## Paper-17 - COST AUDIT & OPERATIONAL AUDIT

**Time allowed-3hrs** **Full Marks: 100**

**SECTION I (50 Marks)**
**(Cost Audit)**
**Answer Question No. 1 (carrying 14 marks) which is compulsory and answer any two (carrying 18 marks each) from the rest in this Section.**

**Working Notes should form part of the answer.**
**"Wherever necessary, suitable assumptions should be made and indicated in answer by the candidates"**

**Question 1.**

**(a) Choose the most correct answer among four alternative statements : [8×1]**

**(i) The Cost Accounting Record Rules, 2011, is applicable to every company including a foreign company whose aggregate value of net worth as on the last date of the immediately preceding financial year exceeds:**
- A. ₹ 5 crores;
- B. ₹ 20 crores;
- C. ₹ 10 crores;
- D. ₹ 25 crores.

**(ii) The Compliance Report is to be submitted by companies to the Central Government within:**
- A. Ninety days from the close of the company's financial year to which the compliance report relates;
- B. Forty five days from the close of the company's financial year to which the compliance report relates;
- C. One hundred and eighty days from the close of the company's financial year to which the compliance report relates;
- D. One hundred and thirty five days from the close of the company's financial year to which the compliance report relates.

**(iii) CAS-13 deals with:**
- A. Pollution Control Cost;
- B. Cost of Service Cost Centre;
- C. Cost of Utilities;
- D. Repairs and Maintenance.

**(iv) Profit Reconciliation under Para 7 of the annexure to Cost Audit Report Rules, 2011 to be furnished for:**
- A. Last year only;
- B. Previous three years;
- C. Current year and previous 2 years;
- D. Current year and previous year.

**(v) The Cost Accounting Standard which deals with the principles and methods of classification, measurement and assignment of Direct Expenses, for determination of the cost of product or service, and the presentation and disclosure in cost statements, is:**

**A. CAS-6;**
**B. CAS-10;**
**C. CAS-11;**
**D. CAS-9.**

**(vi) The Cost Audit and Assurance Standard which deals with Planning an Audit of Cost Statements, is:**
**A. CAAS-101;**
**B. CAAS-102;**
**C. CAAS-103;**
**D. CAAS-104.**

**(vii) Para 8 of the Annexure to Cost Audit Report Rules, 2011 deals with:**
**A. Profit Reconciliation (for the company as a whole);**
**B. Financial Position And Ratio Analysis (for the company as a whole);**
**C. Related Party Transactions (for the company as a whole);**
**D. Value Addition and Distribution of Earnings (for the company as a whole).**

**(viii) The ceilings on the number of cost audits in the case of an individual Cost Accountant, who is not in full time employment are:**
**A. Ten companies, out of which not more than ten should have a paid-up share capital of ₹ 25 lakhs or more;**
**B. Twenty companies, out of which not more than ten should have a paid-up share capital of ₹ 10 lakhs or more;**
**C. Twenty companies, out of which not more than ten should have a paid-up share capital of ₹ 20 lakhs or more;**
**D. Twenty companies, out of which not more than ten should have a paid-up share capital of ₹ 25 lakhs or more.**

**(b) State with reasons whether the following statements are "True" or "False". [6×1]**
**(i) As per Cost Accounting Records Rules, 2011, Form-B is the form of Compliance Report and it includes Annexure to the Compliance Report.**
**(ii) CAS-4 does not apply to proprietorship concern.**
**(iii) As per Cost Accounting Standard, behaviour-wise costs are of three types — Material, Labour and Expenses.**
**(iv) Cost Auditor of a company can be appointed as Internal Auditor of the same company.**
**(v) Value addition is the difference between net sales and the cost of bought out materials and services.**
**(vi) According to Cost Audit Report Rules, 2011, Form-II deals with Performance Appraisal Report.**

**Answer to Question 1(a):**

**(i)** A. ₹ 5 crores
**(ii)** C. One hundred and eighty days from the close of the company's financial year to which the compliance report relates
**(iii)** B. Cost of Service Cost Centre
**(iv)** C. Current year and previous 2 years
**(v)** B. CAS-10
**(vi)** A. CAAS-101
**(vii)** D. Value Addition and Distribution of Earnings (for the company as a whole)
**(viii)** D. Twenty companies, out of which not more than ten should have a paid-up share

capital of ₹ 25 lakhs or more.

**Answer to Question 1(b):**

**(i)** True: As per Cost Accounting Records Rules, 2011, Form-B is the form of Compliance Report and it includes Annexure to the Compliance Report.

**(ii)** False: CAS-4 applies to Proprietorship concern, registered with Excise Department if goods manufactured are for captive consumption.

**(iii)** False: As per Cost Accounting Standard, behaviour-wise costs are of three types — Fixed, Variable, Semi-variable.

**(iv)** False: Since the Cost Auditor is required to comment on the scope and performance of Internal Audit it would tend to militate against proper and dispassionate discharge of the duties of the Cost Auditor if he is also the Internal Auditor of the audited company. Hence the Cost Auditor of a company cannot be its Internal Auditor also.

