

# FRAUD DETECTION THROUGH COSTING INTELLIGENCE (CI)

A special Focus on: The Cost Auditor's mandated role in Reporting Frauds under the Companies Act, 2013

## Abstract

Cost and management accounting today plays a far more strategic role than merely allocating costs or presenting SKU-wise profitability. With globalisation, automation and sophisticated ERPs, costing has become a core governance function and therefore a critical site for detecting operational, managerial, and financial fraud. Advanced costing methodologies, and emerging analytical tools & artificial Intelligence (AI) helps to demonstrate how CMAs can detect anomalies, misstatements, and manipulations hidden within cost records, machine-hour data, overhead allocations, and cost-driver bases. The article offers a structured fraud-detection framework and highlights the evolving role of cost consultants in safeguarding organisational integrity.

## Background

**T**he Companies Act 2013 mandates stringent standards for transparency and accountability, relying heavily on the statutory appointments of various auditors. Among these, the **Cost Auditor** holds a unique and increasingly critical position. While historically focused on ensuring the accuracy of **cost records** and the proper determination of **product costs**, the Cost Auditor's mandate has been profoundly expanded, particularly concerning the detection and reporting of corporate fraud.

The core of this expanded accountability lies in **Section 143(12) of the CA, 2013**. This non-negotiable provision casts an obligation upon all statutory auditors, including the Cost Auditor and the Secretarial Auditor, to report specific instances



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of fraud. This analysis will delve deep into the statutory framework and explore the complex ethical and professional challenges facing the Cost Auditor in executing this vital function of corporate oversight.

The cost data originates directly from **operational systems**—such as machine logs, production and labour records—it is intrinsically susceptible to manipulation. This vulnerability is often exploited to conceal operational inefficiencies, or, more egregiously, to perpetrate financial fraud. The Cost Auditor, therefore, operates as an essential **intelligence partner**, utilizing their specialized knowledge to identify “where fraud could hide” within the company's cost structures, from inflated overheads to fictitious consumption entries.

## Objectives

1. To analyse the statutory basis for Cost Auditor-led fraud detection under CA 2013.
2. To examine cost-related fraud typologies uniquely visible through cost records and operational data.
3. To develop a conceptual framework of Costing Intelligence (CI) as a fraud-detection mechanism.
4. To propose enhancements to strengthen India's audit and fraud-reporting ecosystem.

## Methodology

- ⊙ **Statutory Analysis:** Examination of Companies Act 2013, Section 148, Section 143(12), Rule 13 of Companies (Audit and Auditors) Rules, 2014 and relevant guidance.
- ⊙ **Case-Based Reasoning:** Use of anonymised industry examples and publicly known fraud patterns to illustrate cost-linked manipulation.
- ⊙ **Systems Analysis:** Review of how ERP architectures (SAP, Oracle, D365) create new fraud-detection opportunities.

### I. Statutory Foundation: The Cost Auditor's Legal Basis for Fraud Reporting

The duty imposed on the Cost Auditor is not a professional recommendation but a firm statutory requirement, rooted in the foundational laws of corporate governance.

#### A. Legal Status and Scope of Cost Audit

**Section 148 of the (CA), 2013** is the genesis of the Cost Auditor's appointment, mandating the maintenance of specific cost records and the subsequent conduct of a **Cost Audit** for prescribed companies. The primary purposes of this audit are threefold:

1. To ensure the **reasonable accuracy** of cost determination.
2. To verify the company's **efficiency** in resource utilization.
3. To confirm **compliance** with notified **Cost Accounting Standards (CAS)**.

Crucially, the Act designates the Cost Auditor as an 'auditor' under the general provisions, thereby subjecting them to the same overarching duties,

responsibilities, and liabilities as the Statutory Financial Auditor, specifically under the fraud reporting mechanism.



### B. The Mandate under Section 143(12)

**Section 143(12)** sets the basis for the fraud reporting duty:

*“if an auditor of a company, in the course of the performance of his duties as auditor, has **reason to believe** that an offence of fraud involving such amount as may be prescribed, is being or has been committed against the company by officers or employees of the company, he shall report the matter to the Central Government.”*

The inclusion of the Cost Auditor within the ambit of the term 'auditor' ensures that operational and cost-related frauds, which might otherwise be missed by a purely financial audit focus, are captured. The specifics of the reporting procedure are detailed in the associated regulations, namely the **Companies (Audit and Auditors) Rules, 2014**.

