Paper 19 - COST AUDIT & MANAGEMENT AUDIT

Full Marks: 100

Section A
Answer any four Questions [4x15=60]

1. **(a) From the following figures extracted from the financial and cost accounting records, you are required to compute:**
   - **(i) Value Added.**
   - **(ii) Ratio of Operating Profit to Sales.**
   - **(iii) Ratio of Operating Profit to Value Added.**

Particulars	₹ in lacs
Net Sales excluding Excise Duty	42,000
Increase in Stock of finished goods	500
Expenses:	
Raw Materials consumed	8,600
Packing materials consumed	2,560
Stores and spares consumed	1,120
Power and fuel	9,200
Insurance	240
Direct salaries and wages	960
Depreciation	1,770
Interest paid	2,796
Factory overhead:	
Salaries and wages	480
Others	500
Selling and distribution expenses:	
Salaries and wages	240
Additional sales tax	914
Administration overheads:	
Salaries and wages	240

[10]

Answer:

(i) Computation of Value Added	₹ in lacs	₹ in lacs
Net Sales+ Increase in Stock of Finished Goods		42,500
Less:		
Cost of bought out materials and services:		
Raw Materials	8,600	
Packing Materials	2,560	
Stores and Spares	1,120	

Power and fuel	9,200	
Insurance	240	
Other factory overhead	500	22,220
i) Value Added		20,280
Composition of Value Added:		
Depreciation	1,770	
Interest	2,796	
Additional Sales tax	914	
Salaries and wages (960+480+240+240)	1,920	7,400
Profit before tax (balancing figure)		12,880
Operating Profit:		
PBT		12,880
Interest paid		2,796
		15,676

(ii) Ratio of operating profit to net sales = $\frac{\text{Operating profit}}{\text{Net sale}} = \frac{15,676}{42,000} \times 100 = 37.32\ \%$

(iii) Ratio of operating profit to value added = $\frac{\text{Operating profit}}{\text{Value Added}} = \frac{15,676}{20,280} \times 100 = 77.30\ \%$

(b) What are the matters that are relevant in formulating audit strategy and drawing up the audit plan? [5]

Answer:

As per CAAS – 101, matters that are relevant in formulating audit strategy and drawing up the audit plan are as following:

i. The cost reporting framework generally prescribed by the Cost Audit Report Rules on which the cost information to be audited has been prepared, including need for reconciliation with financial reporting framework.

ii. The specific requirements of industry specific cost accounting record rules.

iii. Industry regulators' requirement as to how costs will be handled.

iv. Unique features of an industry that influence audit requirements e.g. definition of product in the newspaper industry.

v. Reliance that can be placed on the work of financial auditors, other cost auditors appointed by the entity and internal auditors for example their attendance in annual stocktaking

vi. State of IT implementation, whether the entity is using an ERP system or internally developed systems and the reliance that can be placed on them.

vii. Statutory timelines for cost reporting which can be modified by managements for early completion.

viii. Timelines for Board/ audit committee meetings which can set the time limits for completion of audit work.

ix. Resources required and available in terms of manpower, equipment and others and the assignment of these to specific parts of the work.

2. (a) Explain the objectives of Cost Audit. **[8]**

Answer:

Objectives of Cost Audit

Cost Audit has both general and social objectives. The general objectives can be described to include the following:

Verification of cost accounts with a view to ascertaining that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise.

- Ensuring that the prescribed procedures of cost accounting records rules are duly adhered to Detection of errors and fraud.
- Verification of the cost of each "cost unit" and "cost center" to ensure that these have been properly ascertained.
- Determination of inventory valuation.
- Facilitating the fixation of prices of goods and services.
- Periodical reconciliation between cost accounts and financial accounts.
- Ensuring optimum utilization of human, physical and financial resources of the enterprise.
- Detection and correction of abnormal loss of material and time.
- Inculcation of cost consciousness.
- Advising management, on the basis of inter-firm comparison of cost records, as regards the areas where performance calls for improvement.
- Promoting corporate governance through various operational disclosures to the directors.
- Among the social objectives of cost audit, the following deserve special mention :
- Facilitation in fixation of reasonable prices of goods and services produced by the enterprise.
- Improvement in productivity of human, physical and financial resources of the enterprise.
- Channelising of the enterprise resources to most optimum, productive and profitable areas.
- Availability of audited cost data as regards contracts containing escalation clauses.
- Facilitation in settlement of bills in the case of cost-plus contracts entered into by the Government.
- Pinpointing areas of inefficiency and mismanagement, if any for the benefit of shareholders, consumers, etc., such that necessary corrective action could be taken in time.

(b) What are the features of Cost audit? **[7]**

Answer:

The cost audit of the companies under the relevant provisions of the Companies Act, 1956 has the following features:

a. Assessing compliance of the relevant cost accounting records rules as applicable to the product under review;

b. Study of the costing system to assess whether it is adequate for the cost ascertainment of the product under review;

c. Evaluation of the operating and other efficiencies of the organization under audit with special reference to the product under review; to ensure the submission of necessary details required under the Cost Audit Report Rules, 2001 as amended from time to time.

d. Submission of Cost Audit Report in the format prescribed.