**(v)** True: Value addition is the difference between net sales and the cost of bought out materials and services.

**(vi)** False: According to Cost Audit Report Rules, 2011, Form-III deals with Performance Appraisal Report.

**Question 2.**

**(a) Purchase of Materials ₹ 3,00,000 (inclusive of Trade Discount ₹ 3,000); Fee on Board ₹ 12,000; Import Duty paid ₹ 15,000; Freight inward ₹ 20,000; Insurance paid for import by sea ₹ 10,000; Rebates allowed ₹ 4,000; Cash discount ₹ 3,000; CENVAT Credit refundable ₹ 7,000; Subsidy received from the Government for importation of these materials ₹ 20,000. Compute the landed cost of material (i.e. value of receipt of material). [5]**

**(b) Which persons cannot be appointed or reappointed as Cost Auditor of a company? [6]**

**(c) Whether the Cost Accounting Record Rules, 2011 are applicable to foreign companies? State with reason. [2]**

**(d) Give a comparison between Compliance Report and Cost Audit Report. [5]**

**Answer:**

**(a) Computation of Material Cost Sheet**

| | Particulars | Amount (₹) |
|---|---|---|
| | Purchase price of Material | 3,00,000 |
| **Add:** | Fee on Board | 12,000 |
| **Add:** | Import Duties of purchasing the material | 15,000 |
| **Add:** | Freight Inward during the procurement of material | 20,000 |
| **Add:** | Insurance paid | 10,000 |
| | **Total** | **3,57,000** |
| **Less:** | Trade Discount | 3,000 |
| **Less:** | Rebates | 4,000 |
| **Less:** | CENVAT Credit refundable | 7,000 |
| **Less:** | Subsidy received from the Government for importation of materials | 20,000 |

| | | |
|---|---|---|
| | **Value of Receipt of Material** | **3,23,000** |

Note:

(i) Cash discount is not allowed, as it is a financial item.

(ii) Subsidy received, rebates and CENVAT Credit refundable are to be deducted for the purpose of computing the material cost.

**(b)** As per sub-Section (3) of Section 226 of the Companies Act, 1956 implies that the following persons cannot be appointed or reappointed as Cost Auditor of a company –

(i) a body corporate;

(ii) an officer or employee of the company;

(iii) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(iv) a person who is indebted to the company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

(v) a person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. ("security" means an instrument which carries voting rights);

(vi) The sub-Section (4) of Section 226 provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-Section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(vii) A person, who is in full time employment elsewhere [Section 224 (1B)].

If an auditor becomes disqualified after his appointment, under any of the above provisions he shall be deemed to have vacated his office.

**(c)** The Cost Accounting Record Rules, 2011 apply to a foreign company as defined in section 591 of the Companies Act, 1956. According to this section 591, foreign companies are companies incorporated outside India which have a place of business in India. It does not matter whether the place of business in India was established in India before on or after the commencement of the Companies Act, 1956. It would appear that the foreign companies would have to maintain cost records only in respect of businesses and activities transacted in India.

**(d)** Both "Compliance Report" and "Cost Audit Report" cover common ground as both require certificate by Cost Accountant on the following areas:

- Maintenance of proper cost records by company as per Companies (Cost Accounting Records) Rules, 2011 prescribed under clause of sub-section (1) of section 209 of the Companies Act, 1956.
- Maintenance of detailed unit-wise and product/activity-wise cost statements and

schedules thereto in respect of the product groups/ activities cost records comply with Generally Accepted Cost Accounting Principles and Cost Accounting Standards issued by the Institute of Cost and Works Accountants of India. Both have to be filed with Central Government within 180 days of the end of the relevant financial year.

However, there are a number of differences between the two which are tabulated below:

| Sl. No. | Points of comparison | Compliance Report | Cost Audit Report |
|---|---|---|---|
| 1. | Applicable Rules | Companies (Cost Accounting Records) Rules, 2011 | Companies (Cost Audit Report) Rules, 2011 |
| 2. | Observations and Suggestions | Observations and suggestions limited to maintenance of cost records | Observations and suggestions relevant to cost audit to be given. |
| 3. | Nature of examination of cost records involved | Examination of cost records | Audit of cost records |
| 4. | Submission of report to the Central Govt. | Compliance Report to be submitted by the company to Central Govt. | Cost Audit Report to be submitted by the cost auditor to Central Govt. with copy to company |
| 5. | Circulation of Report to shareholders | Company not to circulate compliance report to share-holders | Company to circulate cost audit report to shareholders if directed by the Central Govern-ment. |

**Question 3.**

**(a) Bina Ltd. requiring to make and maintain cost accounts and records contends that the Auditor need not report on the non-maintenance of cost records because the provisions of Cost Audit were not made applicable to it. How would you react to the above situation? [3]**

**(b) Capacity utilization depends on various factors like hours, the plant worked, efficiency with which it worked, quality of input materials etc. In the context of this statement, please give your comments on the following data relating to a chemical plant and a sugar mill.**

| | | **For the year 2013-14** | |
|---|---|---|---|
| **(i)** | **Chemical Plant:** | **Budgeted** | **Actual** |
| | **Production (KL)** | **18,00,000** | **13,50,000** |
| | **Vessel occupancy** | **7,200** | **6,000** |
| **(ii)** | **Sugar Mill:** | **2013-14** | **2012-13** |
| | **Installed Capacity: Tonnes of cane crushing per day (TCD)** | **5,000** | **4,000** |
| | **Duration of the season (days)** | **240** | **250** |
| | **Cane crushed (MT)** | **10,20,000** | **8,00,000** |
| | **Sugar production (MT)** | **1,22,500** | **79,300** |