### II. Mechanics of Fraud Reporting: Adherence to Rule 13

#### A. Two Distinct Thresholds for Reporting

Rule 13 establishes two clear monetary thresholds that determine the recipient of the report (Internal vs. Central Government).

#### 1. Fraud Involving ₹1 Crore or Above: Mandatory Reporting to the Central Government (MCA)

When the Cost Auditor forms a **reason to believe** that a fraud involving **₹1 crore or more** has been committed against the company by its officers or employees, the following strict protocol must be followed:

- ⊙ **Immediate Intimation:** The fraud must be reported to the **Audit Committee (AC) or the Board of Directors** within **two days**

of the Cost Auditor's knowledge of the incident. This initial intimation provides the management with the first opportunity to act.

- ⊙ **45-Day Response Window:** The Board or AC is granted a period of **45 days** from the date of intimation to conduct its own review and furnish a reply to the auditor, detailing its observations and the corrective action taken or proposed.
- ⊙ **Submission to Central Government (MCA):** The Cost Auditor must file the report in **Form ADT-4** with the Ministry of Corporate Affairs (MCA) within **fifteen days** of receiving the Board/AC's response.
- ⊙ **Reporting Without Response:** Crucially, if the Board/AC fails to provide a response within the 45-day window, the auditor must still file Form ADT-4 with the MCA, explicitly stating that "no response was received from the Board/Audit Committee." This mechanism ensures that the duty to inform the government is not circumvented by managerial inaction.

## 2. Fraud Below ₹1 Crore: Internal Reporting Only

If the detected fraud involves an amount **less than ₹1 crore**, the reporting remains internal but mandatory:

- ⊙ **Internal Report to Board/AC:** The auditor reports the fraud to the Audit Committee or Board **immediately** (though the rigid 2-day timeline is not explicitly prescribed, reporting without delay is expected).
- ⊙ **Disclosure in Audit Report:** The Cost Auditor must clearly disclose the details of the reported fraud in the **Cost Audit Report (CAR)** itself.
- ⊙ **Board's Report Disclosure:** The Board of Directors is then obligated to disclose these details, including the nature of the fraud and the remedial steps, in the Board's Report, as part of the "Statement on Fraud Reported by Auditors Under Section 143(12)."

## B. Defining the 'Amount Involved'

Rule 13 provides clarity that the monetary value of the fraud is generally to be considered on a

**per-incident basis.** Multiple smaller fraudulent events are not to be aggregated to meet the threshold unless they are demonstrably part of one connected, overarching scheme or systematic fraud.

## III. The Cost Auditor's Unique Focus: Cost-Related Fraud Examples



The Cost Auditor's focus on operational and resource consumption data provides a distinct and often superior vantage point for detecting frauds that are specifically masked within product costing structures. The definition of 'fraud' under the CA, 2013 (Section 447) is broad, encompassing any act, omission, concealment, or abuse of position committed with the intent to deceive, gain undue advantage, or injure the company's interests.

## Detailed Categories of Cost-Related Fraud

### 1. Material Consumption Manipulation

These frauds directly target the largest component of product cost—raw materials.



- ⊙ **Fictitious Issue/Diversion:** The common scheme is recording the issue of materials to the production process when, in reality, the materials are diverted for personal use, theft, or illicit sale. This artificially inflates the COGS and concurrently reduces the reported

value of the valuable **closing inventory** (an instance of Asset Misappropriation).

- ⊙ **Inflating Scrap/Waste:** Deliberately overstating the quantum of normal or abnormal scrap or spoilage allows unaccounted-for material to be siphoned off. The inflated scrap cost is then absorbed into the product's cost, distorting the company's true operational efficiency metrics.
- ⊙ **Under-Recording Material Receipts:** Payments are made for the full quantity of material, but only a lesser amount is recorded in the books. The surplus is pilfered, and the records are later concealed by adjusting the average purchase price or consumption norms.

## 2. Labour Cost Fraud Schemes

Labour-related frauds primarily exploit payroll and productivity records.

Labour Cost Fraud Schemes



- ⊙ **'Ghost' Workers and Payroll Fraud:** Including non-existent or already terminated employees on the payroll, with the corresponding salaries diverted. Detection involves reconciling labour hours charged to cost centres with biometric/attendance records and physical verification.
- ⊙ **Fictitious Overtime:** Collusion with production supervisors to falsify overtime hours, charging the inflated cost to production.
- ⊙ **Misclassification of Labour:** Intentionally charging direct labour (traceable to products) as indirect labour or administrative overhead (harder to trace). This is often

done to manipulate final product cost data, particularly for internal **transfer pricing** or where regulatory pricing applies.

