COST AUDIT IN ERP ERA – CONFIGURING ERP TO ENABLE ACCURATE REPORTING OF COSTS

Abstract

In the era of Enterprise resource planning (ERP) systems, cost audit effectiveness depends heavily on the quality of system configuration and data discipline. Information Technology plays a decisive role by automating cost capture, strengthening controls, and enabling traceable, analytical reporting. A well-implemented ERP does not merely store transactions; it converts them into auditable cost intelligence.

In this paper we would like to discuss the key to successful identification of costs at Product/customer level for firms under Cost audit and suitably reporting them at CTA heading level in an ERP environment. Given that SAP happens to be the global leader in ERP and also holds a substantial share in the Indian market (its currently around 25% of Indian ERP Market) we would like to address this issue from perspective of SAP ERP and more specifically the Controlling Module (CO).

CMA (Dr.) R. Jayaram
Professor of Practice – IFMR GSB (Krea University)
Sri City
jayaram.ramakrishnan@krea.edu.in

CMA (Dr.) G. Balasubramanian
Senior Professor and Advisor – IFMR GSB
(Krea University)
Sri City
balasubramanian.gopalswamy@krea.edu.in

CMA Srinivasan Kalyanasundaram
Professor of Practice – IFMR GSB (Krea University)
Sri City
srinivasan.kalyanasundaram@krea.edu.in

Introduction

Cost audit is a systematic verification of cost records and an evaluation of the effectiveness of an organisation's costing system. It examines whether the reported cost figures are reliable and whether they accurately reflect underlying resource consumption. These answers directly influence managerial decision-making, cost control, and statutory compliance.

In today's environment, where Enterprise Resource Planning (ERP) systems drive core business processes, the effectiveness of cost audit hinges on the quality of system configuration, master data discipline, and integration fidelity. A properly configured ERP does not merely record transactions—it transforms them into transparent, auditable cost intelligence.

The statutory cost audit framework comprises two primary components:

1. **Form CRA-3,** and

2. **Annexure,** consisting of:
   - Part A
   - Part B (Manufacturing) / Part C (Services)
   - Part D

From an ERP standpoint, the most audit-sensitive sections relate to:

- **Part A – Cost Accounting Policy, and**
- **Part B – Quantitative/Capacity data and Abridged Cost Statements at CTA heading level**

The central design challenge is well understood but operationally demanding:

"Capture accurate and granular product- and customer-level costs, and report them coherently at CTA heading level along with relevant capacity utilisation metrics."

Scope

SAP remains the predominant ERP platform in large manufacturing organisations, particularly in India. Accordingly, this paper focuses on SAP ERP—especially the Controlling (CO) module. The principles, however, are equally applicable to ERPs such as Oracle and Microsoft Dynamics.

While CO is the core engine for cost reporting, it relies on the data quality and processes of interconnected modules (FI, MM, PP, SD, PM, etc.). Put simply:

"CO is the analytical brain; the feeder modules are the sensory organs supplying the inputs."

This paper concentrates on CO configuration and integration elements essential for a credible, audit-ready costing framework.

Configuring SAP for Cost audit - The Critical areas

1. Organisation structure: getting the backbone right

SAP's organisational structure provides the framework for all master data and transactions. Since structural elements are difficult to modify after go-live, they must be designed with cost audit requirements in mind.

Three elements that are critical are:

a) Operating Concern

This is the highest node in SAP's controlling hierarchy. It is specifically used for **Profitability Analysis (CO-PA)**. For seamless generation of output at product profitability level *(requisite of Annexure Part B2 - cost audit)* CO-PA is to be activated within the operating concern. CTA needs to be embedded in the Product hierarchy at this stage.

b) Controlling Area

The controlling area captures and records costs and revenues for internal reporting. It is the logical home of cost centres, activity types, and cost elements. Multiple company codes may be assigned to a single controlling area to unify internal cost flows.

c) Company Code

A company code is the smallest organisational unit for statutory financial accounts. Multiple company codes may map to one controlling area, allowing internal cost flows to be unified even when statutory reporting is split.

