

# Answer to PTP\_Final\_Syllabus 2008\_Jun2015\_Set 1

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## Paper-17 - COST AUDIT & OPERATIONAL AUDIT

Time allowed-3hrs

Full Marks: 100

Working Notes should form part of the answer.

“Wherever necessary, suitable assumptions should be made and indicated in answer by the candidates.”

### 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.

1. a) Choose the most correct answer among four alternative statements : [8×1=8]
- i) Rate per unit for each product separately under annexure 2 of part B of CRA-3 for manufacturing sectors of the Companies (Cost Records and Audit) Rules, 2014 to be furnished for :
    - A) Last year only.
    - B) Current year and previous 2 years.
    - C) Current year and previous year.
    - D) Previous three years.
  - ii) Form CRA-2 of the Cost Records and Audit Rules, 2014 deals with:
    - A) Form of intimation of appointment of Operational auditor by the board to the stakeholder.
    - B) Form of intimation of appointment of internal auditor by the board to the stakeholder.
    - C) Form of intimation of appointment of cost auditor by the company to Central Government.
    - D) Form of intimation of appointment of Branch auditor by the board to the stakeholder.
  - iii) Annexure 5 of Part D of the Companies (Cost Records and Audit) Rules, 2014 deals with
    - A) Value Addition and Distribution of Earning for the company as a whole
    - B) Profit Reconciliation for the company as a whole
    - C) Related Party transactions for the Company as a whole
    - D) Reconciliation of Indirect taxes for the Company as a whole
  - iv) CAS -19 deals with
    - A) Packing material cost
    - B) Joint cost
    - C) Pollution control cost
    - D) Direct material cost
  - v) 'Significant influence' means:
    - A) Participation in the financial policy decisions and control but not operating policy decisions and control of an enterprise.
    - B) Participation in the financial or operating policy decisions of an enterprise and

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- control over those policies.
- C) Participation in the financial or operating policy decisions of an enterprise but not control over those policies.
- D) None of the above.
- vi) According to CAS 2 on Capacity Determination, 'Normal Capacity' is :
- A) Practical capacity minus the loss of productive capacity due to external factors.
- B) Difference between installed capacity and the actual capacity utilization.
- C) Maximum productive capacity of a plant.
- D) Installed capacity minus the inevitable interruptions.
- vii) The Cost auditor of the company shall continue in office, for the financial year for which he has been appointed, in such capacity till the expiry of:
- A) 135 days from the close of the financial year.
- B) Till he submits the cost audit report.
- C) 180 days from the close of the financial year.
- D) 180 days from the closure of the financial year or till he submits the cost audit report.
- viii) Excisable clearance means:
- A) Only sale of goods from factory
- B) Removal from godown
- C) Despatches from bonded warehouse
- D) Total clearance from factory.
- b) State whether following statements are "True" or "False". Reasons or justification is needed for the answer. [6×1=6]
- i) Abridged Cost Statement (for each service separately) is being dealt in annexure 2 of part B of CRA-3 to Cost Audit Report under the Companies (Cost Records and Audit) Rules, 2014.
- ii) Market research cost is not a part of Research and Development Cost.
- iii) XBRL (Extensible Business Reporting Language) is a language based on XML family of languages.
- iv) Under Part-D of the Annexure to Cost Audit Report the Cost Auditor gives Profit Reconciliation for the company as a whole of only 2 years.
- v) M/s. JTS Company situated in Jamshedpur has been planning to file a single form CRA-2 by appointing BMS & Associates a Cost Audit firm for all the three different types of products covered under Cost Audit.
- vi) UK is the first country in the world in introducing the provisions of compulsory maintenance of Cost Accounting Records.