**[8]**

**(c) "Finance costs are those costs which are incurred by an enterprise in connection with the borrowing of funds" — State the principles of measurement of finance costs. [5]**

**(d) Whether the Annexure to the Compliance Report is to be prepared by the company or by the Cost Accountant? [2]**

**Answer:**

**(a)** (i) Legal provisions

- Section 209(1)(d) of the Companies Act, 1956 empowers the Central Government to make it compulsory in case of specified classes of companies to maintain cost records.
- The Central Government may order Audit of cost records maintained under section 209(1)(d) according to provisions of section 233B of the Companies Act, 1956.
- Section 227(3) of the Companies Act, 1956 includes cost records in the term of proper books of account on which the auditor has to express opinion on.

(ii) In the given situation, section 209(1)(d) is applicable to the company though section 233B is not applicable. The Auditor should not accept the management's contention since he would not be discharging his duty under section 227(3) if he accepts it.

**(b)**

| Chemical Plant: | Actual | Budget | Actual as % of Budget |
|---|---|---|---|
| Production (in thousand KL) | 1,350 | 1,800 | 75 |
| Occupancy hours | 6,000 | 7,200 | 83.33 |
| Production per hour (KL) | 225 | 250 | 90 |

**Comments:**

Actual Production is only 75% of the Budget. The lower production is due to —

(i) Lower efficiency (90% of efficiency achieved) and

(ii) Reduction in occupancy hours by 16.67% (i.e., 100 - 83.33).

| Sugar Mill : | 2013-14 | 2012-13 |
|---|---|---|
| Installed Capacity (TCD) | 5,000 | 4,000 |
| Duration of the season (days) | 240 | 250 |
| Cane crushed per day (MT) [10,20,000 / 240, 8,00,000 / 250] | 4,250 | 3,200 |
| As percentage of Installed capacity [4,250 / 5,000 × 100, 3,200 / 4,000 × 100] | 85 | 80 |
| Sugar Recovery Percentage [1,22,500 /10,20,000 × 100, 79,300 / 8,00,000 × 100] | 12% | 9.9125% |

**Comments:**

(i) There is a drop in duration of season from 250 to 240 days i.e., 4% drop as compared to 2012-13.

(ii) Though there is a drop in duration of season by 4% the Production has gone up due to increase in installed capacity.

(iii) Efficiency has gone up from 80% to 85%.

(iv) Sugar recovery percentage is much better and it may be due to better quality sugar cane.

**(c) Principles of Measurement of Finance Costs:**

1. Finance costs incurred in connection with acquisition of resources such as materials, utilities and the like will not form part of the cost of such resources.

2. Bank charges for negotiation of documents in connection with a purchase material or resources are generally treated as finance costs and should not be included in material cost or other resources. This is based on the premise that sale documents are negotiated through bank to avoid credit risks or to avail bank finance. Hence Bank charges on bills negotiated through bank on collection or acceptance basis are often added to material cost or other resources but are best excluded from material cost or other resources.
3. Interest when charged by the supplier for the whole of part of the credit period extended is treated as a finance charge. This is so even if the interest appears on the face of the invoice.
4. In case of leased assets, if it is an operating lease – the entire rentals will be treated as a part of administrative overheads, while in case of a financial lease – the finance cost portion will be segregated and treated as a part of finance costs.
5. Material is often held for long periods for seasoning, maturing etc. The storage and interest cost for such storage should be treated as part of material cost.

**(d)** The Company is responsible for maintenance of Cost Accounting Records. Hence the preparation of the Annexure is the responsibility of the Company.

The "Cost Accountant" authenticating the Compliance Report is required to certify and state whether the same has been maintained in accordance with the Rules.

**Question 4.**

**(a) There are various types of Cost Audit available. Describe those types of Cost Audit on the basis of persons who direct it and on the basis of persons who conduct it. [6]**

**(b) The Cost Account of a company has arrived at a profit of ₹ 73,24,150 based on cost accounting records for the Year ended 31.03.2014. As Cost Auditor, you find the following differences between the Financial Accounts and Cost Accounts (figures are in ₹)**

| Particulars | ₹ |
|---|---|
| (i) Profit on sale of fixed assets | 63,000 |
| (ii) Loss on sale of investments | 11,200 |
| (iii) Voluntary retirement compensation included in salaries & wages in Financial Accounts | 16,75,000 |
| (iv) Donation paid | 25,000 |
| (v) Profit from retail trading activity | 7,12,300 |

**You are required to calculate the profit as per financial books after reconcile between the profit figures as per Cost Accounts and Financial Accounts. [5]**

**(c) "The Council of the Institute of Cost Accountants of India has constituted Cost Accounting Standards Board (CASB)." — State the Objectives and Functions of the Cost Accounting Standards Board in this regard. [5]**

**(d) Define Service Cost Centre according to CAS-13. [2]**

**Answer:**

**(a)** Types of Cost Audit:

**1.** On the basis of persons who direct the audit to be performed —

**(i) Statutory Cost Audit:** Sec. 233B of the Companies Act, 1956 stipulates Cost Audit for certain types of Companies / Industries. However, it is not a regular or recurring feature on an annual basis. The Government orders the conduct of Cost Audit, from time to time, whenever it feels that such type of audit is necessary for a particular industry.

