditing has been criticised due to the economic costs associated with it in recent times (Lee, 1994). The marginal increase in the cost of auditing should equal the marginal decrease in information error cost (Shakun, 1978). Keeping this principle of economics in the forefront, regulators of many economies are considering changing the audit requirement threshold. For example, from March 2004, private limited companies reporting annual turnover of up to £5.6m in the UK are exempt from the legal requirement to have their accounts audited. However, this was only £1m before this regulation came into effect (Davies, 2004). The reason for this increased threshold is to spare many British private businesses from the costly requirement to comply with the audit function.

Globally, after the collapse of the American energy giant Enron and the subsequent collapse of the accounting firm Arthur and Anderson, doubts have been raised over the benefits of auditing compared to its cost. In addition, there lies an expectation gap between the users of financial statements and the auditing profession, which could damage the essence of the auditing profession, that is, trust (Fadzly and Ahmad, 2004). PriceWaterhouseCoopers sold their international consulting firm to IBM in the summer of 2002 for \$3.5 billion. That sum was significantly less than the \$18 billion Hewlett Packard offered in 2000. In just over a year, the loss of trust within the final four large international accounting firms led to the reduction of the value of PWC's consulting arm by 80 per cent (McMillan, 2004).

Normally, the audit function is performed in two ways, external audit and internal audit. While the external audit of financial statements is mandatory for corporations in almost all economies, internal audit is not mandatory. Another form of mandatory auditing function, which is relatively uncommon globally, is getting its foothold in some of the South Asian countries, including India. This is known as "cost audit". India was the first country in South Asia (and perhaps in the world) to make cost audit mandatory for some of its business sectors. The Institute of Cost and Works Accountants of India (ICWAI) (www.mycwai.com) refers to cost audit as an audit of efficiency of minute details of expenditure while the work is in progress and not a post-mortem examination (www.mycwai.com). Cost audit is expected to overcome the criticism of financial audit as financial audit is a post-mortem evaluation and review. This is because post-mortem evaluation and review does not satisfy the requirements of sound management, which needs control to be exercised continuously (Batra and Kaur, 1993).

Based on the definition of cost audit provided by the ICWAI, Basu and Das (1999) point out that the objectives of cost audit include the determination and control of cost together with providing data for making judgements and decisions on various matters, such as operational efficiency. The Government of India (GOI) is making cost audit mandatory for more and more industries each year. For example, the GOI has added industries involved in the manufacturing of plantation products together with the petroleum and telecommunication industries in 2002 to the list of industries requiring mandatory cost audits (www.mycwai.com). Hence, it seems that the GOI is increasingly giving more emphasis to cost auditing. Basu and Das (1999) identified a

number of benefits of mandatory cost audits as intended by Indian regulators from the viewpoints of five interested parties, as follows:

- (1) From the perspective of management:
 - Cost audit detects errors, frauds and misappropriation and hence enhances efficiency.
 - It supplies more dependable cost data.
- (2) From the perspective of shareholders:
 - Cost audit ensures that the valuation of closing stock and work-in-progress are correct, hence helps in the computation of more accurate profit figures.
 - Cost audits conducted by external auditors detect the standard of efficiency of management and hence helps in the improvement of the standard of utilisation of material, labour and other resources.
- (3) From the perspective of the government:
 - Cost audits help the government to settle those cost-plus contracts that have been entered by the government.
 - It helps in the decision to provide tariff protection to any industry.
- (4) From the perspective of customers:
 - Customers may obtain more benefit if the cost is reduced due to effective control, implemented as a result of a cost audit.
- (5) From the perspective of cost accountants:
 - Cost accountants, who are employees of a company, obtain a share of all benefits derived by the company from a cost audit.
 - A cost audit makes cost accountants more careful.

It is still unknown as to whether the mandatory cost audit has achieved the intended benefits outlined above. Further, the potential for cost audit to enhance various stakeholders' trust in the information provided in financial statements has not been substantially explored. Following the dearth of literature in this direction, the present study investigates whether mandatory cost audits in India have resulted in an enhancement of trust by users of financial statements and whether they provide the benefits intended by regulators.

The rest of the paper is organised as follows: we first provide a discussion on the profiles of the mandatory cost audit functions in India. We then discuss our data collection procedures together with the theoretical resources employed to analyse and interpret data, before presenting evidence from the field. This is followed by a critical evaluation of the evidence gathered, before our conclusion.

2. Cost accounting and audit in India

During the early years of World War II, the concept of cost as an independent entity emerged as a beginning in the industrial circles of the world. Owing to the prohibitive cost of defence operations, governments of that time at war faced difficulties in ascertaining the price of defence equipment and hence evolved the concept of cost plus contracts. This mandated the contractors to submit the cost of the work to be undertaken by them, in order to be awarded the contract (www.mycwai.com).

The war ended in 1945, and the nations affected by the war began large-scale reconstruction of their economies through industrialisation. Many nations gained their independence as a result of an end in colonialism. The significance of cost accounting as the basis of the formation of government policies provided the foundation of the rapid growth of the profession. Cost accounting started as a mere exercise in estimating the cost, which later on developed into a movement for efficiency and optimum utilisation of scarce resources (www.mycwai.com).

The provision of the statutory cost audit was first introduced in India by the Companies (Amendment) Act, 1956. The amending act also provided that companies involved in manufacturing, processing or mining activities may be asked by the central government to prepare records disclosing the utilisation of labour, materials or other items of expenditure, as may be instructed. Section 209 (1) (d) of the Companies Act (amended in 1965) states that the central government may require any class of companies involved in production, processing, manufacturing or mining activities to prepare books of accounts incorporating such details in regard to the use of materials or labour or other cost items as may be prescribed. In this regard Cost Accounting Record Rules have been prepared (Basu and Das, 1999).