**Answer:**

- a) i) (C)  
ii) (C)  
iii) (C)  
iv) (B)  
v) (C)  
vi) (A)  
vii) (D)  
viii) (D)

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b)

i) <b>FALSE</b>	Abridged Cost Statement (for each service separately) is being dealt in annexure 2 of part C of CRA-3 to Cost Audit Report under the Companies (Cost Records and Audit) Rules, 2014.
ii) <b>True</b>	Market Research is part of Selling and Distribution Cost.
iii) <b>False</b>	XBRL (Extensible Business Reporting Language) is a language based on XML (Extensible Markup Language) family of Languages.
iv) <b>True</b>	Under Part-D of the Annexure to Cost Audit Report the Cost Auditor gives Profit Reconciliation for the company as a whole for current and previous years.
v) <b>True</b>	A single Form CRA-2 is required to be filed providing details of the sectors/ industries covered under cost audit and details of cost auditor.
vi) <b>False</b>	India is the first country in the world in introducing the provisions of compulsory maintenance of Cost Accounting Records.

2.

a) The Tables listing the industry/sector/product/service in the Rules have described the same by way of description as well as CETA Heading, wherever applicable. For certain sectors, the coverage under the CETA Heading are apparently not in line with the description of the sector. How to determine the coverage in such cases? [6]

b) The following details of the process wise, Input-Output and Direct Employees Costs are taken from the SUSITRA INDUSTRIES LTD., a manufacturing company, for the year ended March 31,2012:

Process	Input (Tonne)	Output (Tonne)	Direct Employee Costs (₹)
I	48,000	43,200	1,29,600
II	50,000	44,000	1,76,000
III	72,000	66,240	3,31,200
IV	60,000	55,500	4,44,000
V	80,000	73,400	6,60,600

Required:

Calculate "the Direct Employees Cost per Tonne of the product as per CAS 7. [6]

c) How would you treat the following as per CAS-15 related to selling and distribution overheads?

- i) Leased Assets;
- ii) Cost of Administrative Services procured from outside;
- iii) Cost of Software

[2×3=6]

**Answer:**

a) The description and the CETA Heading have to be read harmoniously and construed to be supplementing each other. The CETA Heading has been provided in the amended Rules in addition to what was provided in the original Rules issued in June 2014. The CETA Codes are inclusive and all products covered under the codes are covered irrespective

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of the description.

For example, in case of Petroleum Industry, the description states "Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board under the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006)" and the CETA Headings are 2709 to 2715. Hence, all products covered under CETA Headings 2709 to 2715 are included as well as activities like storage, transportation, distribution of Crude Oil or Gas etc. and any other activity that is defined under the Petroleum and Natural Gas Regulatory Board Act, 2006 and regulated by the PNGRB are covered.

Similarly, Rubber and allied products would include all rubber products as specified under CETA Codes 4001 to 4017 and will not be restricted only to such rubber products regulated by the Rubber Board.

Companies engaged in manufacturing Machinery and mechanical appliances falling under CETA Codes 8401 to 8402; 8801 to 8805; 8901 to 8908 are similarly covered irrespective of its ultimate customer/consumer, subject to the company meeting the threshold limits prescribed and it is not necessary that the products have to be exclusively used in defence, space and atomic energy sectors.

b)

### SUSITRA INDUSTRIES LTD

The total Direct Employees Cost per Tonne of the product must be an aggregation of process wise Direct Employee Cost after taking into account the good units occurring in each process.

Process	Input (T)	Output (T)	Factor
I	48,000	43,200	$48,000/43,200 = 1.1111$
II	50,000	44,000	$50,000/44,000 = 1.1364$
III	72,000	66,240	$72,000/66,240 = 1.0870$
IV	60,000	55,500	$60,000/55,500 = 1.0811$
V	80,000	73,400	$80,000/73,400 = 1.0900$

**Process wise Direct Employees Cost per Tonne of the output are:**

Process	₹
I	$1,29,600 \div 43,200 = 3$
II	$1,76,000 \div 44,000 = 4$
III	$3,31,200 \div 66,240 = 5$
IV	$4,44,000 \div 55,500 = 8$
V	$6,60,600 \div 73,400 = 9$

**Aggregating all the above to the Finished Product from Process V:**

Process I	= ₹ 3.00
Process II	= ₹ 3 x 1.1364 + 4 = ₹ 7.4092
Process III	= (₹ 7.4092 x 1.0870) + ₹ 5 = ₹ 13.0538
Process IV	= (₹ 13.0538 x 1.0811) + ₹ 8 = ₹ 22.1125
Process V	= (₹ 22.1125 x 1.09) + ₹ 9 = ₹ <b>33.1026 per Tonne of Finished Product</b>

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- c)
- i) In case of Leased Assets, if the Lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.
  - ii) Cost of administrative services procure from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.
  - iii) The Cost of Software (developed in house, purchased, licensed or customized) including up gradation Cost shall be amortized over its estimated useful life.