## 4. Overhead Absorption and Allocation Fraud

This involves the systematic manipulation of how common costs are distributed across products, departments, or divisions.

Analyzing Overhead Absorption and Allocation Fraud



- ⊙ **Biased Cost Allocation:** Deliberately using non-standard or inappropriate bases (e.g., floor area instead of machine hours) to allocate overheads (maintenance, utilities) to a specific product or division.
- ⊙ **Motive: Deflating Cost:** Allocating a low share of overheads to a product with a regulated price or one facing intense competitive bidding.
- ⊙ **Motive: Inflating Cost:** Allocating a high share of overheads to a product sold to a related party at an inflated **transfer price** (a major area of fraud in multinational companies).
- ⊙ **Capitalisation of Revenue Expenses:** The highly sensitive practice of classifying routine, period-based overheads (e.g., routine repairs) as additions to **Capital Work-in-Progress (CWIP)** or fixed assets. This immediately boosts current year profit and understates the actual cost of production.

## 5. Inventory Valuation Manipulation

The final valuation of **Work-in-Progress (WIP)** and finished goods directly impacts the COGS and the Balance Sheet.



## Inventory Valuation Manipulation Strategies



- ⊙ **Understating/Overstating WIP Stage:** Falsifying the percentage of completion of WIP. Since WIP is an asset, this manipulation can be used to either understate profit (for tax evasion) or overstate it (to meet external earning targets).
- ⊙ **Exclusion of Manufacturing Overheads:** Omitting significant manufacturing overheads from the cost of finished goods inventory. This leads to an understated inventory asset value and a lower COGS, which temporarily inflates current profit.
- ⊙ **Fictitious Inventory:** Creating records for inventory that does not exist to inflate the value of assets, which should be exposed during the Cost Auditor's verification of stock records and reconciliation with physical stock.

#### IV. Professional and Ethical Imperatives

The statutory duty to report fraud places the Cost Auditor in a precarious position, necessitating a high degree of **professional fortitude** and ethical clarity.

##### A. The Conflict of Interest and Due Diligence

The Cost Auditor faces the inherent **conflict of interest** of reporting against the same management team that is responsible for providing the data and recommending their appointment. This can lead to intense pressure to suppress findings or reclassify them as mere 'misstatements' rather than fraud. The auditor must navigate this by adhering strictly to the principle of **professional skepticism**—maintaining

a questioning mind and critically evaluating cost evidence, especially in high-risk areas.

##### B. Establishing 'Reason to Believe'

The term "**reason to believe**" is a legal threshold higher than mere 'reason to suspect' or 'negligence'. It requires the Cost Auditor to have gathered **sufficient and appropriate evidence**—often documentary proof, corroborated records, or systematic anomalies that cannot be explained away as errors—before triggering the statutory reporting requirement to the Central Government. The ambiguity here highlights the need for rigorous adherence to the professional guidance notes issued by the Institute of Cost Accountants of India (ICMAI).

##### C. Accountability and Penal Consequences

The seriousness of the duty is reinforced by the penal provisions under the CA, 2013:

**Sections 143(15) and 143(16)** outline the severe penal consequences, including **fines** and potential **imprisonment**, for any Cost Auditor who is found to have **knowingly or willfully** failed to report a fraud. This liability serves as a powerful deterrent against collusion or suppression of critical findings. The need for robust **whistleblower protection** for the auditor remains critical.

#### V. Conclusion and Recommendations for Strengthening the Framework

The CA 2013, has successfully transformed the Cost Auditor into a proactive **watchdog of corporate integrity**. Their specialized expertise in dissecting operational and cost data provides a necessary complementary perspective to the financial auditor, especially in detecting fraud masked by internal cost manipulations.

For this framework to achieve its full effectiveness, several enhancements are necessary:

##### 1. Mandatory Joint Audit Collaboration:

Implement a statutory requirement for quarterly or half-yearly joint meetings between the Financial Auditor, Cost Auditor and Secretarial Auditors. This formalized cross-auditor fraud risk assessment and sharing of preliminary red flags—particularly

in overlapping high-risk areas

2. **Graded Materiality Threshold:** Moving away from the fixed ₹1 Crore threshold to a **graded or risk-based monetary threshold** (e.g., a percentage of the company's turnover or net worth) would ensure that regulatory attention is focused on frauds that are truly material to the specific company's scale.
3. **Expanded Scope to Include Third-Party Collusion:** The law should explicitly expand the scope of Section 143(12) to include frauds where officers or employees collude with third parties, as this covers pervasive schemes like vendor kickbacks and fictitious sales.
4. **Enhanced Accountability of Audit Committee (AC):** Mandate that the AC provide a detailed, formal explanation in the Board's Report for any case where it disagrees with the auditor's classification of a matter as 'fraud,' particularly for those reported below the Central Government threshold.