Since cost audit is carried out under the various provisions of the Companies Act, 1956, a thorough and comprehensive knowledge of the Indian Companies Act including various rules prescribed thereunder and the circulars issued by the Ministry of Corporate Affairs is essential for conducting an effective Cost Audit.

3. (a) Explain the procedure for appointment of a Cost Auditor. **[10]**

Answer:

Procedure for appointment of cost auditor
The Cost Audit Branch of The Ministry of Corporate Affairs vide General Circular No. 15/2011 dated 11thApril 2011 has set out the procedure for appointment of Cost Auditor. The revised procedure has been made effective from the financial year commencing on or after the 1stday of April, 2011.

i) The company required to get its cost records audited u/s 233B(1) of the Companies Act, 1956 shall appoint Cost Auditor as defined Cost Accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under sub-section (1) of section 6 of that Act and including a Firm of Cost Accountants . However, the cost accountant or partners of a firm of cost accountant should be in whole-time practice and not holding any other employment.

ii) Under the revised procedure, the first point of reference will be the Audit Committee to ensure that the cost auditor is free from any disqualification as specified under section 233B(5) read with section 224 and sub-section (3) or sub-section (4) of section 226 of the Companies Act, 1956. The Audit Committee should also ensure that the cost auditor is independent and is at arm's length relationship with the company. After ascertaining the eligibility, the Audit Committee will recommend to the Board of Directors for appointment of the Cost Auditor.

   In those companies where constitution of an Audit Committee is not required by law, the functions of the "Audit Committee" as per the procedure will be discharged by the "Board of Directors".

iii) The cost auditor will be required to give a separate certificate to the audit committee in respect to his/its independence and arm's length relationship with the company.

iv) The Company is required to e-file its application with the Central Government on www.mca.gov.inportal, in the prescribed Form23C within ninety (90) days from the date of commencement of each financial year, along with the prescribed fee as per the Companies (Fees on Application) Rules, 1999 as amended from time to time and other documents as per existing practice i.e.

(a) certified copy of the Board Resolution proposing appointment of cost auditor; and

(b) copy of the certificate obtained from the cost auditor regarding compliance of section 224(1-B) of the Companies Act, 1956.

v) After filing the online application by the Company, the same shall be deemed to be approved by the Central Government, unless contrary is heard within thirty (30) days from the date of filing such application.

However, if within thirty (30) days from the date of filing such application, the Central Government directs the Company to re-submit the said application with such additional information or explanation, as may be specified in that direction, the period of thirty days for deemed approval of the Central Government will be counted from the date of re-submission of Form 23C by the Company.

vi) After obtaining approval of the Central Government (deemed or otherwise), the Company will be required to issue a formal letter of appointment to the cost auditor.

vii) The Cost Auditor is required to inform the Central Government within thirty days of receipt of formal letter of appointment from the Company. Such intimation is required to be done in prescribed e-Form 23 D along with a copy of such appointment.

vii) The Company is required to disclose full particulars of the cost auditor along with the due date and actual date of filing of the Cost Audit Report by the cost auditor, in its Annual Report for each relevant financial year. Since the notification has made effective from April 1, 2011, companies under cost audit are required to furnish the details in its Annual Report from the financial year 2010 -11.

(b) Cost Auditor is responsible for forming and expressing an opinion on the Cost Statement. Comments. [5]

Answer:

The term "Cost Statements" refers to a structured representation of the cost information, which ordinarily includes accompanying notes, derived from cost accounting records and intended to communicate an entity's use of economic resources and the output obtained in accordance with a Cost reporting framework. The term can refer to for example, a cost statement, reconciliation with financial accounts and related explanatory notes.

The requirements of the Cost reporting framework determine the form and content of the Cost Statements and what constitutes a complete set of Cost Statements. For certain Cost reporting frameworks, a single cost statement as such and the related explanatory notes constitute a complete set of Cost Statements. For example: a Cost Statement under Cost Accounting Standard 4.

The Cost auditor is not responsible for preparing and presenting the cost statements in accordance with the applicable Cost reporting framework including inter-alia:

- Designing, implementing and maintaining internal control relevant to the preparation and presentation of Cost Statements that are free from material misstatement, whether due to fraud or error;
- Selecting and applying appropriate Cost accounting policies; and

- Making cost estimates that are reasonable in the circumstances.

4. (a) Give the following data, compute the relevant variances –

Particulars	Skilled	Semi-skilled	Un-skilled
Number in Standard gang (for 40 hour week)	**16**	**6**	**3**
Standard rate per hour (₹)	**3**	**2**	**1**
Actual number in the gang (for 42 hour week)	**14**	**9**	**2**
Actual rate of pay (₹)	**4**	**3**	**2**

In the week, the gang as a whole produced 900 Standard Hours, during the week, 4 hours per worker was considered idle time due to machine breakdown. [10]

Answer:

i. Computation of Standard Hours (SH)

Total Standard Hours (Given) = 900 hours

Grade	Skilled	Semi-Skilled	Unskilled
Standard Mix	16	6	3
Standard Hours	576 hours	216 hours	108 hours

ii. Computation of Revised Actual Hours (RAH)

Total AH = (14×42) + (9×42) + (2×42) = 1,050 DLH

Grade	Skilled	Semi-Skilled	Unskilled
Standard Mix	16	6	3
RAH	672 hours	252 hours	126 hours

iii. Variance Computation Chart (based on Labour Mix, and without considering Idle Time Effect)