Cost Accounting Record Rules have been framed by the GOI from time to time for selected industries, with the objective of bringing them under the provisions of Sec. 209 of the Companies Act, 1956. These rules supply the guidelines for the companies in regard to the maintenance of cost accounting records. The details of the rules differ in accordance with the nature of the industry. The Cost Accounting Record Rules state the forms of various cost statements in which the costs of the products are required to be disclosed (Basu and Das, 1999). Cost Accounting Record Rules have been prescribed for 47 industries till 2005 (www.mycwai.com).

Section 233-B of the Companies Act (as amended in 1974) states that, the central government may direct any company that is required under clause (d) of sub-section (1) of Section 209 to keep cost records, to have an audit of cost accounts (Basu and Das, 1999). In accordance with the provisions of Section 233-B of the Companies Act, cost audit of certain establishments, to be directed from time to time, has been made mandatory. Cost Audit (Report) Rules, 1968 (as amended in 1969 and 1971) have been framed, that apply to every company where the Central Government u/s 233-B of the Companies Act has ordered a cost audit. It is significant to note in this regard that, audit of cost accounts ordered by the Central Government u/s 233-B of the Companies Act is a statutory audit and it is different from the audit of cost accounts by internal or external persons appointed by the management for whatever reason (Basu and Das, 1999).

Section 233-B of the Companies Act, as amended in 1974, states that the audit is to be conducted in such a way as may be specified in the order by an auditor who shall be a cost accountant as specified under the meaning of Cost and Works Accountants Act, 1959. The meaning of the term "cost accountant" has been specified in the Cost and Works Accountants Act, 1959. The section also refers to the fact that, if sufficient number of cost accountants are not available, the central government may notify in the official gazette that, for that specific period chartered accountants under the meaning of Chartered Accountants Act, 1949, possessing the required qualification, may also conduct the audit of cost accounts (Basu and Das, 1999). In this regard the prescribed qualification for a chartered accountant refers to a pass in the final examination of the

ICWAI (www.mycwai.com) or of the Institute of Cost and Management Accountants of the United Kingdom or Part I of the Management Accountancy examination held by the Institute of Chartered Accountants of India (Government Notification No. G.S.I 258 dated 21.4.72 cited in Basu and Das, 1999). A cost auditor appointed u/s 233-B of the Companies Act possesses the same duties in regard to an audit, as an auditor of a company under sub-section I of Section 227, and the cost auditor shall submit his report to the central government (Company Law Board) in a time and form as specified. The cost auditor is also required to submit a copy of the report to the company (Basu and Das, 1999).

2.1 Differences between cost and financial audit in India

The Institute of Chartered Accountants of India (ICAI) was established in 1949 (Act No. XXXVIII of 1949) to regulate the profession of chartered accountancy in India. The Accounting Standards (ASs) pronounced by the Institute apply to “general purpose financial statements”. This includes balance sheet, profit and loss account and other statements together with explanatory notes, which comprise part thereof, issued for the use of shareholders/members, creditors, employees and the public at large (D’Souza, 2002). The Companies Act 1956, which has been amended several times, and is now known as Companies (Amendment)/(Second Amendment) Act 2002 contains the detailed provisions concerning the preparation of annual accounts and reporting. The annual accounts of companies are prepared in accordance with Schedule VI of the Companies Act, 1956. The Companies Act mandates the companies to abide the ASs issued by the ICAI (Banerjee, 2002). The members of the Institute possessing a practicing certificate are authorised to attest the annual accounts of companies.

While the chartered accountant certifies the books of accounts, a cost accountant offers to perform or perform services concerning the costing or pricing of goods and services or the preparation, verification or certification of cost accounting and related statements. One of the primary objectives of the ICWAI is to develop the function of cost and management accountancy as a powerful tool of management control in all aspects of economic activities (www.mycwai.com). Hence, it can be suggested that cost accounting/auditing is a part of the financial auditing process, as cost auditors only concentrate on the computation of cost of a range of products. However, financial audit is broader in scope and hence may not concentrate on costing of products at the same level as that of cost auditing.

3. Theoretical resource: trust and trustworthiness

In a recent seminal article, Llewellyn (2003) argues that the value of qualitative research is largely influenced by the underlying theoretical resource that is used to make sense of empirical evidence. Following this argument, we draw on trust theory (role of trust) to understand whether cost audit in India has enhanced the trust of various stakeholders. Trust is a valuable contributor to many forms of exchange, and it is generating increased interest in organisational studies resulting in a growing body of literature in social science that examines “trust” (Doney *et al.*, 1998; Mayer *et al.*, 1995; Brown, 1994; Sitkin and Roth, 1993). Seal (2004) suggests that the development of trust is dependent on the institutional environment within which transactions take place. The significance of “trust” in financial reporting that includes auditing and the public accounting profession has been emphasised by McMillan (2004). The author

states that if the character of attest function performed by auditors is not centred on the ideals of trust the practical solutions to various problems proposed by various regulatory bodies will fall short. Similarly, Rezaee (2004) emphasises that auditors need to understand the public trust in their profession and suggest that there exists a trust gap between public confidence in financial reports and audit functions that will take time to narrow down.

Despite the level of interest shown in “trust”, accounting researchers have not generally considered the exploration of trust theory as a methodological resource. A notable exception in this regard is the study conducted by Seal and Vincent-Jones (1997) who explored the role of accounting in enhancing systematic trust during the transition period of the post Czech Republic. Another two studies conducted by Neu (1991a, b) also explored the role of trust in contracting and in new stock issue process. Neu’s studies provided some insights on the role of the accounting profession in creating trust. Seal *et al.* (2004) suggest that “trust” is perceived as a generalised faith in abstract systems. Accounting is only one of these abstract systems in a supply chain management, which is supported by other abstract systems such as marketing, purchasing, quality assurance and logistics. Our study is similar in nature to these studies, adding more insights on the role of auditing in creating trust, through a case study of the implementation of mandatory cost audit in India.

