Paper-19 - COST AUDIT & MANAGEMENT AUDIT

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

The figures in the margin on the right side indicate full marks.
The paper is divided in three sections.
From Section A answer any four questions (4x15=60 marks)
From Section B answer any two questions (2x10=20 marks)
From Section C answer any two questions (2x10=20 marks)

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

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

1.

a) MCA General Circular No. 67/2011 dated 30th November 2011 mentions that the Cost Audit Orders No. 52/26/CAB-2010 dated 2nd May, 2011 and 30th June, 2011 will not be applicable to 100% Export Oriented Unit. The Unit is clearing its goods in the domestic market after taking necessary approval from the Excise Authorities. In this case, whether cost audit is applicable, since the unit is clearing goods for domestic market. Since Cost Audit to 100% EOU is not applicable in terms of said General Circular, is there any exemption from maintenance of Cost Accounting Records? [3]

b) Who can authenticate the Compliance Report as per the Companies (Cost Accounting Records) Rules 2011. [3]

c) Para 9 of the Companies (Cost Audit Report) Rules 2011 requires disclosure of "Cost of Production" and "Cost of Sales" at a company level. How the same would be available when all the products/ activities are not covered under cost audit? [3]

d) "Paints and Varnishes" under Chapter 32 of Central Excise Tariff are covered under Cost Audit vide order no. F.No.52/26/CAB-2010 dated 30th June, 2011. Paints, Coatings and Printing Ink etc. sold under various trade names are produced by using Varnish as primary raw material to which different Pigments are added in different qualities. These products also belong to Chapter 32 of Central Excise Tariff. Whether such products would be considered as "Allied Products" of Varnish and be covered under cost audit? [3]

e) A newly constructed cement factory became operational from the end of June 2011. The projected turnover for the next 2 years is ₹500 crores per annum. State whether in coming years, the company will have to get cost audit done. If yes, then under which cost audit order number. [3]

Answer:

a) A company having multiple industrial units, out of which one or more are approved as 100% EOU, is required to have distinct identities of domestic units and 100% EOUs with separate accounts (Policy given in Chapter-6 Foreign Trade Policy). As per the Policy,

100% EOUs are allowed to sell a fixed percentage of sales in the Domestic Tariff Area (DTA) within permissible approved limits.
If the 100% EOU is functioning within the permissible approved limits, the Unit will be exempted from cost audit as per MCA General Circular No. 67/2011 dated 30.11.2011 but not exempted under Companies (Cost Accounting Records) Rules, 2011 and hence would be required to file a Compliance Report.
The unit not qualifying as 100% EOU will be covered under cost audit subject to the Company meeting the threshold criteria mentioned in the applicable cost audit order.

b) As per Rule 5, the Compliance Report and annexure thereto is required to be certified by a 'cost accountant', as defined under Rule 2(c).
As per Rule 7, the annexure to Compliance Report is to be duly approved by the Board of Directors.
A 'Cost Accountant' within the definition of these Rules does not include:
i) A member holding a part-time certificate of practice
ii) A member who is in full time employment and whose membership fees are in arrears.
iii) A member of 'The Institute of Cost Accountants of India', who has been admitted as a member through reciprocal arrangement of membership by virtue of being a member of Institute of Management Accountants USA.

c) The Companies (Cost Accounting Records) Rules 2011 [CARR] is now applicable to all companies engaged in production, processing, manufacturing & mining. Hence, product-wise/ activity-wise cost of production and cost of sales would be available from the Cost Accounting Records of all the products/ activities, irrespective of whether these are covered under cost audit or not.

It may further be noted that in such a situation, the company would also be required to file a compliance report and for this purpose, product-wise/ activity-wise cost of production and cost of sales would be determined to prepare the reconciliation statement as required in the compliance report.

d) As per cost audit order dated 30th June, 2011, Paints & Varnish along with their "Intermediate" and "Articles and Allied Products" thereof are covered under cost audit. In the MCA General Circular No. 67/2011 dated 30th November 2011, the terms "Intermediate" and "Articles and Allied Products" have been defined. In view of this clarification, the items produced from Varnish are covered under cost audit irrespective of trade name under which it is sold, provided they meet the criteria laid down in the said circular.

e) The company has come into commercial production from June 2011. Assuming, that the turnover for the first year of operation is ₹ 100 crores or more, cost audit will be applicable to the company from the year 2011-12. Incase the first year turnover is less than ₹ 100 crores but the company is a listed company or is in the process of getting listed, then also cost audit would have been applicable from 2011-12. If both the criteria are not met during the first year of operation then cost audit would become applicable from 2012-13.