Particulars	Col. (1): SH × SR	Col. (2): RAH × SR	Col. (3): AH × SR	Col. (4): AH × AR
Skilled	576 × ₹ 3 = 1,728	672 × ₹ 3 = 2,016	(14 × 42) × ₹ 3 = 1,764	(14 × 42) × ₹ 4 = 2,352
Semi-skilled	216 × ₹ 2 = 432	252 × ₹ 2 = 504	(9 × 42) × ₹ 2 = 756	(9 × 42) × ₹ 3 = 1,134
Unskilled	108 × ₹ 1 = 108	126 × ₹ 1 = 126	(2 × 42) × ₹ 1 = 84	(2 × 42) × ₹ 2 = 168
Total	**₹ 2,268**	**₹ 2,646**	**₹ 2,604**	**₹ 3,654**

Labour Sub-efficiency Variance = ₹ 2,268 – ₹ 2,646 = ₹ 378 A

Labour Mix Variance = ₹ 2,646 – ₹ 2,604 = ₹ 42 F

Labour Rate Variance = ₹ 2,604 – ₹ 3,654 = ₹ 1,050 A

Labour Efficiency Variance = Labour Sub-efficiency Variance + Labour Mix Variance

= ₹ 2,268 – ₹ 2,604 = ₹ 336 A

Total Labour Cost Variance = ₹ 2,268 – ₹ 3,654 = ₹ 1,386 A

Grade-wise Breakup of Labour Variance (without considering Idle Time Effect)

Particulars	Skilled	Semi-skilled	Unskilled	Total
(a) Sub-Efficiency Variance = Col. (1) – Col. (2)	₹ 288 A	₹ 72 A	₹ 18 A	₹ 378 A
(b) Mix Variance = Col. (2) – Col. (3)	₹ 252 F	₹ 252 A	₹ 42 F	₹ 42 F
(c) Efficiency Variance (a+b) = Col. (1) – Col. (3)	₹ 36 A	₹ 324 A	₹ 24 F	₹ 336 A
(d) Rate Variance = Col. (3) – Col. (4)	₹ 588 A	₹ 378 A	₹ 84 A	₹ 1,050 A
(e) Total Labour Cost Variance (c+d)= Col.(1) –Col. (4)	₹ 624 A	₹ 702 A	₹ 60 A	₹ 1,386 A

iv. Variance Computation Chart (based on Idle Time Concept, without considering Mix Effect)

Particulars	**Col. (1): SH × SR**	**Col. (2): Net AH × SR**	**Col. (3): AH × SR**	**Col. (4): AH × AR**
Skilled	576 × ₹ 3 = 1,728	14 × (42 – 4) hours x ₹ 3 = 1,596	(14 × 42) × ₹ 3 = 1,764	(14 × 42) × ₹ 4 = 2,352
Semi-skilled	216 × ₹ 2 = 432	9× (42 - 4) hours × ₹ 2 = 684	(9 × 42) × ₹ 2 = 756	(9 × 42) × ₹ 3 = 1,134
Unskilled	108 × ₹ 1 = 108	2 × (42 - 4) hours × ₹ 1 = 76	(2 × 42) × ₹ 1 = 84	(2 × 42) × ₹ 2 = 168
Total	**₹ 2,268**	**₹ 2,356**	**₹ 2,604**	**₹ 3,654**

Labour Net efficiency Variance = ₹ 2,268 – ₹ 2,356 = ₹ 88 A

Labour Idle Time Variance = ₹ 2,356 – ₹ 2,604 = ₹ 248 A

Labour Rate Variance = ₹ 2,604 – ₹ 3,654 = ₹ 1,050 A

Labour (Gross) Efficiency Variance = ₹ 2,268 – ₹ 2,604 = ₹ 336 A

Total Labour Cost Variance = ₹ 2,268 – ₹ 3,654 = ₹ 1,386 A

Labour-wise Breakup of Variances

Particulars	Skilled	Semi-skilled	Unskilled	Total
(a) Net Efficiency Variance = Col. (1) – Col. (2)	₹ 132 F	₹ 252 A	₹ 32 F	₹ 88 A
(b) Idle Time Variance = Col. (2) – Col. (3)	₹ 168 A	₹ 72 A	₹ 8 A	₹ 248 A
(c) Gross Efficiency Variance (a+b)= Col. (1) – Col. (3)	₹ 36 A	₹ 324 A	₹ 24 F	₹ 336 A
(d) Rate Variance = Col. (3) – Col. (4)	₹ 588 A	₹ 378 A	₹ 84 A	₹ 1,050 A
(e) Total Labour Cost Variance (c+d)= Col. (1)–Col. (4)	₹ 624 A	₹ 702 A	₹ 60 A	₹ 1,386 A

Note: Alternatively, instead of the above chart, Labour Idle Time Variance can be computed as = Abnormal Idle Hours × Std Rate ph, and Labour Net Efficiency Variance = Gross or Basic Efficiency Variance less Idle Time Variance.