Researchers have devoted considerable attention to clarifying the meaning of “trust” in different social contexts. Therefore, different models of trust have very different implications regarding how the problems of trust are framed and resolved. In this study we adopted a view that trust is predicted on architecture of rational expectations rather than one that views trust as a complex social process that is embedded in complex social contexts. Following previous literature (McMillan, 2004; Rezaee, 2004) it can be argued that the cost audit is expected to enhance “trust” of users of financial statements (trustors) on those business organisations who are under the purview of mandatory cost audit (trustees), compared to those who are outside the scope of cost audit.

The definition of “trust” provided by Schlenker *et al.* (1973) is most appropriate for our study. Schlenker *et al.* (1973) define “trust” as the reliance upon information (e.g. accounting information) received from another person (e.g. preparer of financial reports) about uncertain environmental states and their accompanying outcomes (e.g. use of accounting information in decision making such as buying shares) in a risky situation. Shapiro *et al.* (1992) regard this type of trust as “knowledge-based trust” and argue that information contributes to the predictability of the other, which contributes to trust. Rousseau *et al.* (1998) regards this type of trust as “calculus-based trust” which is based on economic exchange and trust emerges when the trustor perceives that the trustee intends to perform an action that is beneficial. There are other organisational scientists who also define “trust” in a similar fashion. Coleman (1990) defines “trust” as an incorporation of risk into the decision of whether or not to engage in the action by acting based on estimates of the likely future behaviour of others. Quoting Sabel (1993), Barney and Hansen (1994) define “trust” as “the mutual confidence that no party to an exchange will exploit another’s vulnerabilities.”

Mayer *et al.* (1995) focus on trust in an organisational setting involving two specific parties: a trusting party (trustor) and a party to be trusted (trustee) and try to answer the question why a trustor would trust a trustee. They also define “trust” as the

willingness of a party to be vulnerable to the actions of another party and they further argue that trust is not taking risk *per se*, but it is the willingness to take risk. This definition by Mayer *et al.* (1995) relates appropriately to our research. This is due to the fact that we are exploring whether the willingness of investors (trustor) to take risk, such as investing in a business organisation (trustee), has been enhanced by mandatory cost audit in India. Mayer *et al.* (1995) explore the characteristics of both the trustor and the trustee, which affect the amount of trust a trustor has for the trustee. They propose that if a trustee's ability, benevolence, and integrity were all perceived to be high by the trustor, the trustee would be deemed quite trustworthy. Mayer *et al.* propose that if the level of trust surpasses the threshold of perceived risk, then the trustor will engage in risk-taking in their relationship with the trustee.

Barney and Hansen (1994) add that an exchange partner is trustworthy when it is worthy of the trust of others. In other words, an exchange partner worthy of trust is one that will not exploit other's exchange vulnerabilities. Mayer *et al.* (1995) indicate that ability, benevolence and integrity of the trustee explain a major portion of trustworthiness. While explaining "trust" and "trustworthiness", Barney and Hansen (1994) further point out that opportunism is the opposite to trust. They argue that a firm's actions are opportunistic to the extent that it takes advantage of another's vulnerabilities. Commonly, these researchers view "trust" as an expression of confidence between parties in an exchange of some kind, that is, confidence that they will not be harmed or put at risk by the actions of other party.

Elangovan and Shapiro (1998) propose that given a certain level of motivation to betray, the lower the trustee's penalty rating (e.g. low level of governance) is, the higher the likelihood will be of an actual betrayal. The mandatory cost audit introduced by the GOI is expected to increase integrity of the information provided in financial statements, leading to trust and risk-taking in the relationship between the trustor (the users of financial information) and the trustee (the preparer of financial statements). The trustor is expected to believe that it is contrary to the trustee's best interests to cheat with accounting numbers, as a governance mechanism exists. The users of financial statements make economic decisions based on the information provided in financial statements. The GOI has introduced the mandatory cost audit (governance mechanism) to control the opportunistic behaviour of the preparer of financial statements. In this paper our central theme is to explore whether the cost audit as a governance mechanism affected the trust of the users of financial statements.

4. Research method

The research method involved unstructured open-ended face-to-face interviews with cost auditors in practice, mid- to high-level accounts and finance executives of companies and investors. The "interview" method of data collection has the advantage of flexibility as it allows changing the questions as the researcher proceeds (Sekaran, 2003). For the purpose of our study, which is explorative in nature, this method has been considered as appropriate. On the other hand, unstructured interviews provided us with the option of determining those areas that require further in-depth investigation. Sekaran (2003) suggests that the principle purpose of the unstructured interview is to explore and investigate into the several factors in the situation that might be central to the broad problem area. Similarly, Holstein and Gubrium (1995)

suggest that one of the major advantage of active interviews is it brings out the alternative considerations.

Twenty-three interviews were conducted over a five-week period from December 2004 to January 2005 (Table I). A broad spectrum of respondents from the Kolkata city of India was selected for the interviews. The selection of respondents was purposive, to explore the attitudes of three groups, namely, cost auditors, preparers of financial statements and investors towards mandatory cost audit in India. As a starting point of investigation and considering the aim of our study which is explorative in nature, this sample design was considered as appropriate. Among the respondents, the cost auditors who were selected are involved in conducting cost audit of companies, which have businesses all over India. The investors (i.e. the users of financials reports) who were selected for interviews are involved in investing in companies located all over India. All of these investors represent the “sophisticated investors” group in India as they invest a huge amount of money in various companies in India. Here “sophisticated investors” refer to those who invest in companies after an analysis of financials and who also possess experience of more than one year in regard to investing in companies. The executives (i.e. the preparers of financial statements) of companies were selected from those companies on which mandatory cost audit has been imposed by the regulators.