2. Setting up the Masters

Product costing values materials and activities posted to production orders using material prices and activity rates. It accumulates both planned and actual costs, tracks variances, and supports inventory valuation. Importantly:

- **Direct + conversion costs** form product cost.
- **SG&A** costs are excluded from inventory valuation and appear in profitability analysis later.

Product costing hinges on two master-data pillars:

- **Quantity structure** and
- **Resource/overhead masters**.

The BOM and routing together form "quantity structure," meaning SAP reads quantities and operations from these masters to compute product cost.

- **BOM** requires well-maintained material masters.
- **Routing** requires accurate work centre masters.
- For each SFG or FG, a production version must link the BOM to routing so SAP knows *what goes into the product and where/ how it is processed*

a) Material Master

Material can be

- Raw material/component

- Semi finished
- Finished
- Spares
- Tools & Consumables

It is a **physical and logical grouping** and is the key to *MATERIAL MOVEMENT*

Two critical definitions that affect Product costing and accounts are

- **Valuation class**

  This links Materials Management (MM) with FI. Based on valuation class, material movements post to correct GL accounts. Wrong valuation classes distort inventory valuation and cost roll-ups.

- **Price control and price determination**

  SAP supports two price control indicators:

  - 'V' Moving average price
  - 'S' Standard price

  Indian manufacturing firms typically use:

  - **V** for procured raw materials and components
  - **S** for semi-finished and finished goods (default)

  Price determination method also differs by material type:

  - Transaction-based for procured items
  - Single/multi-level costing for manufactured items

  Unit of Measure (UOM) is another audit-critical point. *UOMs must be aligned with those used for the relevant CTA chapter headings to facilitate cost audit*

b) Masters – Overhead Accounting

Direct costs are only half the story. Conversion costs depend on overhead capture and allocation through multiple master data elements.

i. Cost Centres (CC)

A cost centre is the smallest unit where overheads are planned, booked, and reported. CCs can be defined by:

- Departments (Stores, QC, HR, Maintenance, etc.)
- Machines or cells
- Person-based offices (e.g., MD's office)

Each cost centre belongs to:

- a **standard hierarchy** (tree structure inside controlling area), and
- Optionally, alternative hierarchies for reporting flexibility.

The design challenge is to balance granularity (for accurate costing) with practical feasibility (for consistent data capture).

ii. Work Centres (WC)

A work centre can be a single machine, a machine group, or a production line. Often, WCs act as cost centres, especially where machine-hour costing is central.

iii. Cost elements and the chart of accounts

All expenses and revenues originate in FI and flow into CO through **primary cost elements**. By design:

Each FI GL expense/revenue account has a one-to-one primary cost element.

For cost audit readiness, **cost element groupings** must be designed not merely for MIS convenience but also to match:

- Cost Accounting Standards, and
- Cost audit annexure formats.

Cost element groups should also be classified into **fixed and variable** categories to support capacity analysis.

iv. Activity types

Activity types are measurable outputs of cost centres, such as:

- machine hours
- labour hours
- maintenance hours

These activities are planned in quantities and valued using absorption rates. Poorly defined activity types lead to arbitrary conversion costs.

v. Allocation logic

Allocation refers to moving support costs to production receivers. A maintenance CC, for example, is the sender; production CCs are receivers. Distribution or assessment cycles execute this logic. Without disciplined allocation, overheads remain stranded and products are under-costed.

Ongoing maintenance of master data across modules is an essential prerequisite for audit-quality outputs.

3. Planning cycle: building absorption rates in CO

Conversion costs rely on **predetermined absorption rates**, typically set annually. Firms often base these on nine-month actual adjusted for expected volume changes.

A standard planning cycle is:

a. Set planner profile **(KP04)**
b. Plan activity quantities **(KP26) -** based on expected volume and capacity constraints
c. Plan activity costs **(KP06) -** including fixed/ variable classification
d. Calculate activity prices **(KSPI) -** generating predetermined overhead rates

These rates become the basis for charging overheads onto production orders.

