Paper 19 - COST AND MANAGEMENT AUDIT

The following table lists the learning objectives and the verbs that appear in the syllabus learning aims and examination questions:

	Learning objectives	Verbs used	Definition
LEVEL B	KNOWLEDGE What you are expected to know	List	Make a list of
		State	Express, fully or clearly, the details/facts
		Define	Give the exact meaning of
	COMPREHENSION What you are expected to understand	Describe	Communicate the key features of
		Distinguish	Highlight the differences between
		Explain	Make clear or intelligible/ state the meaning or purpose of
		Identity	Recognize, establish or select after consideration
		Illustrate	Use an example to describe or explain something
	APPLICATION How you are expected to apply your knowledge	Apply	Put to practical use
		Calculate	Ascertain or reckon mathematically
		Demonstrate	Prove with certainty or exhibit by practical means
		Prepare	Make or get ready for use
		Reconcile	Make or prove consistent/ compatible
		Solve	Find an answer to
		Tabulate	Arrange in a table
	ANALYSIS How you are expected to analyse the detail of what you have learned	Analyse	Examine in detail the structure of
		Categorise	Place into a defined class or division
		Compare and contrast	Show the similarities and/or differences between
		Construct	Build up or compile
		Prioritise	Place in order of priority or sequence for action
		Produce	Create or bring into existence

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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.

1. Answer the four Questions [15×4=60]

(a)(i) What are the benefits of cost information as per the expert committee of India? (6 Marks)

Answer:

The Expert committee formed by the Government of India to study the Cost Audit scenario in the country, highlighted the following benefits of cost information:

(i) Cost Information enables the organization to structure the cost, understand it and use it for communicating with the stakeholders.

(ii) Costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively operational processes transform input into output. It contributes to the data input on economy level parameters like resources efficiency, waste management, resources allocation policies etc.

(iii) Costing includes product, process, and resource-related information covering the functions of the organization and its value chain. Costing information can be used to appraise actual performance in the context of implemented strategies.

(iv) Good practice in costing should support a range of both regular and non-routine decisions when designing products and services to

- meet customer expectations and profitability targets;
- assist in continuous improvements in resources utilisation; and
- guide product mix and investment decisions.

(v) Working from a common data source (or a single set of sources) also helps to ensure that output reports for different audiences are reconcilable with each other.

(vi) Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation.

(a)(ii) What constitutes the Cost Records under Rule 2(e)? (6 Marks)

Answer:

As per Rule 2(e) the Companies (Cost Records and Audit) Rules, 2014, "cost records" means 'books of account relating to utilization of materials, labour and other items of cost as applicable to the production of goods or provision of services as provided in section 148 of the

Act and these Rules'. There cannot be any exhaustive list of cost accounting records. Any transaction - statistical, quantitative or other details - that has a bearing on the cost of the product/activity is important and form part of the cost accounting records.

Cost records are to be kept on regular basis to make it possible to "calculate per unit cost of production/operations, cost of sales and margin for each of its products for every financial year on monthly/quarterly/half-yearly/annual basis". What is required is to maintain such records and details in a structured manner on a regular basis so that accumulation is possible on a periodical basis.

(a)(iii) What is the meaning of "Turnover" in relation to the Companies (Cost Records and Audit) Rules, 2014? (3 Marks)

Answer:

Sub-section 91 of Section 2 of the Companies Act, 2013 defines "*turnover*" as *"the aggregate value of the realization of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year*. For the purposes of these Rules, "Turnover" means gross turnover made by the company from the sale or supply of all products or services during the financial year. It includes any turnover from job work or loan license operations but exclude duties and taxes. Export benefit received should be treated as a part of sales.