The length of most interviews ranged between 30 minutes and 1 hour. Most of the interviews were recorded and later transcribed but respondent anonymity was

Pseudo initials	Status	Organization	Number of interviews conducted
PB	Cost auditor	Partner of a cost accounting firm	2
SCM	Cost auditor	Partner of a cost accounting firm	1
MKT	Cost auditor	Partner of a cost accounting firm	1
SM	Cost auditor	Partner of a cost accounting firm	2
SB	Cost auditor	Partner of a cost accounting firm	1
AC	Mid-level accounts and finance executive	Chemicals and pharmaceuticals company	2
DB	Mid-level accounts and finance executive	Telecommunication and power cables manufacturing company, also involved in engineering projects	1
TKM	High-level accounts and finance executive	Engineering company also producing environmental products	2
AA	High-level executive of management audit department	Company manufacturing various products, such as cement, jute, auto trim and synthetic products	2
SL	Investor	Not applicable	1
RB	Investor	Not applicable	1
PA	Investor	Not applicable	1
AP	Investor	Not applicable	1
SA	Investor	Not applicable	1
RL	Investor	Not applicable	1
AD	Investor	Not applicable	1
SR	Investor	Not applicable	1
AG	Investor	Not applicable	1

Table I.
Profile of interviewees

guaranteed. However, in cases where recording was not allowed, notes were taken of major issues raised by respondents. In some cases interviews were taken two times as the respondent had other involvements at the first time and hence our discussion could not be finished. Hence, the discussion continued at a second meeting.

The nature of questions asked varied according to the group of interviewees, such as, cost auditors, preparers of financial reports and investors to explore their attitude towards mandatory cost audit in India. Among the most critical issues discussed with the respondents was the rationale for cost audit in India and the respondents' opinion in this regard. These open interviews have been centred on the theme of whether cost audit in India has enhanced the trust of investors on the operational efficiencies of the cost audited companies. Interviews have also focussed on finding out the benefits that have been brought by cost audit to business organisations and users of financial statements. These open-ended questions facilitated more in-depth "free-flowing" discussion of those issues raised by respondents.

Pseudo initials are used and specific position titles are not given for anonymity reasons.

5. Cost audit and its role in enhancing trust in reality

The findings of the interview analysis are presented below, organised around the three groups of respondents: cost auditors, preparers of financial reports, and investors.

5.1 Cost auditors and the mandatory cost audit in India

The ICWAI has been lobbying for a long time with the regulators of the Indian Government to make cost audit mandatory in India. Therefore, as expected, cost auditors interviewed were highly supportive of the mandatory cost audit in India. The usefulness of cost audit procedures in India is often criticised on the ground that the audit reports are not publicly available. For example, respondent PB opined that:

... users of financial statements cannot have access to cost audit reports, and it is not included in annual reports of respective companies. It is not a public document.

However, although it is not publicly available information, the ICWAI publishes a list of companies on which a cost audit has been conducted. Therefore, users of financial reports can have information on the status of the cost audit of various companies before making their investments decision. Respondent PB particularly emphasised that:

Insurance companies and the income tax authority do not seek cost audit reports, but sales tax authority of India depends on cost audit records to compute sales tax, since it is an indirect tax and the computation of this tax depends on cost data.

While discussing trust, PB suggested that:

I have a strong feeling that cost audit enhances the trust of investors, banks, insurance companies and various government authorities.

He went on to comment that:

... customers are aware of cost audit and I am sure that it has enhanced their trust on companies under the realm of mandatory cost audit.

He also opined that mandatory cost audit helps in the detection of the standard of efficiency of the management:

... by ensuring the accuracy of cost data that helps in a more accurate comparison of actual and expected results.

PB also suggested that cost audit is totally different from financial audit as:

... cost audit is conducted throughout the year, whereas financial audit is only conducted at the end of a financial year.

Respondent SCM suggested that mandatory cost audits have surely enhanced the trust of various user groups, including existing and prospective investors, financial analysts, banks, insurance companies, the income tax authority, and other government authorities, and of course, customers. He opined that, "India is the first country in the world where mandatory cost audit has been introduced." He further added:

... mandatory cost audit helps in the reduction of the utilisation of raw materials helping in more effective utilisation of scarce resources. As a result better quality goods can be produced at less cost thus enhancing the operational efficiency of a company.

He was of the opinion that a cost audit is totally different from a financial audit "as its scope is broader". SCM further suggested that companies become more cautious about keeping cost data, in cases where a cost audit has been enforced, "enhancing trust of various user groups of financial reports." He was also of the opinion that a mandatory cost audit by cost auditor(s) helps in the detection of the standard of efficiency of the management, as:

... mandatory cost audit provides more accurate data in regard to cost of various items and quantity of materials consumed thus helping in proper calculation of quantity variance and hence the productivity.

Respondent MKT believes that a mandatory cost audit enhances the trust of "prospective investors more than the existing ones". This is due to the fact that existing investors access various other information sources to make their investment decisions compared to prospective investors. Apart from investors, he also opined that mandatory cost audit has enhanced the trust of various user groups of financial statements, such as, financial analysts, banks, insurance companies, income tax authority together with other government authorities, and, lastly customers. MKT further stated that the mandatory cost audit "definitely makes companies more cautious about keeping cost data", and hence provides "a better tool to accurately measure the detection of the standards of efficiency of management."