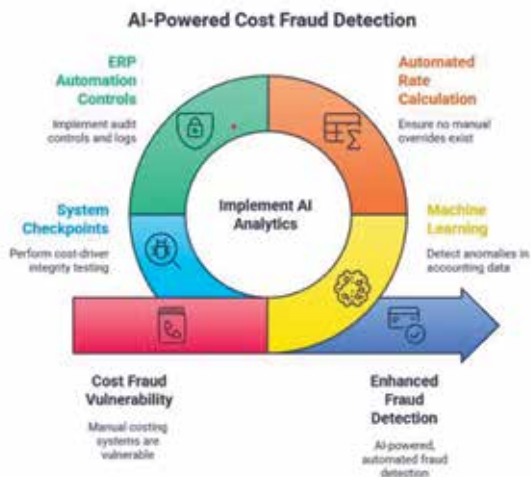
### Cost Auditor Fraud Reporting Use Cases under Section 143(12)

All listed cases involve fraud exceeding the **₹1 Crore** threshold, making reporting to the **Central Government (MCA)** mandatory via **Form ADT-4**, following internal reporting to the Audit Committee/Board.

Use Case	Scenario	Fraud Detected	Statutory Trigger
<b>Inflated Material Consumption</b>	<b>High scrap percentage and wastage</b> reported, with <b>large variance between actual and standard consumption</b> , but <b>no corresponding increase in defective output</b>	<b>Stores and production staff</b> colluded to show excessive consumption and <b>physically pilfer and sell raw materials</b>	Intentional falsification of <b>inventory records</b> constitutes fraud under <b>Section 447</b> of CA, 2013
<b>Bogus Labour Hours and "Ghost" Workers</b>	<b>Labour hours in cost sheets &gt; biometric attendance. Overtime hours unusually high. Several workers untraceable</b> during plant visit.	<b>HR and line supervisors</b> created <b>"ghost employees"</b> and <b>fictitious overtime</b> using fake signatures on muster rolls to siphon funds.	Fraud against the company involving <b>willful misstatement</b> and diversion of funds by employees
<b>Undervaluation of Work-in-Progress (WIP)</b>	<b>Stage of completion understated</b> , and <b>labour hours/consumption artificially recorded lower</b> than actual in WIP calculation.	<b>Plant head</b> intentionally undervalued WIP to <b>reduce reported profit</b> (for lower performance-linked bonuses)	<b>Falsification of asset valuation</b>
<b>Energy Sector Grade Manipulation Case (2023–24)</b>	<b>Unit cost of fuel did not correspond with grade specifications.</b>	Lower-grade coal sold as higher-grade to a state utility, enabling <b>inflated billing</b> and misrepresentation of fuel costs.	A CMA's expertise in <b>quality-cost correlation</b> and <b>cost of fuel analysis</b> is key to early detection.

### Technology, Analytics & AI in Cost Fraud Detection

As companies move to SAP, Oracle, Microsoft D365 and SQL-bridged costing systems analytics becomes central to cost fraud detection.



ERP automation reduces manual intervention; it introduces new manipulation points:

- ⊙ Logic changes in SQL queries
- ⊙ Incorrect links in Excel templates
- ⊙ Manipulation in downtime/manual adjustment fields
- ⊙ Hidden macros affecting absorber calculations

#### System Checkpoints

- ⊙ Cost-driver integrity testing

- ⊙ Variance correlation analysis
- ⊙ Idle-time misallocation checks
- ⊙ Overhead absorption benchmarking
- ⊙ Material-quality vs cost-variance mapping
- ⊙ Machine uptime vs cost-base analytics

Costing is not just mathematical allocation; it is a **control mechanism**. With global and Indian fraud cases demonstrating how cost data can be misused, the role of cost & management consultants has expanded from cost calculation to **cost integrity assurance professionals**.

By combining costing expertise with analytics, controls, fraud-risk thinking, and ERP understanding, consultants and CMAs can uncover misstatements long before they become scandals.

Costing intelligence (CI) is therefore not a future skill—it is a current governance necessity. MA

#### References

1. *Companies (Cost Records and Audit) Rules, 2014*
2. *Companies (Audit and Auditors) Rules, 2014 —Rule 13 (reporting of fraud).*

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