3.

- a) The management of Up and Down Ltd. is worried about their increasing labour turnover in the factory and before analyzing the causes and taking remedial steps, they want to have an idea of the profit foregone as a result of labour turnover in the last year. Last year sales amounted to ₹83,03,300 and the P/V Ratio was 20%. The total number of actual hours worked by the direct labour force was 4.45 lakhs. As a result of the delays by the personnel department in filling vacancies due to labour turnover, 1,00,000 potentially productive hours were lost. The actual direct labour hours included 30,000 hours attributable to training new recruits, out of which half of the hours were unproductive.

An analysis of costs incurred consequent on labour turnover revealed the following:

Settlement cost due to leaving	₹43,820
Recruitment Costs	₹26,740
Selection Costs	₹12,750
Training Costs	₹30,490

Assuming that the potential lost as a consequence of labour turnover could have been sold at prevailing prices, find out the profit foregone last year on account of labour turnover. [6]

- b) The Trial Balance of IGP Ltd as on 31.3.2014 are as follows;

Particulars	Amount (₹) Dr.	Amount(₹) Cr.
Materials consumed	25,00,000	
Salaries	15,00,000	
Employee Training Cost	2,00,000	
Special Subsidy received from Government towards Employee salary		2,75,000
Perquisites to Employees	4,50,000	
Contribution to Gratuity Fund	4,00,000	
Recoverable amount from Employee out of perquisites extended		35,000

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Lease rent for accommodation provided to employees	3,00,000	
Festival Bonus	50,000	
Unamortised amount of Employee cost related to a discontinued operation	90,000	

Calculate the employee cost according to CAS 7. [6]

- c) Boruah Electronics Ltd. is engaged in the manufacture of colour television sets having its factories at Kolkata and Gujarat. At Kolkata the company manufactures picture tubes which are stock transferred to Gujarat factory where it is consumed to produce television sets. Determine the Excise duty liability of captively consumed picture tubes from the following information: - Direct Material Cost (per unit) ₹ 800; Direct Labour ₹ 100; Indirect Labour ₹ 50; Direct Expenses ₹ 100; Indirect Expenses ₹ 50; Administrative Overheads ₹ 50; Selling and Distribution Overheads ₹ 100.

Additional Information: -

(1) Profit Margin as per the Annual Report of the company for 2013-14 was 12% before Income Tax.

(2) Material Cost includes Excise Duty paid ₹ 73.

(3) Excise Duty Rate applicable is 12%, plus education cess of 2% and SHEC @ 1%. [6]

Answer:

a)

Statement of profit foregone due to Labour Turnover (₹)

Contribution foregone	3,86,200
Settlement cost due to leaving	43,820
Recruitment cost	26,740
Selection Costs	12,750
Training Costs	30,490
<b>Total cost of labour turnover</b>	<b>5,00,000</b>

Working Note:

<b>Computation of productive hours</b>	<b>(Hours)</b>
Actual hours worked	4,45,000
Less: Unproductive hours (for training)	15,000
<b>Productive hours worked</b>	<b>4,30,000</b>

Sales per productive hours = ₹83,03,300/4,30,000 hrs.  
= ₹19.31

Sales foregone due to potential productive hours lost = 1,00,000 hours x ₹19.31  
= ₹19,31,000

Contribution foregone on sales lost = Sales foregone x P/V Ratio  
= ₹19,31,000 x 20/100  
= ₹3,86,200.