**(ii) Cost Audit on behalf of the Management:** The objectives of such audit include verifying – (I) accuracy of costing data, (II) accounting for abnormal losses and gains, (III) computation of cost of production, (IV) proper overhead rates, (V) quality of cost accounting system, etc. Thus, this audit seeks to ensure that the cost data placed before the management are reliable and useful for decision-making.

**(iii) Cost Audit on behalf of a Customer:** In case of cost plus contracts, often the buyer or the Contractee insists on a cost audit to satisfy about the correct ascertainment of cost. Sometimes, such audit is contained in the agreement between the parties that the supplier or the contractor will extend all co-operations to the Cost Auditor. The cost of production arrived at for this purpose may differ from the cost of production ascertained for internal control purposes.

**(iv) Cost Audit on behalf of Government:** The Government may order that a Cost Audit may be conducted in the following situations -

- When it is approached with requests for subsidies, protection, etc.- to satisfy itself whether the need is genuine or made up , whether the industry seeking assistance is efficiently run, etc.
- In public interest - to establish the fair price of any product.

**(v) Cost Audit by Trade Association:** The Trade Association may seek full information on the costing system, level of efficiency, utilisation of capacity, etc. It may also require a cost audit when -

- Its activities include maintenance of price of the products manufactured by its member units, or
- Where there is a pooling or contribution arrangement by all members of the association.

**2.** On the basis of persons who conduct the audit —

**(i) Internal Cost Audit —**

- It is conducted by persons who are in the regular employment of the Company.
- It is oriented towards the objectives of the Management, primarily for system compliance and decision making purposes.
- It may be conducted as part of the system of Internal Control and Internal Check.

**(ii) External Cost Audit —**

- It is conducted by parties outside the Firm i.e. those who are not Company's employees.
- It is oriented towards the objectives of the persons who direct the audit to be performed, e.g. Government, Trade Association etc.
- It is not part of the regular organisational procedure.

**(b)**

**Reconciliation of profit between Cost Accounts & Financial Accounts for year ended 31.03.2014.**

| | ₹ | ₹ |
|---|---|---|
| Profit as per Cost Accounts | | 73,24,150 |
| **Add:** Profit on sales of assets not included in Cost Accounts | 63,000 | |
| Profit from trading activity | 7,12,300 | 7,75,300 |
| | | 80,99,450 |
| **Less:** Loss on sale on investments | 11,200 | |
| Voluntary retirement compensation not included in cost | 16,75,000 | |
| Donation paid | 25,000 | 17,11,200 |
| **Profit as per Financial Accounts** | | **63,88,250** |

**(c) Objectives and Functions of the Cost Accounting Standards Board (CASB):**

**Objectives** — the objectives of the CASB are to develop high quality Cost Accounting Standards to enable the management to take informed decisions and to enable regulators to function more effectively by integrating, harmonizing and standardizing cost accounting principles and practices.

**Functions** — the following will be the functions of the CASB:-

a. To issue the framework for the cost accounting standards;

b. To equip the cost & management accounting professionals with better guide lines on cost accounting principles;

c. To assists the members in preparation of uniform cost statements under various statutes;

d. To provide from time to time interpretations on Cost Accounting standards;

e. To issue application guidance relating to particular standard;

f. To propagate the cost accounting standards and to persuade the users to adopt them in the preparation and presentation of general purpose cost statement;

g. To persuade the government and appropriate authorities to enforce cost accounting standards, to facilitate the adoption thereof, by industry and corporate entities in order to achieve the desired objectives of standardization of cost accounting practices;

h. To educate the users about the utility and the need for compliance of cost accounting standards.

**(d)** The cost centre which provides services to Production, Operation or other Service Cost Centre but not directly engaged in manufacturing process or operation is a service cost centre. A service cost centre renders services to other cost centres / other units and in some cases to outside parties.

Examples of service cost centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, welfare services, safety, transport, component, tool stores, pollution control, computer cell, dispensary, school, township, Security etc.

Administrative Overheads include cost of administrative Service Cost Centre.