(b)(i) As a cost auditor of a company, how would you deal with the following expenses -

(1) Separation costs related to voluntary retirement, retrenchment, termination etc. should be amortized over the period benefitting from such costs;

(2) Subsidy, Grant, Incentive or any such payment received or receivable with respect to any Employee cost. (6 Marks)

Answer:

(1) These benefits are amortized over the period benefitting from such additional cost resulting in reduction of current employee cost. Lump sum payments under the above schemes are generally amortized over a period of 5 years. Earlier costs related to voluntary retirement, retrenchment/termination compensation were treated as a part of non-cost items. As per cost accounting standard on employee cost, it should be amortized over the period benefitting from such costs. If this amount is charged off in the financial profit & loss account during the year of incurrence, the difference in the amount charged in cost accounts and the amount carried forward during the years of benefit would be reflected as a reconciliation item in the statement of reconciliation between cost accounts and financial accounts.

(2) Subsidy, grant or incentives are provided for specific purpose. For example, generation of employment in specified areas, subsidy, grant or incentives are given by government to attract setting up units in those areas. Any subsidy, grant received / receivable relating to employee cost shall be reduced from the employee cost.

(b)(ii) Hemant 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 2014-15 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%. (9 Marks)

Solution:

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 (50+50)	100
Quality Control Cost	--
Research and Development Cost	--
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. 1,077 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.

(c)(i) Whether Financial Position and Ratio Analysis [Part D, Para 4] is to be computed based on Cost record data or audited financial data? (3 Marks)

Answer:

Financial Position and Ratio Analysis is to be computed based on audited financial accounts. This reporting Para has been aligned with the nomenclature of Schedule III of the Companies Act, 2013.

(c)(ii) The manufacturing process of a company generates Metal Scrap during production of its main products which may or may not be covered under cost audit. Such scrap is sold in the market after the same is cleared under CETA Codes that are covered in the Rules. Will the company be covered under cost audit for generation of scrap? (4 Marks)

Answer:

Generation of scrap is not a production or processing or manufacturing but is incidental to manufacture of its main products. The Rules are applicable to production of goods or providing of services. CETA Codes have been inducted in the Rules for proper identification of Products that are manufactured. The act of payment of Excise Duty is immaterial in the context of application of the Rules. The generation of scrap and its consequent sale in the market cannot be construed to be covered under the Rules.

(c)(iii) Whether companies registered under Section 8 of the Companies Act, 2013 and One Person Company (OPC) introduced in Companies Act, 2013 covered under the Rules? (4 Marks)

Answer:

The Companies (Cost Records and Audit) Rules, 2014 are applicable to every company registered under the Companies Act, 2013 which are engaged in production of goods or providing of services listed in Table-A or Table-B of Rule 3. Different threshold limits have been prescribed in the Rules for applicability of maintenance of cost accounting records and coverage under cost audit. Exemption has been granted only to companies which are classified as a micro enterprise or a small enterprise including as per the turnover criteria under sub-section (9) of section 7 of the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006) and foreign companies having only liaison offices engaged in Production, import and supply or trading of medical devices specified under Item 33 of Table-B of Rule 3. Any other legal entity registered as a company that meets the conditions stated in Rule 3 and Rule 4 are covered.

(c)(iv) What are the duties of the Companies in relation to provisions of Section 148 of the Companies Act, 2013 and the Rules framed thereunder? (4 Marks)

Answer:

Every company required to get cost audit conducted under Section 148(2) of the Companies Act, 2013 shall:-

a) Appoint a cost auditor within one hundred and eighty days of the commencement of every financial year;

b) Inform the cost auditor concerned of his or its appointment;

c) File a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in **form CRA-2**, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014;

d) Within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in **form CRA-4** along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

(d)(i) The risk of material misstatement at the assertion level consists of two components. Comments (8 Marks)

Answer:

The risk of material misstatement at the assertion level consists of two components as follows:

"Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related cost heads, items of cost and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cost heads consisting of amounts derived from cost estimates that are subject to significant measurement uncertainty pose greater risks than do cost heads consisting of relatively routine, factual data.

External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a cause changes to a manufacturing process rendering the existing classification of variable and fixed costs inappropriate and cause product contribution to be misstated. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of cost heads, items of cost, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, external market constraints may cause normal capacity as an unreliable basis for determining unit costs.