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**b) Computation of Employee Cost**

	Particulars	Amount (₹)
	Salaries	15,00,000
<b>Add</b>	Net Cost of Perquisites to Employees = Cost of Perquisites (-) Amount recoverable from employee = 4,50,000 (-) 35,000	4,15,000
<b>Add</b>	Lease rent paid for accommodation provided to employee	3,00,000
<b>Add</b>	Festival Bonus	50,000
<b>Add</b>	Contribution to Gratuity Fund	4,00,000
<b>Less</b>	Special subsidy received from Government towards employee salary	(2,75,000)
	<b>Employee Cost</b>	<b>23,90,000</b>

**Note:**

- i) Recoverable amount from employee is excluded from the cost of perquisites.
  - ii) Employee training cost is not an employee cost. It is to be treated as an Overhead, hence, not included.
  - iii) Special subsidy received is to be excluded, as it reduces the cost of the employer.
  - iv) Unamortized amount of employee cost related to a discontinued operation is not an includible item of cost.
- c) Cost of production is required to be computed as per CAS-4. Material cost is required to be exclusive of CENVAT credit available.**

Computation of Cost of Production (as per CAS-4)

Particulars	Amount (₹)
Material Consumed (Net of Excise duty) (800 – 73)	727
Direct Wages and Salaries	100
Direct Expenses	100
Works Overheads	100
Quality Control Cost	--
Research and Development Cost	--

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Administrative Overheads ( relating to production capacity)	50
Less: Sale of Scrap	--
Cost of Production	1,077
Add: 10% Profit margin on cost of production (i.e. 33,946 x 10%)	108
Assessable Value as per Rule 8 of the valuation rules	1,185

**Note -**

- (1) Indirect labour and indirect expenses have been included in Works Overhead
- (2) In absence of any information, it is presumed that administrative overheads pertain to production activity.
- (3) Actual profit margin earned is not relevant for excise valuation.

4.

a) The following is the abridged Balance Sheet of BRL Batteries Ltd:

	₹ in lacs	
	31.3.2014	31.3.2013
<b>Liabilities:</b>		
Share Capital	450	450
Debenture Redemption Reserve	25	30
Capital subsidy from State Government	30	30
Revaluation Reserve	125	140
General Reserve	160	120
Balance in Profit and Loss A/c	48	32
Secured Loans	275	295
Unsecured Loans	123	117
	1236	1214
<b>Assets:</b>		
Gross Block	725	680
Accumulated Depreciation	(315)	(290)
Capital WIP	43	37
Investments	165	165
<b>Current Assets:</b>		
Inventories	417	441
Sundry Debtors	182	195
Advances for Capital Equipment	24	17
Other Loans & Advances	144	137
Cash and Bank Balances	21	19
<b>Current Liabilities:</b>		
Sundry Creditors		
For Capital Expenses	(17)	(21)
For others	(185)	(197)
Provision for Taxes	(64)	(71)
Misc. Expenses	96	102
<b>Total</b>	1236	1214



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**Notes:**

- (i) Fixed Assets include Goodwill and Patents ₹122 lacs (Previous year ₹137 lacs)
- (ii) Term loans due for repayment within 12 months are ₹96 lacs (Previous year ₹ 84 lacs)

**Calculate & analyse the following for the company as a whole:**

- (i) Capital Employed for the year ended 31.3.14
- (ii) Net worth as on 31.3.12 and 31.3.14
- (iii) Debt/ Equity Ratio as on 31.3.2014. [5+4+3=12]

- b) What are the penal provisions for non-compliance of any of the provisions of the Act regarding Cost Audit? [6]

**Answer:**

a)

<b>Capital Employed:</b>	<b>(₹ in lakhs)</b>	
	<b>31.3.14</b>	<b>31.3.13</b>
Gross Block	725	680
Less: Depreciation	<u>315</u>	<u>290</u>
Net Block	410	390
Less: Goodwill & Patents	<u>122</u>	<u>137</u>
Net Fixed Assets	<u>288</u>	<u>253</u>
Current Assets:		
Inventories	417	441
Sundry Debtors	182	195
Advance for Capital Equipment	24	17
Other Loans & Advances	144	137
Cash and Bank Balances	<u>21</u>	<u>19</u>
(A)	<u>788</u>	<u>809</u>
Current Liabilities		
Term loan due for repayment within 12 months	96	84
Sundry Creditors		
For Capital	17	21
For others	185	197
Provision for Taxes	<u>64</u>	<u>71</u>
(B)	<u>362</u>	<u>373</u>
Working capital (A - B)	426	436
Capital Employed (Net Fixed Assets + Working Capital)	714	689

Capital Employed = (714 + 689)/2 = 701.50 lacs.