SM was a strong supporter of mandatory cost audit, stating that:

... cost accounting records enhances trust only when it is done properly and I believe that it is done properly when it is mandatory only.

He further argued that:

... mandatory cost audit specifically enhances the trust of insurance companies as it helps in more accurate valuation of stock.

SM raised the matter of conflict of interest between industries and the government, as companies always try to reduce their income tax liabilities, and as a result they are opposed to mandatory cost audit. The reason being by providing a proper valuation of

stocks mandatory cost audit is expected to help in an accurate computation of income tax of companies. Customers also benefit from a cost audit as:

... it makes companies more efficient, the fruit of which reaches customers in the form of supplying goods to them at right prices.

Like his colleagues, SM emphasises that companies become cautious about keeping cost data when a mandatory cost audit is imposed on them, and the process of mandatory cost audit accurately detects the standard of operational efficiency of management.

Respondent SB suggested that mandatory cost audits enhance the trust of various user groups of financial statements. He specifically stresses that, "it enhances the trust of central excise department." He also opined that:

... it helps in proper costing leading to proper pricing of goods thus enhancing the trust of customers.

In context to whether mandatory cost audits make companies more cautious about keeping cost data he exclaimed "definitely".

From the above discussion it is evident that the cost auditors in practice interviewed are supportive of the mandatory cost audit in India. All of them have the opinion that cost audit reports of companies do enhance the trust of various user groups of financial statements as cost audit helps in the detection of operational inefficiency. They also have the opinion that cost audit is helpful specifically to some government departments, such as sales tax and excise duty. It is interesting to note a contradictory view, as one of the respondents suggested that the income tax authority of India do not seek cost audit reports, while another respondent suggested that it is expected that mandatory cost audit facilitates the accurate computation of income tax by providing a proper valuation of stocks. The contradiction arises due to the fact that, if the income tax authority does not require cost audit report, then how can one be assured that the valuation of stock has been proper for income tax purpose with the introduction of mandatory cost audit. Similarly, another contradictory view has been, while a respondent suggested that insurance companies do not seek cost audit report, but all of other respondents commented that cost audit enhances the trust of insurance companies.

5.2 Cost audit and the preparers of financial reports

The preparers of financial reports that were interviewed are not supportive of mandatory cost audits (Table II). They think that mandatory cost audit is simply a duplication of financial audit work. They have the opinion that external auditors carefully investigate various cost and expense matters of a company before signing an audit report. Therefore, there is no need to create extra burden by the regulators to make cost audits mandatory. It is a time-consuming affair and also involves an extensive outflow of cash, as the companies have to pay fees to cost auditors. For example, respondent AC mentioned that cost audits have not at all enhanced the trust of existing and prospective investors of his company due to the very fact that investors have serious doubts about the integrity of the whole process of cost audit. He further opined that the cost audit has no significance to financial analysts, banks and insurance companies:

Respondent group	Benefits	Limitations
Cost auditors	<p>Cost audits help in proper computation of sales tax by enhancing the chance of properly computing cost data</p> <p>Cost audit enhances the trust of existing and prospective investors, financial analysts, banks, insurance companies, various government authorities and customers</p> <p>Cost audit helps in detecting the standard of efficiency of management</p> <p>Cost audit helps in effective utilisation of scarce resources, by emphasising on the reduction of raw materials' usage</p>	<p>Cost audit reports are not accessible by the public</p>
Preparers of financial reports	<p>Cost audit is not too expensive to conduct, as it only involves payment to the auditor</p>	<p>Mandatory cost audit is simply a duplication of financial audit work, as financial auditors also investigate various cost and expense matters</p> <p>Cost audit does not contribute to enhancing trust of existing and prospective investors, as the process of cost auditing lacks integrity</p> <p>Cost audit has no significance to financial analysts, banks, insurance companies and the income tax authority of India. The income tax authority only relies on financial audit reports</p> <p>Financial audit is sufficient. Cost audit has no special role in supplying more accurate cost data</p>
Investors	<p>Cost audit may help in providing more accurate cost data and hence may enhance the chance of a more accurate computation of a profit or loss figure</p> <p>Cost audit will contribute more in a monopoly situation</p>	<p>Cost audit does not provide any benefit in India as perfect competition in India motivates every company to keep its cost as low as possible, to compete in the market</p> <p>Cost audit has no role in investment decisions, as it has not enhanced the trust of investors</p> <p>Cost audit increases the price of products as it imposes extra cost on companies</p> <p>Cost audit is unable to detect the standard of operational efficiency of management</p> <p>Cost audit is simply a duplication of a part of the financial auditing exercise</p>

Table II.
Perceived benefits and limitations of mandatory cost audit from respondents' viewpoints

Cost audit has no relevance to the income tax authority together with other government authorities and they only refer to financial audit.

He emphasised that:

... cost audit is a useless burden which is not even beneficial to companies and to various user groups so the question of trust on cost audit does not arise.

He suggested that the cost audit is just a duplication of financial audit as “cost audit is a part of the financial audit process” and hence cannot be perceived as value-added service. According to him “spending a single rupee[1] on cost audit is a waste of money”, and cost audit has been made mandatory due to pressures from the ICWAI.

Respondent DB opined that “cost audit report is not a public document” and hence it does not enhance the trust of any user groups of financial statements and customers. He also suggested that mandatory cost audit has “no benefits”. He opined that, “I do not find any validity of the whole exercise of mandatory cost audit.” The only reason that he could think of is political lobbying by the ICWAI. He believes that:

... the cost associated with a mandatory cost audit is not too much, except a nominal fee of the auditor, which is a waste of money.

He was also of the opinion that cost audit does not carry much value for businesses, investors and customers and it does not enhance the chance of detecting errors, frauds and misappropriation since “it is a duplication of a part of financial auditing process, nothing more.” He also disagreed that a cost audit helps in the supply of more accurate cost data concerning closing stock, work-in-process and profit.