**SECTION II (50 Marks)**
**(Operational Audit)**

**Answer Question No. 5 (carrying 14 marks) which is compulsory and Answer any two (carrying 18 marks each) from the rest in this Section.**

**Question 5.**

**(a) State with reasons whether the following statements are "True" or "False". [6×1]**

- **(i)** **Compliance control is one of the major parts of internal control.**
- **(ii)** **Due Diligence Audit has been defined as an inspection, survey and analysis of energy flows in a building, process or system with the objective of instituting energy efficiency programs in an establishment.**
- **(iii)** **Management Audit Report is to be submitted to the Cost Audit Branch.**
- **(iv)** **One of the objectives of Environmental Audit is to make a social cost-benefit analysis.**
- **(v)** **The Audit Committee should meet at least twice in a year.**
- **(vi)** **Management Audit Programme is an essential prerequisite to conducting the Management Audit.**

**(b) Fill up the blanks: [8×1]**

- **(i)** **__________________ Audit concentrates on seeking out aspects of operations in which waste, inefficiency and excessive costs would be subject to reduction by the introduction of improvement of operating controls.**
- **(ii)** **Valuation Audit u/s 14A of Central Excise Act can be ordered only with prior approval of _____________ of Central Excise.**
- **(iii)** **The audit which ensures that adequate internal controls within banking organizations are supplemented by an effective internal audit function, which independently evaluates the control systems within the organization, is called _________________ Audit.**
- **(iv)** **Dumping is an ___________ trade practice.**
- **(v)** **The Director-General, head of the Secretariat of the WTO shall be appointed by the ________________.**
- **(vi)** **The concept of Management Audit was developed by ______________.**
- **(vii)** **_________________ integrates all facets of the business, including planning, purchasing, manufacturing, sales and marketing etc., which are sometimes located at different geographic locations.**
- **(viii)** **The qualifications of a Statutory Auditor are prescribed under the provisions of section ____________ of the Companies Act, 1956.**

**Answer to Question 5(a):**

- **(i)** True: Compliance control is one of the major parts of internal control.
- **(ii)** False: Energy Audit has been defined as an inspection, survey and analysis of energy

flows in a building, process or system with the objective of instituting energy efficiency programs in an establishment.

**(iii)** False: Management Audit Report is to be submitted to the Management of the concern.

**(iv)** True: One of the objectives of Environmental Audit is to make a social cost-benefit analysis.

**(v)** False: The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings.

**(vi)** True: Management Audit Programme is an essential prerequisite to conducting the Management Audit. It is a plan of action drawn in advance of taking up the audit, and to help the auditor to cover the entire area of his function thoroughly.

**Answer to Question 5(b):**

**(i)** Operational
**(ii)** Chief Commissioner
**(iii)** Concurrent
**(iv)** unfair
**(v)** Ministerial Conference
**(vi)** T. G. Rose
**(vii)** Enterprise Resource Planning
**(viii)** 226

**Question 6.**

**(a) You are the Internal Auditor of Arena Manufacturing Ltd. The Managing Director has asked you to enquire into the cause of abnormal wastage of raw materials during the month of April. The wastage percentages for the last few months are: Jan. — 1.3%, Feb. — 1.1%, Mar. — 1.3% and Apr. — 3.9%. How will you proceed to carry out the assignment? [6]**

**(b) Distinguish between Management Audit and Internal Audit. [6]**

**(c) From the following figures extracted from the accounting records, you are required to compute:**
**(i) Value Added;**
**(ii) Operating Profit;**
**(iii) Ratio of Operating Profit to Net Sales; and**
**(iv) Ratio of Operating Profit to Value Added.**

| | ₹ lakhs |
|---|---:|
| Net sales excluding excise duty | 20,980 |
| Increase in stock of finished goods | 241 |
| Expenses : | |
| Raw materials consumed | 2,686 |
| Packing materials consumed | 1,196 |
| Stores and spares consumed | 560 |
| Power and fuel | 4,640 |
| Repairs and maintenance | 199 |
| Insurance | 117 |
| Direct salaries and wages | 480 |
| Depreciation | 880 |
| Interest paid | 1,390 |
| Factory overheads : | |

| | |
|---|---|
| **Salaries and wages** | **240** |
| **Others** | **220** |
| **Selling and distribution overheads :** | |
| **Salaries and wages** | **120** |
| **Additional sales tax** | **457** |
| **Others** | **1,673** |
| **Administration overheads:** | |
| **Salaries & Wages** | **120** |
| **Others** | **82** |

**[2+2+1+1]**

**Answer:**

**(a) Abnormal Wastage:** The rate of wastage in the month of April is about 3 times than that of the previous months. Hence, it may be considered as abnormal. In respect of audit of abnormal wastage, the Auditor should proceed on the following lines —

1. **General:**
   (i) Procure a list of Raw Materials, showing the names and detailed characteristics of each Raw Material.
   (ii) Enquire whether there is any change which will affect material wastage, e.g. changes in - (I) source of supply of raw materials, (II) methods or process, (III) operating condition of machines, (IV) labour force i.e. replacement of experienced employees by raw hands etc.
   (iii) Enquire whether any new production line was taken up during the month in respect of which standard Input-Output Ratio is yet to be set up.

2. **Wastage Figures:**
   (i) Obtain the standard consumption figures, and ascertain the basis of computation of normal wastage figures.
   (ii) Examine whether the basis adopted for wastage calculation for the month of April is the same as that adopted for the other three months.
   (iii) See the breakup of normal wastage - (I) transit, (II) storage, (III) handling, and (IV) processing.
   (iv) Obtain a statement showing break up of wastage figures, (as above) for the four months under review and compare the results of the analysis for each of the four months.

3. **Consumption Records:** Examine the following to find out material variances / deviations if any -
   (i) Purchase of various lots,
   (ii) Identification of each lot with actual material consumption, and
   (iii) Ascertaining actual wastage figures.