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**(ii) Net worth:**

	<b>₹ in lacs</b>	<b>₹ in lacs</b>
	<b>31.3.14</b>	<b>31.3.13</b>
Share Capital	450	450
General Reserve (including Debenture Redemption Reserve)	185	150
Capital subsidy from State Government	30	30
Balance in P&L A/c	<u>48</u>	<u>32</u>
	713	662
Less: Intangible Assets	122	137
Less: Capital WIP	43	37
Less: Misc. Expenditure	<u>96</u>	<u>102</u>
Net worth	<u>452</u>	<u>386</u>

**(iii) Debt- Equity Ratio:**

	<b>31.3.14</b>	<b>31.3.13</b>
<u>Debt</u>		
Debt (Secured & Unsecured Loans)	398	412
Less: Due in 12 months	<u>96</u>	<u>84</u>
Long term debt	<u>302</u>	<u>328</u>
 <u>Equity</u>		
Share Capital	450	450
General reserve	160	120
Debenture Redemption Reserve	25	30
Balance in Profit and Loss A/c	48	32
Capital subsidy from State Government	30	30
Less: Misc. Expenses	<u>(96)</u>	<u>(102)</u>
	<u>617</u>	<u>560</u>
 <b>Debt Equity Ratio</b>	 <b>0.49:1</b>	 <b>0.59:1</b>

Note:

- (i) There is no existing liability towards Debenture-holder of the Company. So, balance in Debenture Redemption Reserve Account is treated as part of Reserve & Surplus.
- (ii) As per Accounting Standard 12 "Accounting for Government Grants" under Capital approach – Grant is treated as part of Shareholder's Funds. So, Capital subsidy is taken for the calculation of Capital Employed and for the calculation of Net Worth.

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- b) As per section 148(8) of the Companies Act, 2013, if any default is made in complying with the provisions relating to Cost Audit,—

### **In case non compliance by companies -**

The company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147.

As per section 147(1), if any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.

### **In case non-compliance by companies -**

The cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.

As per section 147(2), if an auditor of a company contravenes any of the provisions of section 139, section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.

Provided that if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

As per section 147(3), where an auditor has been convicted under section 147(2), he shall be liable to—

- (i) refund the remuneration received by him to the company; and
- (ii) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

As per section 147(4), the Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

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## 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.

5.

a) Fill in the blanks in the following sentences by using appropriate word(s)/phrase(s) :

[8×1=8]

- i) The Secretariat of WTO is headed by a \_\_\_\_\_.
- ii) \_\_\_\_\_ is a movement protecting interest of the consumers.
- iii) Section 177 of the Companies Act 2013, provides for Constitution of \_\_\_\_\_.
- iv) SALVAGE is considered as \_\_\_\_\_ by insurer against what is owed under the policy for an insured loss.
- v) Excise Audit-2000 was initiated from \_\_\_\_\_.
- vi) The origin of the term 'Due Diligence' owes to \_\_\_\_\_.
- vii) The main emphasis of Management Audit is problem \_\_\_\_\_ rather than problem \_\_\_\_\_.
- viii) Corporate image and \_\_\_\_\_ are closely related concepts.

b) State whether the following statements are TRUE or FALSE with justification for your answer. No credit will be given for merely answering TRUE or FALSE — without giving any justification/reasoning :

[6×1=6]

- i) There are no fixed items of evidence to be checked by Management Auditor.
- ii) For stock hypothecation to the Bank, Insurance Coverage is required for seventy-five percent of stock as margin money;
- iii) CAS 17 deals with the principles and methods of determining the Research and Development Costs and their classification, measurement and assignment for determination of the cost of product or service and the presentation and disclosure in cost statements.
- iv) According to CAS 19, Joint Costs shall not include imputed costs.
- v) The impact of higher depreciation due to revaluation of assets shall be assigned to cost object.
- vi) Cost incurred after split-off point for further processing of Joint product/By-Product shall be the aggregate of only direct costs.