Particulars	Skilled	Semi-skilled	Unskilled	Total
(a) Gross Efficiency Variance = Col. (1) – Col. (3) (as above)	₹ 36 A	₹ 324 A	₹ 24 F	₹ 336 A
(b) Idle Time Variance = Abnormal Idle Hours × Std Rate ph	14×14 × ₹ 3 = 168 A	9×4× ₹2 =72 A	2×4× ₹1 =8 A	₹ 248 A
(c) Net-Efficiency Variance = (a) – (b)	₹ 132 F	₹ 252 A	₹ 32 F	₹ 88 A

(b) Discuss briefly the role of the Cost Accountant In a manufacturing Firm. [5]

Answer:

The Cost Accountant performs the following functions in a manufacturing organization -

i. Accounting and MIS: The Cost Accountant establishes the Cost Accounting Department in the Firm. He ascertains the information requirements of Managers at different levels in the organizational hierarchy. He defines the system to account for costs and to transmit relevant cost information on a timely basis to all Managers.

ii. Costing Manual: The Cost Accountant develops the Cost Accounting Manual. The manual specifies the functions of the Cost Accounting Department. It also provides the format of various documents, vouchers, forms and reports for compilation, accounting and dissemination of cost information.

iii. Cost Ascertainment: Cost of products, services, departments etc. are ascertained by effective implementation of the Cost Accounting System. The Cost Accountant supervises the operation of the accounting system and is thus responsible for cost ascertainment.

iv. Cost Reports: The Cost Accountant is responsible for preparation of various cost reports. These reports assist Managers in reviewing their own performance and in identifying critical areas where control measures should be taken to avoid cost escalation.

v. Cost Comparison: The Cost Accountant provides cost comparison information which is useful for decision making. Some bases of comparison may be - (a) Standard Costs with Actual Costs, (b) Budget and Actual activity levels, (c) Financial and Costing Profits, etc.

vi. Cost Analysis: The Cost Accountant analyses costs based on information available internally and externally. Such analysis is useful for decisions such as acceptance of additional orders, quotations for new products and orders, make or buy of components, sub-contractor own make, etc.

vii. Cost Control: The Cost Accountant suggests techniques for cost reduction and cost control. He may also supervise the implementation of the cost control techniques.

5. (a) A Company uses a purchased component in an assembly. It follows a policy of Economic Order Quantity for procurement of the component. The Purchase Price of the component is ₹800 each and the cost of carrying one unit is 15% per annum. The cost of placing an order is ₹150. The Company has estimated the total cost of carrying and order placement at ₹36,000. The Supplier has offered a discount of 3% on the Purchase Price if the entire requirement of the component is covered in two purchase orders in a year.

i. Find the Economic Order Quantity.

ii. Calculate the Total Cost of Component Procurement and Storage, if the Discount Offer is accepted. Compare this cost with the Total Cost of the EOQ.

iii. What further discount if any, should be negotiated for minimising the cost? Assume that the inventory carrying cost does not vary according to discount policy. [8]

Answer:

i. Computation of EOQ

It is given in the question that at EOQ, Total Cost of Carrying and Order Placement, i.e. Associated Cost p.a. = ₹ 36,000. Hence, Buying Cost p.a. = Carrying Cost p.a. = ½ of Associated Cost p.a. = ½ of ₹ 36,000 = ₹ 18,000.

Equating Carrying Cost p.a. we have –	Equation Buying Cost p.a. we have –
Carrying Cost p.a. = (Avg. Inv. × Carrying Cost p.u. p.a.) $18{,}000 = \frac{Q}{2} \times$ (15% of ₹ 800). So, $18{,}000 = \frac{Q}{2} \times 120$ On solving, Q = 300 units. Hence, EOQ = 300 units. Note: The Company follows EOQ policy. Hence Q = EOQ.	Buying Cost p.a. = (No. of Orders × Cost per Order) $18{,}000 = \frac{A}{Q} \times$ ₹ 150. $18{,}000 = \frac{A}{300} \times 150$ On solving, A = 36,000 units.

ii. Discount Analysis

Particulars	EOQ	3% Discount
(a) Quantity Ordered every time	300 units	36,000 ÷ 2 = 18,000 units
(b) Number of Orders p.a.	36,000 ÷ 300 = 120 orders	(Given) = 2 orders
(c) Buying Costs p.a. at ₹150	120 × ₹ 150 = ₹ 18,000	2 × ₹ 150 = ₹ 300
(d) Average Inventory = ½ of (a)	½ × 300 = 150 units	½ × 18,000 = 9,000 units
(e) Carrying Costs p.a. at ₹120	150 × ₹ 120 = ₹ 18,000	9,000 × ₹ 120 = ₹ 10,80,000
(f) Purchase Costs p.a. [Note: The Question requires Total Costs. Hence, Discount Approach is not applied here.]	36,000 units × ₹ 800 = ₹ 2,88,00,000	36,000 units × (₹ 800 less 3%) = ₹ 2,79,36,000

(g) Total Costs p.a. = (c + e + f)	₹ 2,88,36,000	₹ 2,90,16,300

Conclusion: 3% Discount Offer is not worthwhile, due to additional costs of ₹ 2,90,16,300 – 12,88,36,000 = ₹ 1,80,300, when compared with EOQ.

iii. Computation of Additional Discount required

Additional Discount to be negotiated to justify 2 purchase orders p.a. = $\frac{₹\ 1,80,300}{36,000 \text{ units}}$ = ₹ 5 p.u. approximately.