Respondent TKM had a slightly different view concerning the scope of mandatory cost audit. He suggested that:

... cost audit is not a duplication of financial audit but it can as well be done by financial auditors.

For example, one of the audit issues of cost auditors is to investigate whether appropriation of overhead expenses have been done properly. The financial auditors could easily perform this investigation. Like the opinions of his other colleagues, he also has the opinion that a cost audit does not enhance the trust of various user groups of financial statements and customers. The principle purpose of introducing the cost audit in India, as TKM stated, is due to the fact that:

... the government wants to make the cost accountants happy and to keep these cost accountants employed.

He opined:

... the cost of cost audit should not be too high. However, the benefits obtained from it do not surpass the cost as there is no benefit of conducting a cost audit on top of financial audit in this era of perfect competition.

He had a different opinion from his colleagues about the advantage of cost audit as he believes that cost audit enhances the chance of detecting errors, by carefully computing costs of each individual process and/or departments. However, he also believes that financial auditors could perform this job.

Respondent AA suggested that the cost audit is a duplication of financial audit. He also opined that, "cost audit report is not available to the public and hence to investors." Hence:

I do not think that cost audit has a role in enhancing trust of users of financial statements and customers.

In a similar tune as other respondents he suggested that the cost audit has been introduced in India as mandatory by the government "due to pressures from the cost accountants in practice at the moment." He also believes that the benefits from cost audit are "far less than costs associated with it." He further stated that a cost audit on top of a financial audit does not enhance the chance of detection of errors and does not contribute towards supplying more accurate cost data concerning valuation of closing stock, work-in-progress and profit, since the financial audit also examines the same cost data as well.

It is evident from the above discussion that the preparers of financial reports interviewed are highly sceptical of the perceived benefits of a mandatory cost audit in India and held completely different opinions compared to the opinions provided by the cost auditors. All of the respondents in this group opined that the cost audit does not help in enhancing the trust of various user groups of financial statements, such as existing and prospective investors, financial analysts, banks, insurance companies and government authorities. These preparers also stated that cost audits have even failed to enhance the trust of the customers, since cost audit reports are not publicly available and also due to the fact that perfect competition exist in the market place. Hence, every business is trying to provide the best quality product at reasonable price. All of the respondents opined that the cost audit has been introduced in India due to political lobbying by the ICWAI and there is no benefit from this audit to companies. On the other hand, companies spend money on mandatory cost audit, though the exercise is not too expensive to carry out. However, considering the fact that cost audit does not bring about any benefit to companies, it is not worth spending money on this exercise. All of these respondents, except one (who is a member of ICWAI), stated that the cost audit does not enhance the chance of detecting errors, frauds and misrepresentation. All of the respondents advised that a mandatory cost audit does not help in the supply of more accurate cost data, such as, concerning the valuation of closing stock, work-in-progress and profit.

5.3 Cost audit and the investors

The experiences and expectations of the investors interviewed with regard to the perceived benefits of a mandatory cost audit are similar to the preparers of the financial reports. For example, SL, an experienced investor with about 11 years of experience opined that the mandatory cost audit has not enhanced his trust on the operational efficiency and accuracy of financial report numbers of a company. However, he stated that one of the benefit cost audit may bring about is an increase in accuracy in product costing thereby providing more accurate profit or loss figures. However, he opines "the same function is done under financial audit as well." He suggested that, "cost audit is only essential in a monopoly situation, but as in India companies are competing with each other to sale their products and hence companies are always trying to improve their operational efficiency to provide better quality goods at reasonable price", cost audit is unnecessary. Therefore, :

... companies are trying to get accurate cost data to survive in competition and an enforcement of cost audit is not necessary.

He stated strongly that his investment decisions are not at all influenced by whether there is a mandatory cost audit in a company, as his trust in financial statements of companies has not been affected by the mandatory cost audit.

Respondent RB, having an experience of about ten years in the share market, provided the same opinion as that of SL. He suggested that "I have serious doubt about the integrity of the cost auditors" and hence:

I do not believe that cost audits have any role in providing more dependable cost data concerning closing stock, work-in-progress and hence profit.

He was quite disappointed while discussing about the role of cost audit in enhancing the level of trust on product pricing and numbers in financial statements of those companies where cost audits are conducted, as he claimed that "I have no trust in the process as I told you before and how many customers are aware about the cost audit exercise? To me cost audit affect product pricing by increasing it" by the cost of a mandatory cost audit. He also suggested that, the mandatory cost audit to his belief; do not help in detecting the standard of operational efficiency of the management.

PA, the most experienced investor in this group of respondents, with an experience of about 30 years was quite disappointed with the implementation of mandatory cost audit in India stating that "cost audit in India has failed to guarantee the accuracy of financial statement numbers." While discussing about the role of cost audits in providing more accurate cost data concerning closing stock and work-in-progress, he opined that:

I myself am a Chartered Accountant, what do you think we do? We do the same job. What's the use of cost audit then? Useless.

Mandatory cost audits have not increased the trust of AP (an investor with about 20 years' experience) concerning product costing, as he stated that:

... companies are competing with each other here and hence trying to provide products to customers at low price to increase their individual market share. Why do we need mandatory cost audit then?

Cost audits have also not enhanced his level of trust in financial statements. He also stated that:

I do not consider cost audit while making an investment decision. I depend on the market. Audits are just a process, specifically the cost audit.

Respondent SA, having an experience of ten years in the share market, opined that the mandatory cost audit has not at all enhanced his trust on the costing efficiencies of the cost audited companies because "cost audit does not help in bringing down the cost." He was also of the opinion that the level of trust in financial statement numbers does not increase as a result of an enforcement of cost audits and cost audits do not impact his investment decisions.