Answer:

a)

- i) Director – General
- ii) Consumerism
- iii) Audit Committees
- iv) Credit
- v) 1<sup>st</sup> December 1999
- vi) US Securities Act, 1933
- vii) identification, solving
- viii) Brand equity.

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- b)
- i) **True.** A Management Auditor has to rely more on his experience and acumen to identify areas of review.
  - ii) **False.** When stock is hypothecated to Bank Insurance Coverage is required for Full value.
  - iii) **False.** CAS 18 deals with the principles and methods of determining the Research, and Development Costs and their classification, measurement and assignment for determination of the cost of product or service, and the presentation and disclosure in cost statements.
  - iv) **True.** As per CAS 19 imputed costs are not included in Joint Costs.
  - v) **False.** The impact of higher depreciation due to revaluation of assets shall not be assigned to cost object.
  - vi) **False.** Cost incurred after split-off point for further processing of Joint product/By-Product shall be the aggregate of direct and indirect costs.

6.

- a) Explain whether the following amounts to professional misconduct by a Cost Accountant:
- i) **A practicing Cost Accountant uses a visiting card in which he designates himself, besides as Cost Accountant, as Tax Consultant.**
  - ii) **A Cost Accountant takes voluntary retirement from his employer and starts practice. He continues his association with his previous employers as an advisor, on a monthly retainer.**
  - iii) **A Cost Accountant gives a certificate of cost for a product manufactured by an SSI unit owned entirely by his son.** [3+2+3=8]
- b) **You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.** [5]
- c) **XYZ, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.** [5]

Answer:

- a)
- i) Section 7 of the Cost Accountants Act, 1949 read with Clause 7 of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Cost Accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than Cost Accountant for a Cost Accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognized by the Central Government or the Council. Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognized by the Central Government nor it

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- is a recognized professional membership by the Central Government or the Council.
- ii) As the accountant has severed his connection with his previous employer as an employee and acts only in an advisory capacity, which is a legitimate activity of a practicing cost accountant, it does not amount to misconduct.
  - iii) The Second Schedule to the Cost and Works Accountants Act, 1959 stipulates that a Cost Accountant in practice shall be deemed to be guilty of professional misconduct if he expresses his opinion on cost or pricing statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses the interest also in his report. Strictly speaking, a cost accountant issuing a certificate for a unit in which he has no direct interest is in order. However, as in this case the factory is owned by the cost accountant's son it would be prudent on the part of the accountant to desist from issuing such a certificate on moral grounds.
- b)** As per SA 610 (Revised) "Using the Work of Internal Auditor" the statutory auditor has to consider the following:
- i) Organizational status – whether the same is done internally or by an external agency.
  - ii) Scope of work – What is the nature and depth of the coverage of the assignment.
  - iii) Technical competence – Whether the internal auditor is technically competent to do the work i.e. having adequate technical training and proficiency.
  - iv) Due professional care – Whether his work and reports appear to be properly planned, supervised reviewed and documented.
  - v) Audit Evidence - Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
  - vi) Conclusions - Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
  - vii) Response to unusual matters - Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.
- If the above factors are not satisfactory, the statutory auditor will have to modify his audit program and increase the verification to be carried out.
- c) Alternative way to tackle the hostile management:** While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations. These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit. The Participative Approach, in this case, comes to the help of the auditor. In this approach the auditor discusses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the operational audit becomes co-operative enterprise. This participative approach encourages the audited to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When participative

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method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the audited together try to achieve the common goal. The proposed recommendations are discussed with the audited and modifications as may be agreed upon are incorporated in the operational audit report. With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the audited themselves take initiative for implementing and the auditor do not have to force any change on the audited. Hence, Operational Auditor of XYZ manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of XYZ.