4. **Abnormal Process Loss:**
   (i) Material Quality: Examine inspection and testing reports to find out if raw material purchased are of poor quality or sub-standard. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.
   (ii) Machine Utilisation: Machine breakdown, power failure, etc. may also result in loss of materials in process. Check Machine Utilisation Statements.
   (iii) Inspection: A high rate of rejection in the finished lots may also be responsible for abnormal wastage. Examine the Inspection Reports for the inspection carried out on

the completion of each stage of work or process.
(iv) Old Lot Consumption: It is possible that the wastage may have occurred because, the particular lot out of which issues were made in April was lying in the store for a long time, leading to deterioration in quality, or because of a change in weather, which may have led to the deterioration.
(v) Previous period comparison: Compare the wastage figures of April this year with that of April last year and see whether there is any correlation.

5. **Abnormal Storage and Handling Loss:** This can happen due to —
   (i) Write-offs on account of reconciliation of physical and book-stocks. In case of periodical physical stock-taking, such write offs will be reflected only in the month in which reconciliation takes place.
   (ii) Accidental, theft or fire losses in storage. The Auditor should examine such possibilities also.

**(b) Distinction between Management Audit and Internal Audit:**

| Particulars | Management Audit | Internal Audit |
|---|---|---|
| 1. Definition | Management Audit is the systematic independent appraisal activity within an organisation for a review of the Management's efficiency in its decision-making function. | Function of internal control with the objective of determining whether other internal controls are well designed and properly operated. |
| 2. Relationship to Internal Control | It is not a part of Internal Control. It is over and above the regular internal control system. | This operates as a part of Internal Control System. |
| 3. Objectives | It is concerned with appraising —<br>• Management's accomplishment of organizational objectives,<br>• Management functions of planning, organizing, directing, and controlling, and<br>• Adequacy of Management's decisions and action in moving towards its objectives. | • To determine whether internal controls are well designed and properly operated, and<br>• To assist all members of Management in the objective of discharging of their responsibilities by reviewing activities and procedures. |
| 4. Function | Constructive Function, i.e. to provide suggestions for improvement. | Protective Function, i.e. to safeguard the assets of the Enterprise. |
| 5. Areas | All aspects of managerial decision-making 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. |
| 6. Aspect | Qualitative aspects of decision-making are analysed. | Internal Audit Function focuses more on quantitative aspects when compared to Management Audit. |

**(c)**

| | | **₹ lakhs** |
|---|---|---|
| **Computation of Value Added:** | | |
| Net sales + increase in stock of finished goods | | 21,221 |
| Less: Cost of bought out goods & services: | 2,686 | |
| Raw materials | 1,196 | |
| Packing materials | 560 | |

| | | |
|---|---|---|
| Stores and spares | 4,640 | |
| Power and fuel | 199 | |
| Repair and maintenance | 117 | |
| Insurance | 220 | |
| Other factory overheads | 1,673 | |
| Other selling and distribution overheads | 82 | |
| Other administration overheads | | 11,373 |
| | | 9,848 |
| **Composition of Value Added:** | | |
| Depreciation | | 880 |
| Interest | | 1,390 |
| Additional sales tax | | 457 |
| Salaries & wages | | 960 |
| Profit before tax | | 6,161 |
| Total | | 9,848 |
| **Operating Profit:** | | |
| Profit before tax | | 6,161 |
| Depreciation | | 880 |
| Interest | | 1,390 |
| Operating profit | | 8,431 |

Ratio of Operating profit to Net Sales: ₹ 8,431 lakhs/₹ 20,980 lakhs × 100 = 40.19%
Ratio of Operating Profit to Value Added: ₹ 8,431 lakhs/₹ 9848 lakhs × 100 = 85.61%

**Question 7.**

**(a) "Management Audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management." — List out the uses of management Audit in this context. [3]**

**(b) How can an internal control system with regard to sales return and purchase return be designed? [7]**

**(c) State the roles of stakeholders in Corporate Governance. [4]**

**(d) "Environmental Audit is nowadays absolutely necessary for the survival of the industry and the economy to serve the best interest of the society at large." — State the objectives of the Environmental Audit in this regard. [4]**

**Answer:**

**(a) Uses of Management Audit:**

1. Management Audit is useful in synthesizing, accounting, economic and other data required by management in constructing basic policy framework.
2. Management Audit assists in establishing, reviewing and improving the planning system.
3. Management Audit ensures that the management is getting the adequate information for correct decisions.
4. Management Audit aids in the design and maintenance of adequate authority structure.

5. It helps in the improvement information system to expedite flow of information among responsibility centres.
6. It substantially contributes for improvement of entire communication system.

**(b) Internal control systems with regard to sales return and purchase return are as follows:**

- **Sales return —** An internal control/internal check system should provide for authorization of goods returned by customers and the processing of claims. The system should operate at the following points :
  - **(i) Authorising returns** - The authority to grant returns is a matter of management policy. For example, a company may fix limits on authority of officials to accept returns in terms of value of goods returned.
  - **(ii) Receiving and accepting goods**- Receipt of goods returned is handled by the receiving department. It should inspect the goods for their quality and quantity and prepare an inspection report. It also prepares pre-numbered inward return note and sends a copy of it to the clerk maintaining inventory records and another to the person responsible for making and issuing credit notes.
  - **(iii) Authorising credits** - A responsible official of the company may be authorised to issue a pre-numbered credit note to the customer. He should give authorisation on the basis of copy of inward return note and on the basis of inspection report of the receiving department. One copy of credit note should be sent to the clerk maintaining accounts receivable ledger and other to the clerk handling sales return book to enable them to update their records.