"Control risk" is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's Cost Statements. Some control risk will always exist because of the inherent limitations of internal control.

Inherent risk and control risk are the entity's risks; they exist independently of the audit of the Cost Statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. When the auditor's assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. The CAAS AND GACAAPs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risk of material misstatement." Although the CAAS AND GACAAPs ordinarily describe a combined assessment of the risk of material misstatement, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

"Detection risk" is the risk that the cost auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of cost heads, items of cost, or disclosure and because of other factors. Such other factors include the possibility that a cost auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, and supervision and review of the audit work performed.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.

(d)(ii) Who can be appointed as a cost auditor and what is the procedure for appointment of cost auditor under the Companies Act, 2013? (3+4=7 Marks)

Answer:

Only a Cost Accountant, as defined under section 2(28) of the Companies Act, 2013, can be appointed as a cost auditor.

Clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 defines "Cost Accountant". It means a Cost Accountant who holds a valid certificate of practice under sub-section (1) of section 6 of the Cost and Works Accountants Act, 1959 and is in whole-time practice. Cost Accountant includes a Firm of Cost Accountants and a LLP of cost accountants.

The cost auditor is to be appointed by the Board of Directors on the recommendation of the Audit Committee, where the company is required to have an Audit Committee. The cost auditor proposed to be appointed is required to give a letter of consent to the Board of Directors. The company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in **form CRA-2**, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.

(e)(i) WED Ltd. has its own power plant, which has two users, Cutting Department and Welding Department. When the plans were prepared for the power plant, top management decided that its practical capacity should be 1,50,000 machine hours. Annual budgeted practical capacity fixed costs are ₹9,00,000 and budgeted variable costs are ₹4 per machine-hour. The following data are available:

	Cutting Department	Welding Department	Total
Actual Usage in 2013-14 (Machine hours)	**60,000**	**40,000**	**1,00,000**
Practical capacity for each department (Machine hours)	**90,000**	**60,000**	**1,50,000**

Required:

(i) Allocate the power plant's cost to the cutting and the welding department using a single rate method in which the budgeted rate is calculated using practical capacity and costs are allocated based on actual usage.

(ii) Allocate the power plant's-cost to the cutting and welding departments, using the dual – rate method in which fixed costs are allocated based on practical capacity and variable costs are allocated based on actual usage.

(iii) Allocate the power plant's cost to the cutting and welding departments using the dual-rate method in which the fixed-cost rate is calculated using practical capacity, but fixed costs are allocated to the cutting and welding department based on actual usage. Variable costs are allocated based on actual usage.

(iv) Comment on your results in requirements (i), (ii) and (iii). **(10 Marks)**

Solution:

(a) Working notes:

1. Fixed practical capacity cost per machine hour:

Practical capacity (machine hours)	1,50,000
Practical capacity fixed costs (₹)	9,00,000
Fixed practical capacity cost per machine hour (₹9,00,000/1,50,000 hours)	₹ 6

2. Budgeted rate per machine hour (using practical capacity):

= Fixed practical capacity cost per machine hour + Budgeted variable cost per machine hour

= ₹6 + ₹4 = ₹10

(i) Statement showing Power Plant's cost allocation to the Cutting & Welding departments by using single rate method on actual usage of machine hours

	Cutting Department	Welding Department	Total
Power plants cost allocation by using actual usage (machine hours) (Refer to working note 2)	6,00,000 (60,000 hours × ₹ 10)	4,00,000 (40,000 hours × ₹ 10)	10,00,000

(ii) Statement showing Power Plant's cost allocation to the Cutting & Welding departments by using dual rate method

	Cutting Department	Welding Department	Total
Fixed cost (Allocated on practical capacity for each department i.e.): (90,000 hours: 60,000 hours)	5,40,000 (₹9,00,000 × 3/5)	3,60,000 (₹9,00,000 × 2/5)	9,00,000
Variable cost (Based on actual usage of Machine hours)	2,40,000 (60,000 hours × ₹4)	1,60,000 (40,000 hours × ₹4)	4,00,000
Total cost	7,80,000	5,20,000	13,00,000