7.

a) **Your client, ASHEETA LTD. is contemplating to take over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets. —State (in brief) the major areas you would examine for the above.** [7]

b) **A company manufacturing consumer electronic goods has a fairly Research and Development set up. So far the company has been earmarking 2% of its turnover to R&D budget. Such an approach has so far paid ample dividends to the company. The company has been able to establish a reputation of introducing innovative products, which has excellent customer acceptability.**

**The company, however, is now worried that new players, some of whom are of international repute, entering Indian market, whether their R&D efforts are really giving them value for their money. Since your firm is well known consultancy firm, they have approached you to conduct a management audit of their R&D activities.**

**List out five major questions, which your audit will address.** [5]

c) **The management of a very big public sector Company suspects and the existence of “ghost workers”. You, as an Internal Auditor of the company are required to formulate a system of Internal Control for payment of wages and salaries.** [3]

d) **A company under Cost Audit has three sources of power supply:**

- i) **Electricity Board**
- ii) **Heavy Power Generator**
- iii) **A bank of 100 windmills**

**In the Power Cost Statement the generator power and the windmill power are valued at Electricity Board energy bill rate which consists of maximum demand charges and energy charges.**

**Is this method acceptable for cost statements for Cost Audit.** [3]

**Answer:**

a) **Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review. Normally, cases of hidden liabilities and overvalued assets are not apparent from books**

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of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas:

- Any show cause notice, which have not matured into demands but may be material and important.
- Contingent liabilities not shown in books.
- Letters of comforts given to banks and financial institutions.
- Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same, prior to the date of transfer.
- Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- Tax liability under direct and indirect taxes
- Long pending sales tax assessment.
- Cases of custom duty where only provisional assessment has been made and final assessment is yet to be completed.
- Agreement to buy back shares at a stated price.
- Future lease liabilities.
- Claims against the company including third party claims.
- Unfunded retirement benefit of employees.
- Labour claims under negotiations.

**Regularly Overvalued assets:** The auditor shall have to specifically examine the following areas:

- Uncollectable receivables.
- Obsolete, slow and non-moving inventories and inventories valued above net realizable value, if any.
- Obsolete and unused plant and machinery and their spares. Assets value which have been impaired due to sudden fall in market value.
- Assets shown in books above market value due to capitalization of expenditure / foreign exchange fluctuation or capitalization of revenue expenditure.
- Assets under litigation.
- Investments shown at cost whose market value is much lower.
- Investments carrying very low rate of return.
- In fructuous project expenditure.

**b)** The major five questions, which the management audit should address are :-

**i) Selection process :**

Whether the project selection based on prediction of market needs or responding to the market needs? What are the mechanics of consultation between the market research group and R&D group? Would the success of percentage of projects be better if R&D follows the perception of market research or would the initial advantage of breakthrough in new area give the company a sharp competitive edge?



**ii) Collection of project wise R&D costs :**

Are the costs collected projects wise? Is there an agreed format for collecting such costs? Have the terms used in the format agreed upon by the management? Who would be monitoring costs? Whether R&D would be using the collected information?

**iii) Monitoring of costs :**

How are the R&D budgets prepared? At the time of approval of projects for research, are any efforts made to indicate the value expected to flow from the successful completion of the projects and has attempted to match the expected cost and anticipated benefits?

Is there a regular system of responsibility accounting? Are the accounting criteria like target rate of return, target payback period, target net present value built into the system? Are the criteria understood and accepted by R&D group?

**iv) Parameters for suspending further work:**

Who takes the decision about suspending or scrapping a project initiated? What criteria are to be used to arrive at such decision? If the criteria are already laid down, what is the process of authorizing deviation from such norms?

**v) Customizing the results for production :**

When is the project considered to be successful? How is the successful project customized for production? What are the responsibilities of R&D group in such customization vis-à-vis design and such other production support services?

**c) The term 'ghost employees' means those employees who exist only on papers. In other words they can also be termed as dummy worker who are on payroll.**

The following controls can be implemented for reducing the possibility of ghost employees:

- i) Company can issue identity cards which can be used electronically to mark attendance or it can use finger print reader for the movement of employees. The cards should include all the relevant details of the employees like his name, division, grade, photo, job description etc. Wearing of identity cards should be enforced so that the possibility of fraud is reduced.
- ii) Controls like employee register; wage sheet etc can be used for verifying the signatures placed by the personnel when entering the premises and when leaving the premises.
- iii) Company can also implement a good system of internal check wherein the work of Human Resource department is verified by another department.
- iv) Verification of Bank account details will also serve to establish the identity of the employee and they should be occasionally reviewed by the management, particularly the manner in which transactions are executed will play an important role.
- v) Auditor shall seek corroborative evidences in case of ghost employees. He can occasionally request the management to call employees on sample basis. If there are any ghosts workers the same will be automatically be revealed.