The mandatory cost audit has not enhanced the trust of RL (who possesses about 20 years' experience in the share market) concerning product costing and accuracy of financial statement numbers. He commented concerning the mandatory cost audit that, "Its relevance is nil." It does not play any role in his investment

decisions as well. He also opined that, the cost audit does not at all help in obtaining more dependable cost data concerning the valuation of closing stock, work-in-progress and profit.

AD, a comparatively less experienced investor in the share market, that is, only possessing an experience of one and a half years, stated that:

I do not consider cost audit while making investment decision. I only look at the annual report and the financial auditor's report. However, I depend on the market and my friends who are in share market a lot to make my investment decisions.

He disagreed that a cost audit helps in providing more dependable cost data in regard to the valuation of closing stock, work-in-progress and hence, profit.

Respondent SR, having an experience of about two years in the share market, opined that his trust on product pricing and financial statements did not increase as a result of mandatory cost audit. He opined:

... cost audit is a post-mortem examination. It is done after financial statements are prepared for a specific year. Hence, I believe that there is no relation between trust and cost audited financial statements.

He disagreed that it is better to buy securities of those companies, where a cost audit is conducted. He further stated that a mandatory cost audit does "not at all" help in obtaining more dependable cost data concerning the valuation of closing stock, work-in-progress and hence the profit figure. He also opined that mandatory cost audit has "no role" in more accurately detecting the efficiency of management. He exclaimed that:

I do not at all believe in cost audit and it has only been imposed to provide employment to cost accountants.

AG, with about five years of experience in the share market, opined that companies are now competing with each other to capture a significant portion of the market, and hence they are trying to achieve the highest level of operational efficiency. So, the mandatory cost audit has no specific significance in enhancing trust concerning product costing and financial statements numbers. He also opined that "investors compute ratios and do their own analyses before investing, and mandatory cost audit has no role in it." Hence, according to AG, the cost audit has not enhanced his trust in financial statements. Similarly, he stated that he does not believe that a mandatory cost audit helps in obtaining more dependable cost data concerning the valuation of closing stock, work-in-progress and profit. This is due to the fact that:

... in India cost audit is centrally organised around few firms. One cost auditor has lots of companies to audit. Hence, cost audit is not conducted properly.

He also opined:

... cost audit is wastage of resources. Companies do not want cost audit. They will go to any length to ward off mandatory cost audit. Cost audit still exists because of lobbying by the ICWAI.

He also stressed that:

... public does not know whether a company is subjected to cost audit and hence the question of enhancement of trust in financial statements due to mandatory cost audit does not arise.

It is evident from the above analyses that these investors support the views expressed earlier by the preparers of financial statements. All of the respondents in the investor group opined that the mandatory cost audit has not enhanced their trust on product costing and on the accuracy of financial reporting numbers. Some of the respondents suggest that the job of a cost auditor coincides with that of the financial auditor, and hence cannot be perceived as a value-added service. All of the respondents in this group also opined that the mandatory cost audit does not help in obtaining more dependable cost data in regard to valuation of closing stock, work-in-progress and profit. These respondents also stated that their investment decisions are not influenced by a mandatory cost audit. They did not agree with the statement that it is better to buy securities of those companies where a cost audit has been made mandatory,; i.e. risk-taking (Mayer *et al.*, 1995). One of the reasons behind the fact that cost audit has been unable to enhance the trust of investors appears to be that cost audit reports are not publicly available.

6. Conclusion

It is apparent that the users of financial reports (trustors) interviewed do not have much trust in the cost audit, as they do not consider mandatory cost audit to have any role in their investment decisions that is, risk-taking in relationship. It is interesting to note the differences in opinion between cost auditors in practice and the users of financial statements. In contrast to the opinions of the latter, all of the cost auditors interviewed suggested that a mandatory cost audit enhances trust of various user groups of financial statements. It could be argued that cost auditors have an interest in promoting mandatory cost audits. It has also been observed that the opinions of the preparers of financial reports are similar to those of the users of these reports. They also stated that a mandatory cost audit does not increase the trust of existing and prospective investors on financial statement numbers.

Hence, there lies a doubt concerning whether the mandatory cost audit is fulfilling its purpose in the Indian context. All of the high-level officials of the companies and sophisticated investors suggested that the mandatory cost audit function is wasteful of money and resources in this era where competition is vital between business organisations, which can take care of the perceived operational efficiency expected to be gained through cost audit compliance.

The investors interviewed do not perceive cost auditors to possess additional ability, compared to auditors, in performing the audits of financial statements. Mandatory cost audit has not been perceived to provide any value-based service as business organisations try to improve their operational efficiency in order to provide better quality goods at reasonable price so that they can compete at the market place. Similarly, the ability of cost auditors to provide more accurate data concerning closing stock, work-in-progress and hence profit has also been questioned by those investors interviewed as they perceive that the financial audit also does the same function. From this perspective, imposing a cost audit is a duplication of the same job. The same opinion has been expressed by the preparers of financial reports interviewed. These preparers of financial reports do not believe that a cost audit has better ability to detect fraud and misrepresentation as well.

The benefit of the mandatory cost audit has also been questioned by some preparers of financial reports and investors as the cost audit report is not disclosed to the public

and does not form a part of the annual report. The integrity of the mandatory cost audit has been doubted by one of the preparers of financial statements. Most of the respondents perceived few, if any, specific benefits arising from the cost audit process, and suggested that the main benefit of the implementation of mandatory cost audit in India has been to cost accountants, especially those engaged in auditing.