Hence, Additional Discount Percentage required = $\frac{₹\ 5}{₹\ 800}$ = 0.626% of Purchase Price.

(b) DDR Manufacturers, a small scale enterprise, produces a single product and has adopted a policy to recover the production overheads of the factory by adopting a single blanket rate based on machine hours. The budgeted Production Overheads of the Factory are ₹10,08,000 and budgeted Machine Hours are ₹96,000.

For a period of first six months of the financial year, following information were extracted from the books:

- **Actual Production Overheads ₹6,79,000**
- **Amount included in the Production Overheads:**

(a) Paid as per Court's order	**₹45,000**
(b) Expenses of previous year booked in current year	**₹10,000**
(c) Paid to workers for strike period under an award	**₹42,000**
(d) Obsolete Stores written off	**₹18,000**

Production and sales data of the concern for the first six months are as under:

Production:	**Finished Goods**	**22,000 units**
	Work-in-Progress (50% complete in every respect)	**16,000 units**
Sales:	**Finished Goods**	**18,000 units**

The actual machine hours worked during the period were 48,000 hours. It is revealed from the analysis of information that ¼ of the under-absorption was due to defective production policies and the balance was attributable to increase in costs.

You are required to:

i. Determine the amount of under-absorption of Production Overheads for the period,

ii. Show the accounting treatment of under-absorption of Production Overheads, and

iii. Apportion the Unabsorbed Overheads over the items. [7]

Answer:

Difference in Absorption = Absorbed OH (-) Actual OH
= (48,000 hours x ₹ 10.50 per hour) (-) ₹6,79,000 = ₹ 1,75,000 (Under-absorption)

Normal Increase in OH Costs = Total ₹1,75 000 - Abnormal ₹1,30,000 = ₹ 45,000

Treated as Cost and apportioned to
Units Sold (18,000 units) = ₹27,000
Closing Stock of Finished Goods (4,000 units) = ₹6,000
Closing Stock of WIP (16,000×50% = 8,000 units) = ₹ 12,000
So, Supplementary OH Recovery Rate = ₹ 1.50 per unit

Abnormal Items	₹
1. Labour Court Award	45,000
2. Prior Period Item	10,000
3. Strike Period Wages	42,000
4. Obsolete Stores written off	18,000
5. Defective Policies = 1/4th of (₹ 1,75,000 - Total of Items 1 to 4)	15,000
Total of above	1,30,000

Treated as Loss and debited to Costing P & L

Notes:

i. Budgeted OH Recovery Rate = $\frac{\text{Budgeted OH}}{\text{Budgeted Machine Hours}} = \frac{₹\,10{,}08{,}000}{96{,}000 \text{ units}}$ = ₹10.50 per machine hour.

ii. Supplementary OH Recovery Rate = $\frac{\text{Total OH}}{\text{Total Output Qtty}} = \frac{₹\,45{,}000}{30{,}000 \text{ units}}$ = ₹ 1.50 per unit.

This calculation can be based on either Units Sold, (or) Closing Stock of FG, (or) Closing Stock of WIP, (or) Total of all these.

Section B
Answer any two Questions [2x10=20]

6. (a) What are the objectives of Management Audit? [5]

Answer:

Management audit is carried out to –
i. appraise the management performance at all the levels;
ii. spotlight the decision or activities, that are not in conformity with organizational objectives.
iii. ascertain that objectives are properly understood at all levels;

iv. ascertain that controls provided at different levels are adequate and effective in accomplishing management objectives or plans of operations;

v. evaluate plans which are projected to meet objectives.

vi. review the company's organizational structure, i.e. assignment of duties and responsibilities and delegation of authority.

The main objectives of management audit can be summarized as follows:-

- to ensure optimum utilization on all the resource employed, including money, materials, machines, men and methods;
- to highlight efficiencies in objectives, policies, procedures and planning;
- to suggest improvement in methods of operations;
- to highlight weak links in organizational structure and in internal control systems, and suggest necessary improvements;
- to help management by providing health indicators and help prevent sickness or help cure in case of sickness; and
- to anticipate problems and suggest remedies to solve them in time.

(b) What are the pre-condition for initiating Management Audit? [5]

Answer:

Pre -conditions for Management Audit

(i) Overall Objectives: The objectives of the enterprise should be clearly perceived, identified and stated in specific terms.

(ii) Operational Plans: The overall objectives of the organisation are to be analysed into quantifiable, detailed targets and plans for various segments like production, sales, etc.

(iii) Management Hierarchy: An organisational structure should be created, with specific targets and objectives for each function, and also their reporting responsibilities.

(iv) Performance Measurement: There should be a mechanism for measuring the performance of each functional area or responsibility centre. Performance expressed in quantitative terms facilitates comparison with objectives and targets. MIS: A suitable Management Information System (MIS) should provide timely and adequate information to the Management Auditor on various efficiency aspects.

(v) Attitude: There should be co-ordination between the Management Auditor and various department heads. A motivation system may be adopted, e.g. incentives for best performance.

7. Distinguish the followings – [2x5=10]

(a) Operational Audit and Internal Audit

(b) Operational Audit and Management Audit

Answer:

(a) Distinguish between Operational Audit and Internal Audit.