(iii) Statement showing power plant's cost allocation to the cutting & Welding departments using dual rate method

	Cutting Department	Welding Department	Total
Fixed cost (Allocation of fixed cost on actual usage basis (Refer to working note 1)	3,60,000 (₹60,000 × 6)	2,40,000 (₹40,000 × 6)	6,00,000
Variable cost (Based on actual usage)	2,40,000 (60,000 hours × ₹4)	1,60,000 (40,000 hours × ₹4)	4,00,000
Total cost	6,00,000	4,00,000	10,00,000

(iv) Comments:

Under dual rate method, under (iii) and single rate method under (i), the allocation of fixed cost of practical capacity of plant over each department *are* based on single rate. The major advantage of this approach is that the user departments *are* allocated fixed capacity costs only for the capacity used. The unused capacity cost ₹ 3,00,000 (₹ 9,00,000 - ₹ 6,00,000) will not be allocated to the user departments. This highlights the cost of unused capacity. Under (ii) fixed cost of capacity *are* allocated to operating departments on the basis of practical capacity, so all fixed costs *are* allocated and there is no unused capacity identified with the power plant.

(e)(ii) Whether maintenance of cost accounting records and cost audit thereof, subject to threshold limits prescribed, is applicable to products which are for 100% captive consumption?

(5 Marks)

Answer:

The Companies (Cost Records and Audit) Rules, 2014 has specified different products and services for which maintenance of cost accounting records and cost audit thereof, subject to threshold limits prescribed, is mandatory.

In case a product is manufactured and 100% captively consumed for production of some other product which is also covered under these Rules and is subject to cost audit, then the cost of such captively consumed product would form part of the final product which is also under cost audit and as such a separate cost audit report for the captively consumed product will not be necessary.

However, if the product is partly for captive consumption and partly sold, or if the product is 100% captively consumed for production of some other product which is not covered under these Rules, then cost audit would be applicable for such captively consumed product(s).

(2) Answer any two questions [10×2=20]

(a) What are the limitations in implementation of an effective internal control system of a company? (10 Marks)

Answer:

Limitations of internal control

An important ingredient in development of an effective internal control system aimed at the achievement of management's objectives is to ensure that the organization has adequate relevant policies accompanied by effective monitoring and reporting mechanism. Moreover, while establishing the management objectives, the management must take into consideration the cost of attempting to achieve them. In other words, the cost of achieving objectives must be less than the anticipated benefits to be derived by achieving the objectives. One extreme is to achieve objectives "*As quickly as possible*" implying zero controls, while other extreme of achieving of objectives with "*No errors*" implies strong internal controls covering all aspects of objective. Controls must therefore be practical, useful, achievable, and compatible with both operating and control goals and there is always a trade-off between cost and benefit. Since all controls cost resources in terms of money, personnel, equipment, and time, internal controls always imply a trade-off between the anticipated cost and benefit envisaged. (Is it worth to spend rupees ten thousand to prevent a possible loss of rupees five thousand?).

For example, those risks that have a low probability and low cost should simply be *ignored.* But for those with high probability and high costs, control activities need to be implemented to *prevent* the risk from occurring. For example, a disaster may have a low probability but it has a high cost, therefore management should employ *insurance and/or backup plan* as an appropriate control activity. This model requires management to identify what needs protecting, what the risks are for those assets, and the level of cost impact and probability for each risk. Therefore, the organization must do a comprehensive risk assessment before actually designing an internal control system, i.e., identify the risks to which it is subjected to and the corresponding amount of loss if that risk comes true. In other words, any Internal Control System must ensure that all anticipated risks are taken care up to the point of cost benefit analysis i.e., cost of effecting control or managing a risk does not exceed the estimated amount of losses, if that risk actually happens or comes true. However, this condition may not be strictly applicable to those controls, which are aimed at ensuring compliance with applicable laws and regulations.