Considering the above, it can be suggested that the mandatory cost audit in India has not enhanced the level of trust of investors in financial statements. It seems to have had little or no impact in minimising the perceived risks of investors with respect to financial statement numbers, and the process of cost audit does not impact their choice of investment decision. These results suggest that the mandatory cost audit has not brought those benefits expected by the regulators.

Finally, it can be suggested, following our findings, that future research should carefully consider the usefulness and the cost and benefit aspects of the mandatory cost audit. The extent to which the financial audit enhances the users' trust in financial statements, which is outside the scope of the present paper, should also be considered in this regard.

Note

1. Rupee is the currency of India.

References

- Banerjee, B. (2002), *Regulation of Corporate Accounting and Reporting in India*, The World Press Calcutta Private Limited, Calcutta.
- Barney, J.B. and Hansen, M.H. (1994), "Trustworthiness as a source of competitive advantage", *Strategic Management Journal*, Vol. 15, pp. 175-90.
- Basu, S.P. and Das, M. (1999), *Theory and Practice of Costing*, 9th ed., Rabindra Library, Calcutta.
- Batra, G.S. and Kaur, N. (1993), "Emerging dimensions audit accountability: a case study of public enterprise management and efficiency audit in India", *Managerial Auditing Journal*, Vol. 8 No. 6, pp. 30-40.
- Brown, P. (1994), *Restoring the Public Trust*, Beacon, Boston, MA.
- Brown, R. (1968), *A History of Accounting and Accountants*, Frank Cass and Company Limited, Holland.
- Coleman, J. (1990), *Foundations of Social Theory*, Harvard University Press, Cambridge, MA.
- Davies, J. (2004), "Audit exemption: the sky's the limit?", *Credit Management*, May, pp. 36-7.
- Doney, P., Cannon, J. and Mullen, M. (1998), "Understanding the influence of national culture on the development of trust", *Academy of Management Review*, Vol. 23 No. 3, pp. 601-20.
- D'Souza, D. (2002), *Indian Accounting Standards and GAAP*, 1st ed., Snow White Publication Pvt Ltd, Bombay.
- Elangovan, A. and Shapiro, D. (1998), "Betrayal of trust in organisation", *Academy of Management Review*, Vol. 23 No. 3, pp. 547-66.
- Fadzly, M.N. and Ahmad, Z. (2004), "Audit expectation gap: the case of Malaysia", *Managerial Auditing Journal*, Vol. 19 No. 7, pp. 897-915.
- Holstein, J.A. and Gubrium, J.F. (1995), *The Active Interview*, Sage, Thousand Oaks, CA.

- Lee (1994), "Financial reporting quality labels: the social construction of the audit profession and the expectations gap", *Accounting, Auditing & Accountability Journal*, Vol. 7 No. 2, pp. 30-49.
- Llewellyn, S. (2003), "What counts as 'theory' in qualitative management and accounting research? Introducing five levels of theorising", *Accounting, Auditing & Accountability Journal*, Vol. 16 No. 4, pp. 662-708.
- McMillan, K.P. (2004), "Trust and the virtues: a solution to the accounting scandals?", *Critical Perspectives On Accounting*, Vol. 15, pp. 943-53.
- Mayer, R.C., Davis, J.H. and Schoorman, F.D. (1995), "An integrative model of organizational trust", *Academy of Management Review*, Vol. 20 No. 3, pp. 709-34.
- Neu, D. (1991a), "New stock issues and the institutional production of trust", *Accounting, Organizations and Society*, Vol. 16 No. 2, pp. 185-200.
- Neu, D. (1991b), "Trust, contracting and the prospectus process", *Accounting, Organizations and Society*, Vol. 16 No. 3, pp. 243-56.
- Rezaee, Z. (2004), "Restoring public trust in the accounting profession by developing anti-fraud education, programs, and auditing", *Managerial Auditing Journal*, Vol. 19 No. 1, pp. 134-48.
- Rousseau, D., Sitkin, S., Burt, R. and Camerer, C. (1998), "Not so different after all: a cross-discipline view of trust", *Academy of Management Review*, Vol. 23 No. 3, pp. 393-404.
- Schlenker, B., Helm, B. and Tedeschi, J. (1973), "The effects of personality and situational variables on behavioral trust", *Journal of Personality and Social Psychology*, Vol. 25, pp. 419-27.
- Seal, W. (2004), "Towards an enabling research agenda for the accounting/contracting nexus", *Accounting Forum*, Vol. 28, pp. 329-48.
- Seal, W. and Vincent-Jones, P. (1997), "Accounting and trust in the enabling of long-term relations", *Accounting, Auditing & Accountability Journal*, Vol. 10 No. 3, pp. 406-31.
- Seal, W., Berry, A. and Cullen, J. (2004), "Disembedding the supply chain: institutionalized reflexivity and inter-firm accounting", *Accounting, Organizations and Society*, Vol. 29, pp. 73-92.
- Sekaran, U. (2003), *Research Methods for Business: A Skill Building Approach*, 4th ed., Wiley, New York, NY.
- Shakun, M.F. (1978), *Cost-Benefit Analysis of Auditing*, American Institute of Certified Public Accountants, New York, NY.
- Shapiro, D., Sheppard, B. and Cheraskin, L. (1992), "Business on a handshake", *Negotiation Journal*, Vol. 8 No. 4, pp. 365-77.
- Sitkin, S. and Roth, N. (1993), "Explaining the limited effectiveness of legalistic 'Remedies' for trust/distrust", *Organizational Science*, Vol. 4, pp. 367-92.

Corresponding author

Bikram Chatterjee can be contacted at: b.chatterjee@massey.ac.nz

To purchase reprints of this article please e-mail: reprints@emeraldinsight.com
Or visit our web site for further details: www.emeraldinsight.com/reprints

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.