4. Actual cost booking and absorption

Once planning is set, actual costs start flowing. Not all costs are first collected in CCs. Some examples:

- Direct materials → production orders
- Trial/prototype materials → internal orders
- Spares → maintenance orders
- Erection materials/man-hours → WBS elements

Still, in a manufacturing firm, cost centres remain the most common sender/receiver of overhead.

Example:

If a CNC cost centre has a planned rate of ₹400/hour and a product consumes 90 seconds, the production order gets debited by:

(400 x 90 / 3600) = ₹10 per unit, and the CNC CC is credited correspondingly.

However, the CNC CC also receives real expenses through FI postings. Its debit (actual spending) will rarely equal its credit (absorbed costs). The gap is **under- or over-absorption**, typically caused by:

- spending variance
- volume variance
- mix variance
- efficiency variance

For cost audit reconciliation, this variance must be transferred back to products through **actual activity price calculation**.

5. Actual price calculation and full absorption

At month-end, SAP recalculates actual activity prices for each activity type. Using CON2 (or KSII in some setups), SAP:

- Posts the difference between plan and actual rates,
- Revalues production orders at actual rates, and
- Fully absorbs CC costs.

This step ensures that **Cost of Production reconciles with financial accounts**—an explicit requirement for cost audit.

6. Profitability analysis (CO-PA): completing product cost to profit

Once COP is reconciled, SAP settles production variances to CO-PA. Now we add:

- Administrative overheads
- Selling and distribution costs
- Finance costs

This delivers product/customer profitability needed for Part D.

CO-PA is an analytical tool, not a statutory ledger and supports internal and audit reporting

Integration Dependencies

ERP integration is the controlled flow of data between modules. For CO to produce credible cost audit outputs, feeder modules must be accurate and up-to-date.

Key integration points include

S.No.	Modules	Integration
1	MM – CO	Standard costs of procured materials are calculated at the beginning of the period in controlling-product costing (CO-PC). The standard cost is then used to valuate inventory, as well as record goods movements during the month in MM
2	MM and FI-GL + FI-AP + CO-PC	Tracking purchase price variance (actual price from vendor) with standard price in CO-PC.
3	PP & CO-PC	BOM & ROUTING are the foundation of Product costing are defined in Production planning (PP) Module. Production orders on whose confirmation Product costing happens are in PP.

4	PP & CO - ABC	Activity types (MC & Lab hrs) confirmed against Production orders. Costed thru Pre determined rates defined in CO –ABC
5	MM, FI-AA &CO	Capital equipment purchases are recorded in Asset accounting (AA) Module of FI and serves as base for identification of depreciation against WCs
6	PM & CO	Identification of costs against Plant maintenance orders raised against equipment mapped to WC (PM- Plant maintenance)
7	SD FI-GL+AR + MM &CO-PA	Sales captured in Sales & distribution (SD) impacts FI GL&AR and MM (Reduction in FG stock) same is used in CO-PA multidimensional reporting

This above integration table highlights the need for diligent updating of records in all modules before running the costing module

A costing system implemented along the above lines can seamlessly deliver the following critical output for Cost audit

- Annexure to CAR – Part A 4
- Practical & Actual capacity – Annexure to CAR Part B 1
- Abridged Cost statement for each product rolled up to CTA Heading under Annexure Part B 2
- Part D 1 - Product profitability & D2 – Profit reconciliation with Financials

7. Typical pain areas from a Cost audit perspective

Despite the highly integrated nature of configuration in SAP we need to remember the old adage of "Garbage in, garbage out". This is particularly true of ERP systems in an Indian context where some of the issues typically faced by Cost auditors are

a) Material accounting

i. **Infrequent updation of standards** – A robust costing system demands at the least, an annual updation of standard costs if not monthly. However majority of firms do not update on a regular basis .While adoption of Price control ,"V" ensures issues are valued at moving average, outdated standards render variance figures useless and deprive firms of real-time material variance analysis.