The second ingredient or evaluation parameter is that of reasonable assurance. Even though in actual practice, there is no such thing as 'perfect internal control system'. No computer system is impervious to hacking attacks, malicious activities or sometimes genuine errors. Moreover as already stated above, controls have a cost and the concept of cost-benefit needs to be applied even to controls also. If it costs ₹ 2 crores per annum to make computer hacking free or error free and the risk assessment shows an estimated loss of ₹ 5 lakhs only, it may be better to have reasonable controls only to avoid prohibitive costs. Therefore, internal controls are designed to provide management with *reasonable assurance* regarding the achievement of these objectives.

It may be added here that most of the internal controls are aimed at anticipated risks or transactions of usual nature. Therefore, un-anticipated event or the transactions of un-usual nature may still escape all controls despite all precautions. Further, all controls need to be updated regularly to keep pace with changing conditions. So rigorous and effective internal controls of past may no longer be effective in present or future.

Lastly no depth of internal control can avoid losses due to potential human error or due to collusion between two or more persons. For example '*Disgruntled employees*' probably present the highest risk—even more than hackers external to the firm. These people can always be motivated to cause harm to the organization and depending on their knowledge and access to systems, data or other assets, they can cause extensive damage. Similarly, a person who has an extreme cash flow problem for any reason (like gambling, excessive lifestyle, etc.) may sometimes be tempted to steal assets to cover personal losses; often with the intention to "pay back" after some time. It is also sometimes possible that someone in the organisation may become an industrial spy.

Sometimes, *management* itself is a risky group. They can very easily override controls because of their unique position and hence can more easily commit fraud etc. Sometimes, managements are forced to do 'window dressing' of their balance sheets to show higher profits to contain the declining share prices or to earn their bonuses (if based on profits). Even the normal aggressive nature of managers can sometimes become a risk if not mitigated by strong personal and corporate ethics, and an effective internal control system (e.g., audit committee). For example, one management accountant reported his dilemma when his boss wanted him to reverse a correct accounting transaction because it resulted in the department missing its profit goals for the first time in three years. Such actions are indicative of ethical soft spots that can lead to fraud, theft, or material misstatements. These risks are very difficult to anticipate because of their nature. However this aspect should be thoroughly analyzed by external auditors during financial audits.

Therefore, an evaluation of internal controls is necessary to establish the effectiveness of those controls. The Auditor should keep in mind the following two sets of basic objectives while evaluating internal control –

(a) to safeguard assets and control transactions; and

(b) to provide reasonable assurance, through his opinion report' that there is no material errors in the financial statements.

(b) (i) Explain the main area of operation of an internal audit of a company? (5 Marks)

Answer:

Internal audit involves five areas of operations:

1. ***Reliability and integrity of financial and operating information***: Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measures, classify and report such information.
2. ***Compliance with laws, policies, plans, procedures and regulations:*** Internal auditor should review the systems established to ensure compliance with those policies, plan and procedures, law and regulations which could have a significant impact on operations and reports and should determine whether the organisation is in compliance thereof.

3. ***Safeguarding of Assets*:** Internal auditors should verify the existence of assets and should review the means of safeguarding assets.

4. ***Economic and efficient use of resources:*** Internal auditor should ensure the economic and efficient use of resources available.

5. ***Accomplishing of established objectives and goals for operations:*** Internal auditor should review operation or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.

It is said that scope of internal audit is very much related to business phases. The first phase of business is basically the planning stage, and the decisions are on issues like whether to make or buy, whether to undertake a new project or export etc. These are more of managerial decisions and the scope of internal audit is often not much practical, in the initial stage, unless it takes to what is called management audit. The 2nd phase is the execution stage having its base in the subsequent recording in the books of account. In this stage, the scope of internal audit emerges out of need for correctness of accounts and proper classification of heads in a required manner. The third and final phase is the review of transactions where scope of internal auditing is immense.