Particulars	Operational Audit	Internal Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	Function of internal control with the objective of determining whether other internal controls are well designed and in place.
Link with Internal Control	This is not a part of Internal Control. This is over and above the regular internal control system.	This operates as a part of Internal Control System.
Objectives	1. Appraisal of controls. 2. Evaluation of performance. 3. Appraisal of objectives and plans. 4. Appraisal of organizational structure.	1. To determine whether internal controls are well designed and properly operated, and 2. To assist all members of Management in the objective discharge of their responsibilities by reviewing activities and procedures.
Function	Constructive Function, i.e. to provide suggestions for improvement.	Protective Function, i.e. to safeguard the assets of the enterprise.
Areas	All aspects of operations are analysed to see whether they are in tune with Management Policies, Objectives and Goals.	The traditional field of internal Auditors is restricted to financial accounting and internal control.
Aspect	Qualitative Aspects are analysed. For example in Cash Management, the Operational Auditor would analyse - 1. Whether quantum of cash in hand is related to requirement of cash? 2. Whether surplus cash is promptly invested in short-term securities for maximizing return? 3. Whether maximum possible protection has been given to cash?	1. The Internal Audit Function is said to focus more on quantitative aspects when compared to Operational Audit. 2. Internal Auditors view and examine internal controls in financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not found. 3. They check the accounting books and records to see whether the internal checks work properly and the resulting accounting data are reliable.

(b) Distinguish between Operational Audit and Management Audit.

Particulars	Operational Audit	Management Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	The Audit of the Management focuses on evaluating Managers' ability to manage.
Areas Covered	Operational Areas where standards and actual performance defined and expressed in quantitative terms are considered.	It is concerned with appraising - • Management's accomplishment of organizational objectives, • Management functions of planning, organizing, directing, and controlling, and • Adequacy of Management's decisions and action in moving towards its objectives.
Focus	Focus is on efficiency and economy in operations.	Focus is on effectiveness of Management decisions and actions.
Standards	Expectations or standards are expressed in quantitative terms, for comparison of actual therewith.	Standards are not defined in quantitative or monetary terms.
Evaluation	It is objective in nature, since standards are quantifiable.	Evaluation is comparatively subjective, since standards are not defined in monetary terms.
Technical Background	Operational Auditor should have a strong technical and operational background.	Management Auditor should have conceptual background. Technical Background is desirable, but not compulsory.

8. (a) Explain the Scope of Internal Control. [5]

Answer:

It is clear from above that internal control is an essential pre-requisite for efficient and effective management of any organisation and is therefore, a fundamental ingredient for the successful operation of the business in modern days. In fact, an effective internal control system is a critical success factor for any organization in the long term. They are indispensable tools for the ever-increasing risks, exposures, and threats to accounting systems, data, and assets. It embraces the whole system of controls – financial, operational or otherwise, established by the management in the functioning of a business including internal check, internal audit and other forms of control. In fact, internal control has now been recognized as fundamental and indispensable to modern auditing. Thus internal control has its all-embracing nature and is concerned with the controls operative in every area of corporate activity as well as with the way in which individual controls interrelate.

The scope of internal control, according to the aforesaid definitions, extends well beyond accounting control. Thus, the latest definition of internal control encompasses operational controls like quality control, work standards, budgetary control, periodic reporting, policy appraisals, quantitative control, etc., as all parts of the internal control system. In an independent financial audit or the statutory audit, the auditor is concerned mainly with the financial and accounting controls. However, in an operational audit (as part of internal controls), the auditor reviews all the controls including operational functions. The internal controls can be broadly classified into following four main categories: financial & accounting controls, administrative controls, operational controls and compliance controls.

(i) Administrative control – Administrative controls include all types of managerial controls related to the decision-making process. An example of administrative controls is the maintenance of records giving details of customers contacted by the salesmen.

(ii) Operational control – This is exercised through "management accounting" techniques viz. budgetary control, standard costing etc.

(iii) Financial and Accounting control – This control refers primarily the management plans, objectives and procedures that are concerned with the safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records, and timely preparation of reliable financial information.

(iv) Compliance control - These controls aim at ensuring compliance with applicable laws and regulations. These Controls also help to ensure compliance with laws regarding the system and intellectual property.

(b) Explain the silent features of special reports for Banks, Shareholders, Employees & Small Business. [5]

Answer:

Salient features for these special reports are briefly discussed below:-

(i) Reports for banks and creditors

Form and content of financial statements and schedules re-important to the lender but explanatory notes to the statements and schedules are perhaps more important to them. They require accuracy in report and confirmation of statement made, which should be properly verified and certified. Bankers are more oriented towards security due to their long-term expectation of debt servicing by the business. Hence, reliability of report is an important factor. All statements by the auditor should be clear and positive.

(ii) Report to shareholders

The reports are read by financial experts, bankers, tax authorities, public officials and research people. The report should, therefore, be useful in analytical details for its user, and give full facts of the organisation's business. The report should also convey the right and correct message to a lay man. The reports are often used as a public relation exercise to improve relations with investors and to promote loyalty. In India, auditor's report in the prospectus at the time of public issue is very important. Experts read "between the lines" of the auditor's report. It will ultimately reflect in the auditor.