- **Purchase returns —** An internal control/check system with regards to purchase returns should operate at following points :
  - **(i) Authorising returns** - The power to authorise purchase returns is, generally, vested with an official of receiving department or purchase department and is a matter of management policy.
  - **(ii) Preparing advice note for returns** - The receiving department which inspects such goods, should prepare an advice note to be sent to the finance department mentioning the details of goods to be returned. Notification copies are also sent to stores and despatch department.
  - **(iii) Preparing outward return notes** - The stores department issues goods to be returned to the despatch department on authorisation of advice note. It should prepare a statement for all such returns. The despatch department prepares prenumbered goods outward return notes for such returns and arranges for their transportation and follow control procedures similar to those in case of sales transactions. It also sends a copy of outward return note to the finance department.
  - **(iv) Preparing debit note and authorising debits** - The accounts department examines the advice note with original invoice and outward return notes. A numerically controlled debit note is prepared and sent to the supplier. One copy of debit note is sent to the clerk maintaining purchase return book and other to the clerk handling accounts payable ledger. After obtaining a credit note to that effect from the supplier, payment to him is adjusted accordingly.

**(c)** The role of stakeholders in Corporate Governance —

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

(i) The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

(ii) Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

(iii) The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.

(iv) Where stakeholders participate in the corporate governance process, they should have access to relevant information.

**(d) The objectives of the Environmental Audit:**

(i) to ensure cost effectiveness compliance with the statutes and company policies
(ii) cost savings from improved practices
(iii) to prepare data-base relating to pollution potential of all facilities
(iv) to make a social cost-benefit analysis
(v) to develop social reputation, confidence of customers
(vi) to develop overall awareness, identifying problems and areas of risk
(vii) to encourage the use of low waste technologies and prudent use of resources and to identify potential hazards and risks.

**Question 8.**

**Write a short note on any three out of the following: [6×3=18]**

**(a) Excise Audit 2000 (EA-2000);**

**(b) Ratios used in measuring productive efficiency of the resources deployed and utilized in the context of Productivity Audit;**

**(c) Corporate Services Audit;**

**(d) Audit checks — Inventory Control Function.**

**Answer:**

**(a)** Excise Audit 2000 (EA 2000) was initiated from 1st December 1999. Excise Audit 2000 is the audit based on the scrutiny of business records of the assessee. This is a more systematic form of audit, wherein the auditors are required to gather basic information about the assessee and analyze them to find out vulnerable areas before conducting the actual audit. The audit is therefore more focused and in-depth as compared to the traditional audit. Further, at every stage of audit, the assessee is consulted. This makes EA 2000 audit user friendly.

The process of EA 2000 begins with identification of an unit to be audited. About 300 to 400 units are selected for conducting audit during a financial year based upon the manpower availability. The units were picked up for audit randomly under the conventional system without any scientific basis of selection. Under EA 2000, the selection of the unit is based on taking into account in the 'risk-factors'. The assesses, who have a bad track record (having past duty evasion cases, major audit objections, past duty dues etc.) are given priority for conducting audit over those having clean track record.

The auditors are required to gather as much information about the assessee as possible. They can gather information from the departmental records, published documents like balance sheets, annual statements etc., and through market Enquirer. Since this can be done without interacting with the assessee, this step is called 'Desk Review'. At this stage of 'Desk Review', the auditors may have already identified certain areas which warrant closer examination from the assessee to complete his preliminary investigation. For this he may write letter to the assessee or send him a questionnaire to obtain this information. This step is called 'gathering and documenting assessee information'. The auditor then visits the unit of the assessee to see the actual running of the unit, the systems that are followed for maintaining records in various sections and the system of movement of goods and the related documents within the unit. This step is called 'touring of the premises'.

The next step is the conduct of actual audit, which in technical parlance is called 'Verification'. The auditors visit the unit of the assessee on a scheduled date (informed to the assessee in advance) and carry out the scrutiny of the records of the assessee as per the audit plan. The auditor is required to compare the documentation of a fact from different documents.

A 'Draft Audit Report' is prepared at the end of the verification stage. The Draft Audit Report is then reviewed by the senior officers to ensure the sustainability of the objections raised by the auditors. The Audit Report becomes final after such review and in cases where the disputed amounts have not already been paid by the assessee at the spot, demand notices are issued by the department for their recoveries.

**(b)** The following ratios are generally used in measuring productive efficiency of the resources deployed and utilized in the context of Productivity Audit:

- **Resources Deployment:**
  - (i) Capital employed per capita
  - (ii) Capital employed per unit of product
  - (iii) Gross profit to capital employed
  - (iv) Net profit to capital employed
  - (v) Debt equity ratio
  - (vi) Net worth and long-term debts to gross fixed assets
  - (vii) Net worth and long-term debts to net fixed assets
  - (viii) Debts to fixed loans
  - (ix) Debts to floating loans
  - (x) Current assets to current liabilities
  - (xi) Net working capital
  - (xii) Total inventory to capital employed.