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- d) Electricity Board Power Bill consists of two elements, maximum demand charges and energy charges i.e. Units × Electricity Board per unit rate.  
The maximum demand charges are levied and collected by Electricity Board on the total connected load multiplied by a rate per KVA. Hence, this is a fixed charge. Even if power is not drawn from the Electricity Board, this charge will have to be paid in full.  
Hence units of power generation by generator and windmill will have to be charged to the user departments only at cost of generation. This is because inter-divisional profit on captively consumed services should not be included in cost of products particularly when such costs are used for valuation of inventories of Finished Goods & WIP. Where costs of generation of power are lower than valuation of Electricity Board power rate, a profit will result.

8. Write short notes on any three out of the following: [6×3=18]
- a) The major characteristics of ERP systems necessitating change in Audit Approach.
  - b) Industrial Sickness
  - c) Audit of Work-in-Progress
  - d) Environment Pollution

Answer:

- a) **The major characteristics of ERP systems necessitating change in Audit Approach:**

The major characteristics are as follows:

- i) On-line real time processing
- ii) All transactions are stored in one common database
- iii) System usually resides on multiple computers
- iv) Optimum co ordination is a challenge
- v) Traditional 'batch' controls and audit trails not available
- vi) Data bases can be accessed by any module
- vii) System modules are transparent to the users
- viii) Significant increase in number of users
- ix) Network and data base access security is critical.

The audit of an ERP system requires specific knowledge and an understanding of the integrated complex features required for the successful implementation. The auditors require not only specialized skills but also capability to use unique methodologies to deal with various risks involved. Audit and review guidelines should also be developed providing management oriented frame work and proactive control self assessment.

- b) **Industrial Sickness**

The term industrial sickness is used for those companies which have incurred cash loss for a continuous period of three years. There are many causes due to which company may incur losses. Such causes may be both internal as well as external. Usually sick units have symptoms like low capacity utilization, default in repayment of loans and dues, frequent refinancing activates, financing long term requirements from short time and costly loans. The internal causes for industrial sickness are:

- i) Obsolescence of technology used by the company
- ii) Declining industry margin and demand

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- iii) High cost of inputs and comparatively less increase in price of the finished product
- iv) Improper planning, pricing and product development
- v) Dishonest or incompetent management personnel's

Apart from these there are certain external causes also for industrial sickness:

- i) Incompetent product portfolio
- ii) Lack of basic infrastructure resources like water, power etc.
- iii) Changes in customer taste and preferences
- iv) Changes in government policy.

### c) Audit of Work-in-Progress

In respect of semi-finished goods, the following guidelines will be of help:

- i) Verify that the physical stage of completion as shown in the inventory sheets reflects correct valuation.
- ii) Verify that the costs up to the stage of completion have been properly determined.
- iii) Scrutinize whether overhead allocation to cost centres is properly done and cost absorption has been correctly done.
- iv) The costs should be related to production and credit for scraps, joint products and by-product should be taken care of.
- v) Costs shall include normal loss. Anything abnormal should be excluded.
- vi) When comparing the actual costs with the net realizable value, proper care should be taken to see that all the costs that have not been incurred for the unprocessed part should be deducted from the gross realizable value.

### d) Environmental Pollution:

Pollution caused in air, water, soil, noise etc by some contamination in their nature due to smoke, waste effluents, liquid resins etc. which are not recyclable is termed as environmental pollution. Often industries pollute the environment due to effluents from chemical plants, smoke and gases from industries, noise of running factories, garbage dumps, radioactive waste etc.

Environmental pollution is a major threat faced by all developed and developing countries. Such pollution is caused mainly due to improper disposal of waste. It affects the flora, fauna and also the marine life. The example of pollution caused due to the failure of the cooling plant in Fukushima nuclear plant of Japan may be cited in this case.

As a part of good corporate governance system the corporates are liable not only to share holders but also to the public at large. Due consideration is given to the environment when a large industry is set up. Companies, now a days try to compensate the deforestation caused by them, by planting new trees somewhere else.