(iii) Reports to employees

Reports for employees are mainly prepared for better understanding of the business, to dispel any misconceptions, counter charges by unions, or explain the need for continuance of the business in times of strike, competitions or sickness. The report to employees must gain the confidence of employees and earn respect for the statements. The report should consider the needs of employees, when the employee morale is low or where the relations with employees are strained. Auditor's views will be expected to be totally unbiased.

(iv) Reports for small business

The form of annual accounts and other requirements under the Companies Act is the same for a large or a tiny private company. However, the management auditor should design his report in a very simple way as the report for a small business if specifically directed to a person or a small group of persons only. A great deal of reporting for small business is subjective, due to lack of adequate data. This poses problems an analyzing and comparing data. Suggestions in the report must be based on proper appraisal of the problem.

Section C

Answer any two Questions [2x10=20]

9. (a) What are the Characteristics of a good Performance Appraisal Report? [10]

Answer:

Characteristics of a good Performance Appraisal Report are as follows –

(i) It should be remembered that the Performance Appraisal Report is meant to be used by the company and this report is confidential.

(ii) The report, being an annexure to the cost audit report, should basically lay more thrust on the cost management aspect of the business and should effectively bring out comments on how the business performance could be improved by elevating the cost performance.

(iii) When commenting on or analyzing the cost performance, the cost auditor could assess the impact of changes in the costs on the profitability of the products, profitability by customers or market segments.

(iv) The cost drivers that are the fulcrum of the cause and effect relationship in the cost statement, are the ones which form the first level of KPIs that are easily understood and actionable for the operational executives. The cost auditor while evaluating the KPIs can also look at the efficacy of the cost drivers. This evaluation will also enable the operational executives to relate what is being done at the shop floor to the cost statements that are the end product of the cost accounting system.

(v) It would be necessary to analyze the use of various resources to boost economy, efficiency and effectiveness of the operations. Economy indicates incurring of the least possible cost for acquiring and/or utilizing the resources, without compromising the quality. Efficiency denotes maximization of the output-input ratio. Effectiveness means achieving the desired goals. The Performance Appraisal Report should cover, at the minimum, all the three aspects of cost management.

(vi) For being a valuable report, Performance Appraisal Report should portray analysis of a range of performance measures. While selecting these measures, care should be taken to include those having a material impact on the past or future performance of an organisation. These measures could change over period of time and may require to be reconsidered for inclusion to or exclusion from the Performance Appraisal Report.

(vii) The following criteria may help the cost auditor to select and include the various performance measurement criteria in the Performance Appraisal Report:

- Effect on profitability
- Effect on resource utilisation
- Effect on liquidity
- Effect on risks
- Effect on quality
- Effect on competitiveness
- Effect on responsiveness to the market etc.

(viii) The Performance Appraisal Report should include non-financial performance indicators in addition to the use of traditional financial ratio analysis. The non-financial measures provide useful information about the probable future of performance of the company. E.g. a consistently good customer satisfaction index would guarantee a certain growth in business.

(ix) An ideal Performance Appraisal Report should possess the following characteristics:

- Objectivity
- Capability of being predictive value
- Comprehensiveness
- No information overload
- Coverage of strategic thrust
- Trend measures and current status
- Timeliness
- Segmented and enterprise-wide coverage

(b) Explain the Impact of IFRS on the Cost Structure, Cash Flows and Profitability. [10]

Answer:

The new era of accounting standards has started in India after India committed to converge to the IFRS. The Ministry of Corporate Affairs had notified 35 new Ind AS in 2011. The timeline for the adoption of these new standards is not yet given. The date had been postponed in view of pending the suitable amendments required to be done in the other enactments.

However, it will be useful for the cost auditor to run through the effects that the new standard may have on the organizations in the new ear. The cost auditor should get acquainted with the requirements of the new standards and the differences as compared to the existing standards.

In the Performance Appraisal Report, the cost auditor many point out the impact of IFRS on the existing cost structure, cash flows, and profitability. It may be noted that the new standards provide a principle based framework in place of rule based standards, and as such the companies may need to assess the effect of their actions and choices made for accounting.

The five main elements of financial statements are assets, liabilities, equity, income and expenses. The IFRS provide for recognition, measurement and disclosure criteria for these elements. In cases, where the measurement criteria change, there will be an impact on the costs. The changed recognition criteria may impact the profitability and cash flows of the company.

The most important effect on valuation will happen through the adoption of "fair value" concept in measuring various assets and liabilities. The cost auditor must enumerate the ceses where use of fair value is mandatory or permitted as management's choice. It should be noted that any change in the fair value as on the reporting date has to be taken to the profit and loss a/c.

It may not be possible to split the effect of new standards on individual product or product group costs and profitability. It could be assessed for the organization as a whole.