- **Resource Utilisation:**
  - (i) Capacity utilisation –
    Installed capacity: Utilised capacity of machines (by units)
  - (ii) Capacity utilisation –
    Installed capacity: Utilised capacity of machines (by machine hours)
  - (iii) Machine time available: Machine time utilised
  - (iv) Machine time consumed: Per unit of product (individually)
  - (v) Machine time consumed: Per capita
  - (vi) Gross fixed assets: Turnover
  - (vii) Net fixed assets: Turnover
  - (viii) Inventories: Turnover (inventory turnover)
  - (ix) Raw materials: Turnover (No. of days of stock)
  - (x) Work in process: Turnover (No. of days of stock v. cycle time)
  - (xi) Finished goods: Turnover (No. of days of stock v. lead time)
  - (xii) Labour time consumed: Division-wise
  - (xiii) Labour time consumed: Product-wise
  - (xiv) Labour time consumed: Product group-wise
  - (xv) Turnover per capita
  - (xvi) Value added: per capita
  - (xvii) Indirect labour: Direct labour number

(xviii) Indirect labour costs: Direct labour costs
(xix) Levels of management.

**(c) Corporate Services Audit:** The term "Corporate Services" refers to the activities that combine or consolidate certain enterprise-wide needed support services, provided based on specialized knowledge, best practices, and technology to serve internal (and sometimes external) customers and business partners. These services co-ordinate the diverse organizational units and helps them to focus on organizational goals by effectively exploiting resources and developing core competencies that enable an organization to keep its edge over its industry competitors. It sometimes amounts to combining operations with another competitor in the same industry to increase competitive strengths and lower competition among industry rivals.

Corporate services are the support infrastructure of a company. These include public relations, customer assistance or call centers, training, engineering, human resources and procurement etc. to create new business value and help the company function more effectively by improving internal processes, managing customer relationships and extending the organization. The advantages of corporate services are productivity gains, cost savings and service improvements. The benefits of these services extend to core business areas in form of reduced costs, less inventory, less working capital requirements, improved procurements and higher profits. It also helps in much higher efficiency and productivity of the employees as new technologies can introduce an array of new possibilities with powerful computers and integration of database with web technologies.

The scope of corporate services audit extends to the critical examination of the different aspects of services and their extent that have been satisfactorily rendered by a corporate body, and of evaluation of degrees of responsiveness and awareness on the part of such enterprise. Thus the performance of management towards consumers, employees, shareholders, community, fellow-businessmen and Government is studied separately and properly evaluated by management auditor. The areas of corporate services audit and the scrutiny and evaluation criteria can be categorized as follows:

(i) Consumers Quality goods in right quantities at right prices, place and time.
(ii) Employees Pay, training, safety, welfare, industrial relations, etc.
(iii) Shareholders Safety of investment, satisfactory return, appreciation.
(iv) Community Social cost and social benefit, public relations.
(v) Fellow-businessmen Business ethics and fair trade dealings
(vi) State Compliance with the spirit of laws, fair trade practices, payment of taxes.

The appraisal system of corporate services audit should consider the level of contribution a business entity makes to society and its business environment towards raising the quality of life through better product quality and services rather than profit maximization. The corporate services audit thus attempts to distinguish between the ends (i.e. profits) and means (i.e. services) of business and provides a new dimension to the concept of audit approach. It is the fulfillment of social responsibility of a business unit. Auditor's responsibility lies in evaluating the company's response to social needs.

**(d) Audit checks — Inventory Control Function:**
(i) How are maximum and minimum stock controlled?
(ii) What customer service level is required?
(iii) How are these limits determined?

(iv) Within the permitted overall value coverage of stocks, how are permitted quantities of each stock item determined?
(v) Is the stock of each item definitely related to the production program and the forecasted sales?
(vi) Is stock control also a function of the economic batch quantities?
(vii) How is raw material stock valued for production purposes and for balance sheet purposes?
(viii) How is the issue of stock controlled?
(ix) What are the systems of stock security?
(x) What are the procedures to be followed when stock is found to be defective in store?
(xi) Who has authority to scrap the stock?
(xii) Who has authority to issue stock at other than the normal prices to production or to customers?
(xiii) What control is there on samples?
(xiv) Are all stock movements accounted for by any paper work?
(xv) Is there any security check that goods leaving the premises are covered by one or other of the permitted authorizing documents?
(xvi) What system is in force for counting the stock to reconcile it with the book values, e.g. continuous stock checking?
(xvii) What is the procedure for investigating any discrepancies in stock? Who has authority to consider any investigation closed?
(xviii) In the case of discrepancies caused by system deficiencies, what follow up is there to ensure that the systems re improved?
(xix) What procedure is there for writing down the value of stock, say, for obsolescence?
(xx) If material has been issued to the shop floor as work in progress, what facilities are there in the production control system for establishing the point at which any stock deficiencies occur?
(xxi) What controls are there on the overlooking or work done by operators?