(b)(ii) What are the documentations required for an internal audit as per Standard on Internal Audit-3? (5 Marks)

Answer:

Internal Audit Documentation (SIA 3):

i. Internal audit documentation should be designed and properly organized to meet the requirements and circumstances of each audit. To formulate policies for standardization of internal audit documentation.

ii. It should be sufficiently complete and detailed for an internal auditor to obtain an overall understanding of the audit.

iii. All significant matters which require exercise of judgment, together with internal auditor's conclusion thereon should be included in the internal audit documentation. Documentation prepared by internal auditor should enable reviewer to understand:

   - the nature, timing and extent of audit procedures performed to comply with SIAs and applicable legal and regulatory requirements;
   - the results of audit procedures and audit evidence obtained;
   - significant matters arising during the audit and conclusions reached thereon; and
   - terms and conditions of an internal audit engagement/requirements of internal audit charter, scope of work, reporting requirements, any other special conditions, affecting the internal audit.

iv. It should cover all the important aspects of an engagement viz., engagement acceptance, engagement planning, risk assessment and assessment of internal controls, evidence obtained and examination/evaluation carried out, review of the findings, communication and reporting and follow up.

v. The internal audit file should be assembled within sixty days after the signing of the internal audit report.

vi. To formulate policies as to the custody and retention of the internal audit documentation within the framework of the overall policy of the entity in relation to the retention of documents.

(c)(i) Explain the objects of Management Audit? (5 Marks)

Answer:

Objects of Management Audit

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

(i) to ensure optimum utilization on all the resource employed, including money, materials, machines, men and methods;

(ii) to highlight efficiencies in objectives, policies, procedures and planning;

(iii) to suggest improvement in methods of operations;

(iv) to highlight weak links in organizational structure and in internal control systems, and suggest necessary improvements;

(v) to help management by providing health indicators and help prevent sickness or help cure in case of sickness; and

(vi) to anticipate problems and suggest remedies to solve them in time.

(c)(ii) Explain the need for capacity determination of an organisation in India. (5 Marks)

Answer:

Need for Capacity Determination

The need for determining "production capacity" in respect of industrial organisation in India arises from the following reasons :-

(i) For purpose of Cost Audit Report under section 148 of the Companies Act, 2013 where a cost audit has been ordered by Government.

(ii) For internal management purpose, to be used:

(a) in planning, scheduling and controlling production, and

(b) in planning expansion of capacity and correction of imbalances.

(iii) For assessment of capacities for national level planning.

(iv) For fixing the price of product(s) after ascertaining the capacity costs and per unit incidence thereof, and

(v) For determination of allotment of scarce raw-materials in the form of quotas, import licenses, etc.

(3) Answer any two questions [10×2=20]

(a) Explain the Characteristics of a good performance appraisal report? (10 Marks)

Answer:

Characteristics of a good performance appraisal report

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

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

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

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

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

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

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

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

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

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

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

(b) The extracted Balance Sheet of a single product company subject to cost audit and the information extracted from Profit and Loss Account are given below :

Extract Balance Sheet as at 31st March, 2015

			₹	₹
Sources of Funds :				
1.	**Shareholder's funds**			
	Capital		97,00,000	
	Receipt of Unpaid Calls		5,000	
	Capital Reserve		25,00,000	
	General Reserve		50,60,000	
	Development Rebate reserve		15,000	
	Investment Allowance Reserve		25,50,000	
				1,98,30,000
2.	**Loan funds**			
	Secured loans —	**Cash credit**	1,40,00,000	
		Term Loan	5,00,000	
	Unsecured loans —	**Public deposits**	40,00,000	
		Interest accrued	2,00,000	1,87,00,000
		Total		3,85,30,000
Application of Funds :				
1.	**Fixed Assets**			
	Gross block		1,70,00,000	
	Less : Depreciation		90,00,000	
	Net block		80,00,000	
	Capital Work-in-Progress		75,000	80,75,000
2.	**Investments**			
	Other than trade — at cost		5,000	
	National Savings Certificates (Post Office 6 yrs') for Central excise Bonds		25,000	30,000
3.	**(a) Current Assets, Loans and Advances**			
	Inventories		2,52,20,000	
	Sundry Debtors		81,40,000	
	Cash & Bank Balances		30,00,000	
	Loans & Advances		15,65,000	
			3,79,25,000	