These effects arise due to the balance sheet orientation of IFRS rather than the P&L smoothing practices follows by companies. Given below is an illustrative list of areas where major impact would be arising out of the IFRS provisions related to:

- Revenue recognition – companies may have to defer part or whole of their revenues.
- Inventory valuation – explicit rejection of LIFO method could change the inventory costs and thus profitability.
- Property, plant and equipment – recognition of assets and depreciation may change, provisions on revaluation of assets are noteworthy.
- Financial instruments-accounting for hedges and FOREX may result in profits or losses to be recognized or derecognized.
- Construction contracts – there could be changes in contract revenues and profit measurement thereon
- Impairment of assets-recognition of provisions may impact profitability
- Intangible assets-certain existing assets may have to be derecognized

- Business combinations – some costs of M & A cannot be capitalized

The impact of changeover has been explained in the Ind AS 101 – first time adoption. It may be noted that the impact based on this standard would be in the first year in which the new standards are applied. In the first financial statements, the adjustments will have to be made in the retained earnings, subject to some exceptions and exemptions. This standard may required an entity to

(i) Recognize all assets and liabilities whose recognition is required by Ind AS
(ii) Not to recognize items as assets or liabilities if Ind AS do not permit such recognition;
(iii) Reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under Ind AS and
(iv) Apply Ind ASs in measuring all recognized assets and liabilities.

The Performance Appraisal Report should include comments of the potential changes for the understanding of the Board and Audit Committee members. The cost auditor could provide them an insight to the likely changes in the cost structure. This content area is an important aspect to be covered till the new standards are not adopted. In subsequent years, it may lose its relevance.

(c) The Balance Sheet of Ruma Ltd. stood as follows as on: (₹ in Lakhs)

Liabilities	31 March 2013	31 March 2012	Assets	31 March 2013	31 March 2012
Capital	1,500	1,500	Fixed Assets	2,400	1,800
Reserves	696	600	Less: Depreciation	840	600
Loans	600	720		1,560	1,200
Creditors & Others			Investment	240	180
Current Liabilities	774	150	Stock	720	600
			Debtors	420	300
			Cash & Bank	120	120
			Other Current assets	150	150
			Miscellaneous Expenditure	360	420
	3,570	2,970		3,570	2,970

You are given the following information for the year 2012-13:

	₹ in Lakhs
Sales	**3,600**
Profit before Interest & Tax	**900**
Interest	**144**
Provision for Tax	**360**
Proposed Dividend	**300**

Required:

i. **Calculate for the year 2012-13:**
   A. **Return on Capital Employed.**
   B. **Stock Turnover Ratio.**
   C. **Return on Net Worth.**
   D. **Current Ratio.**
   E. **Proprietary Ratio**

ii. **Give a brief comment on the financial position of Ruma Ltd.** **[10]**

Answer:

(A) Computation of Capital Employed –

	2013	2012
Fixed Assets	2,400	1,800
Less: Depreciation	840	600
	1,560	1,200

Current Assets		
Stock	720	600
Debtors	420	300
Cash & Bank	120	120
Other current assets	150	150
	1,410	1,170

Current Liability	774	150

Working capital	636	1,020
Net Fixed Assets + Working Capital	2,196	2,220

Average Capital Employed = (2,196 + 2,220)/2 = 2,208

Total Earning = Profit after tax + Interest on debt funds + Non-Operating Adjustments
= (900 – 144 – 360) + 144
= 540

$$\therefore \text{Return on Capital Employed} = \frac{\text{Total Earning}}{\text{Average Capital Employed}}$$

$$= \frac{540}{2,208} \times 100 = 24.46\%$$

It is normally expressed as a percentage. It indicates the rate of return earned by an enterprise from its total Capital Employed in the business. It is also an indicator of the profit earning capacity of an enterprise. A higher return reveals a better profitability on the total Capital Employed in the business.

(B) Computation of Stock Turnover Ratio = $\frac{\text{Net sales Excluding Excise Duty \& Sales Tax}}{\text{Average Stock}}$

$$= \frac{3,600}{(720 + 600)/2} = 5.45 \text{ times}$$

This ratio indicates the movement of stock during a particular period. In other words, it indicates how fast goods are sold out from the stock of those goods. Higher ratio indicates a faster movement of stock.

(C) Return on Net Worth = $\frac{\text{Total Earning}}{\text{Average Net Worth}}$

Net Worth = Share Capital + Reserve & Surplus – Revaluation reserve – Intangible assets – Accumulated losses, if any

Net Worth = 1,500 + 696 - 360 = 1,836

Return on Net Worth = $\frac{540}{1,836}$ = 29.41%

It is normally expressed as a percentage. It indicates the rate of return earned by an enterprise on the capital invested by its owners. This is an indicator of the rate of return on the shareholders' fund invested in the business. A higher return reveals the better profitability to the shareholders' of the enterprise.

(D) Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Current Ratio = $\frac{1,410}{774}$ = 1.82

This ratio indicates whether an enterprise possesses sufficient Current Assets to pay off its Current Liabilities. This ratio is an indicator of short term solvency or liquidity position of an enterprise. Ideal ratio is 2:1, i.e., the enterprise should have twice the current assets than the current liabilities, to exhibit ideal short term solvency position.

(E) Proprietary Ratio = $\frac{\text{Proprietary Funds}}{\text{Total Assets}}$

Proprietary Ratio = Equity Share Capital + Preference Share Capital + reserve & Surplus – Accumulated Losses
= 1,500 + 696 – 360 = 1,836

Total Assets = Net Fixed assets + Total Current Assets (Only tangible assets will be included)
= 1,560 + 1,410 = 2,970

Proprietary Ratio = $\frac{1,836}{2,970}$ x 100 = 61.82 %

This ratio indicates the portion of Proprietory' fund or Shareholders' fund invested in Fixed Assets. It is also an indicator of the efficiency of the management regarding the formulation of the financial planning.