ii. **Postponement of accounting for rejections** – This causes mismatch between physical stocks and books and under-reporting of material costs. Discrepancies are often caught only at physical stocktaking, leading to large adjustments. If adjustments are passed outside MM through JVs in FI, rejection costs are lumped and not linked to specific part numbers.

iii. Common part numbers used for items sourced locally and imported distort costs unless split valuation is activated or alternate BOMs are used. Similarly, if prototype or sample parts are accounted against regular parts, moving average costs get distorted

b) Cost centre/Work centre inputs

i. Lack of updation of Work centres in Routing inputs (machine inputs) leads to distorted Overhead costs. This necessitates a physical audit of facilities with Routing as per books by the cost auditor to align Conversion costs

ii. **Lackadaisical CC accounting** is one of the greatest impediments to Costing in ERP. This coupled with **lack of updation of Overhead rates** in CO - PC renders inventory valuation an exercise in futility. This renders moving to CO-PA from CO-PC highly improbable while also forcing the cost auditor to adopt blanket rates to reconcile the financials with Cost figures generated by the system. The cost auditor to avoid this scenario needs to emphasize on the need to tightly integrate FI with modules like payroll, AA & MM

c) Looking beyond unit level drivers of cost

Firms often use only unit-level drivers like machine hours, labour hours, or weight to load conversion costs onto products. Few use batch- and product-level cost drivers, even though SAP allows such activity types. This leads to overburdening high-volume products with overheads and distorting product costs.

Given the above scenario it is critical for cost auditors to focus on

- Regular updation of standards – BOM, Routing,

material costs, Overhead rates

- Actively participate in audit of inventory and review accounting for rejections
- Encourage use of batch and product level cost drivers
- Push for use of scientific measures for reapportionment of service CC costs to production CCs (distribution/assessment method by integrating inputs from modules like PM, QC, HCM etc)
- Focus on veracity of SKFs essential for allocating Administrative, Selling & Distribution Overheads

> This article demystifies cost-audit readiness in ERP, more specifically SAP, showing how smart configuration, clean master data, and strong integration turn ERP data into audit-proof cost intelligence. A quick, practical guide to avoiding common pitfalls and building a credible costing framework in ERP

Case study of a leading auto ancillary unit

VE Ltd was a leading supplier of assembled electronic components to Indian and Foreign OEMs

The company planned to migrate from QAD ERP to SAP ECC. The cost auditors of VE Ltd felt that this would be an opportune moment to upgrade the Costing system.

VE ltd operated a Standard costing system for Material accounting. Materials accounted for over 75% of total cost. The reconciliation with actual issues at Moving Wacc was performed at month end. MIS was released only by the 10th of every month due to elaborate manual analysis of variances. The Overhead accounting system was rudimentary with Production OH Being identified to parts as a percentage of Material cost. This was highly unsatisfactory absorption base given the diversified portfolio of parts dealt with by VE.

The cost auditors through active involvement at the design stage along with the implementation partners of VE gave a roadmap for phased roll out of fully integrated Costing system along following lines

- Phase 1 was devoted to ensuring that Material accounting including capturing of rejections was accurately done against work orders. The idea was to eliminate manual reconciliation of variances and ensure real time availability of accurate Material consumption data
- Phase 2 was devoted to setting up a Standard costing system for Overhead accounting. Activity rates (primarily labour time based) were defined to replace percentage of material cost basis
- Once Overhead accounting stabilised, the client was advised to pursue actual activity price calculation and settlement of differences. This ensured COP reconciled with financials.
- Post this VE Ltd went in for CO-PA activation
- The cost auditors also encouraged VE team to update of Material Prices and activity rates on a quarterly basis to ensure the relevance of variances calculated.
- Finally a customized Z Report was developed to deliver Cost audit Part B 2 report on a product vide basis duly reconciled with financials

Conclusion

Cost audit in the ERP era is less about manual compilation and more about **system truth**. If organisation structure is designed for audit logic, master data is disciplined, planning is rigorous, and month-end absorption is correctly executed, cost audit becomes a natural by-product of operations—not a year-end scramble. MA

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