.	**Less :**		
	(b) Current Liabilities and provisions		
	Acceptances (under IDBI bills discounting scheme guaranteed by the Bank)	**5,00,000**	
	Sundry Creditors	**40,00,000**	
	Provisions (for taxation, contingencies & dividend)	**30,00,000**	
		75,00,000	
	Net Current Assets (a — b)		**3,04,25,000**
	Total :		**3,85,30,000**

Information (extracted from profit and Loss Account) for the year ending 31/3/2015.

	₹ in lacs		**₹ in lacs**
Sales	**975**	**Mfg. Cost of Goods Sold**	**725**
Other income	**4**	**H.O. Establishment expenses**	**95**
Excise Duty	**81**	**Interest paid/payable**	**30**
Provision for taxation	**10**	**Development rebate Reserve (written back)**	**0.15**
Investment allowance reserve	**0.5**		
		Profit before Appropriation	**37.35**

As a Cost auditor, you are required to work out the figures of:
(A) Capital Employed,
(B) Net Worth,
(C) Profit before Interest and Taxation, and
(D) The relevant Ratios, necessary for the Cost Audit Report.

(10 Marks)

Solution:

(A) Capital Employed:

	₹	
Total Assets at book values	3,85,30,000	
Less : Work-in-progress	75,000	
	3,84,55,000	
Less : Investment outside trade	5,000	
∴ Capital Employed	3,84,50,000	… (Method 1)
Less : Term Loan	5,00,000	
Less : Interest accrued	2,00,000	
(Net) Capital Employed	3,77,50,000	… (Method 2)

Alternatively,

Fixed Assets	80,75,000	
Less : Work-in-progress	75,000	
Net Fixed Assets	80,00,000	…(a)
Investments	30,000	
Less : Other than trade	5,000	
Net Investments for the business	25,000	…(b)
Current Assets, loans and Advance	3,79,25,000	
Less : Current Liabilities & Provisions	75,00,000	
Working Capital	3,04,25,000	…(c)
∴ Capital Employed (a + b + c)	3,84,50,000	(Method 1)

Less : Term Loan		₹5,00,000		
Interest		₹2,00,000		
			7,00,000	
(Net) Capital Employed			3,77,50,000	(Method 2)

[**Note:** For method 2, the liabilities of 'term loan' and 'interest accrued' included within the Loan Funds are assumed to be repayable within a year and so deducted.

6 years' N.S.C.'s for Excise Bonds are investments within the business.]

(B) Net Worth: ₹1,98,30,000 (Capital + Reserves.)

[**Note:** Here, the Shareholders' funds are the net worth. Receipts of unpaid calls should also be considered.]

(C) Profit before Interest and taxation :

		₹	
Sales		9,75,00,000	
Less : Mfg. Cost of goods sold		7,25,00,000	
Gross Trading Profit		2,50,00,000	
Add : Other Income		4,00,000	
		2,54,00,000	
Less : H.O. Establishment	₹95,00,000		
Excise Duty	₹81,00,000		
		1,76,00,000	
∴ Profit before Interest & Taxation		78,00,000	(Method 1)

Alternatively,

Profit before Appropriation		37,35,000	
Add : Investment Allow. Reserve	₹50,000		
Devpt. Rebate Reserve	₹15,000	65,000	
Profit after Taxation		38,00,000	
Add : Provision for taxation	₹10,00,000		
Interest Payable	₹30,00,000		
		40,00,000	
∴ Profit before Interest & Taxation		78,00,000	(Method 2)

[**Note:** Here, 'other income' includes income from 6 years' N.S.C's as investments and is assumed to be business income only]

(D) Ratios (for cost audit report) :

1. Profit before Interest & Taxation to Capital Employed —

   Method 1 : (78,00,000/3,84,50,000) x 100 = 20.3%
   Method 2 : (78,00,000/3,77,50,000) x 100 = 20.7%

2. Profit before Interest & Taxation to Net Sales —

(78,00,000/8,94,00,000) x 100 = 8.7%

[Note: Net Sales = Sales — Excise Duty = ₹ (975 — 81) lacs. = ₹894 lacs.]

3. Current Assets to Current Liabilities —

(3,79,25,000/75,00,000) x 100 = 505.7%

4. Net Worth of Long term Borrowing & Liabilities —

(1,98,30,000/2,55,00,000) x 100 = 77.8%.

[**Note:** Long term borrowing & liabilities = (Loan Funds + Current liabilities — Short term loans)

=₹ (187 + 75 - 7)lacs = ₹255 lacs.

5. Net Worth to Capital Employed —

Method 1 : (1,98,30,000/3,84,50,000) x 100 = 51.6%
Method 2 : (1,98,30,000/3,77,50,000) x 100 = 52.5%

6. Cost of Production to Capital Employed —

Method 1 : (7,25,00,000/3,84,50,000) x 100 = 188.6%
Method 2 : (7,25,00,000/3,77,50,000) x 100 = 192.1%

[**Note:** Cost of production = Mfg. Cost of goods sold]

(c)(i) Manufacture's specification capacity for a machine per hour = 1550 units
No. of shifts (each shift of 8 hours each) = 3 shifts
Paid holidays in a year (365 days):

Sundays	**52 days**
Other holidays	**8**

Annual maintenance is done during the 8 other holidays.
Preventive weekly maintenance is carried on during Sundays.
Normal idle capacity due to lunch time, shift change etc =1hour.
Production during last five years = 76.20, 88, 65.82, 78.5, 76.6 lakhs units
Actual production during the year = 76.40 lakhs units.
Calculate Installed capacity, Available capacity, Actual capacity, Idle capacity and Abnormal idle capacity as per CAS 2 from the data given. (6 Marks)

Answer:

Installed capacity for the machine	= 365 x 8 x 3 x 1550
	= 135.78 lakhs units
Available capacity	= (365 – 52 - 8) x (8 -1) x 3 x 1550
	= 305 x 7 x 3 x 1500
	= 99.28 lakhs units
Normal capacity	= (76.2 + 78.5 + 76.6)/3

	= 77.1 lakhs units.
Actual capacity utilization	= 76.4 lakhs units = 76.4/135.78 x 100 = 56.27%
Idle capacity	= (135.78 - 76.4) lakhs units = 59.38 lakhs units = 59.38 /135.78 x 100 = 43.73%
Abnormal idle capacity	= (77.1 - 76.4) lakhs units = 0.70 lakhs units

(c)(ii) A chemical manufacturing unit uses ingredient 'Q' as the basic material. The cost of the material is ₹ 20 per kg and the Input-Output ratio is 120%. Due to a sudden shortage in the market the material becomes non-available and the unit is considering the use of one of the following substitutes available:

Materials	Input - Output Ratio	₹/ per Kg
B1	135%	26
B2	115%	30

You are required to recommend which of the above substitutes is to be used. (4 Marks)

Answer:

Cost of Raw Material = $\frac{\text{Input}}{\text{Output}}$ x Rate per Unit

Cost of Material of: (Per Kg)

$$Q = \frac{120}{100} \times 20 = ₹24.00$$

$$B1 = \frac{135}{100} \times 26 = ₹35.10$$

$$B2 = \frac{115}{100} \times 30 = ₹34.50$$

Material B2 is cheaper to be used in the final product. It is cheaper than B1 by ₹0.60 (₹35.10 - ₹34.50).