The cost audit would have to be conducted under cost audit order no 52/26/CAB – 2010 dated 3rd May, 2011 modified vide order dated 30th June, 2011.

2.

a) Does a company mandatorily require indicating previous year(s) figures in the relevant columns of the Para(s) to Annexure to the Cost Audit Report even if the Cost Accounting Records Rules were not applicable to the company in the previous years? [5]

b) How can the cost audit report and compliance report is converted into the XBRL format? [5]

c) In a manufacturing shop Product X requires 2.5 man hours and Product Y requires 6 man hour. In a month of 25 working days of 8 hours a day 2,000 units of X and 1,000 units of Y were produced. The Company employs 50 workers in the shop and the budgeted man-hours are 1, 08,000 for the year. You are required to work out the capacity ratio, activity ratio and efficiency ratio. [5]

Answer:

a) If a company was already covered under erstwhile Cost Accounting Records Rules, previous year figures are required to be given in the cost audit report even in the first year of cost audit. Suitable disclosure may be made by the cost auditor that the previous year figures are as provided by the management.

In case some of the products of the company was under cost accounting records/cost audit prior to 2011-12 and additional products have come under cost accounting records and cost audit from 2011-12, then previous year figures in respect of such products that were under cost accounting records prior to 2011-12 is required to be provided. The taxonomy provides reporting of previous year figures according to product group and the same should be suitably disclosed in Para 3.

However, if both cost accounting records rules and cost audit becomes simultaneously applicable for the first time on a company, then disclosure of previous year figures is optional.

Any non-disclosure of previous year figures must be supported with reasoned justification.

b) XBRL is an open source technology. Any of the following methods can be adopted to create the instance document required for filing of the respective reports.

i) XBRL-enabled software packages developed by different software vendors which support the creation of cost reports in XBRL format can be used to create the necessary document.

ii) Various elements of Cost Audit Report and Compliance Report can be mapped into XBRL tags of the costing taxonomy using specialized XBRL software tools specifically designed for this purpose.

iii) Different third party packages can be integrated into the existing accounting systems to generate XBRL Cost statements.

iv) There are various web based applications available that take input reports in various formats viz. Microsoft Excel etc. and transform them into XBRL format.

The methodology adopted by an individual company will depend on its requirements and the cost accounting software and systems being used and other factors.

c)

Budgeted Hours (B.H.)		= 1,08,000 for the year
i.e.		= 9,000 for the month
Maximum possible Hours		= 25 x 8 x 50 workers = 10,000
Actual Hours Worked (AHW)		= 25 x 8 x 50 workers = 10,000 (assumed)
Standard Hours (S.H.) Produced :		
Product X	= 2000 x 2.5	= 5,000
Product Y	=1000 x 6	= 6,000

Total = 11,000

(1) Capacity Ratio:

Standard Capacity usage Ratio = BH/Max. possible hours x 100
= 9,000/10,000 x 100 = 90%

Actual Capacity Usage Ratio = AHW/Max. Possible Hours x 100
= 10,000/10,000 x 100 = 100%

(2)Activity Ratio = Actual production in terms of SH/BH
= 11,000/9,000 x 100 = 122.22%

This is more than 100%. It is good.

(3) Efficiency Ratio = Actual production in terms of SH/Actual Hours Worked (AHW) x 100
= 11,000/10,000 x 100 = 110%

This is more than 100%. It is good.

3.

a) What are the benefits of Process Mapping? [5]

b) 'A' an employee of XYZ Co. gets the following emoluments and benefits.

(a) Salary	**₹250 per month**	**(c) Employers Contribution to Provident Fund E.S.I.**	**8% Salary and D.A.**
(b) Dearness Allowance		**(d) Bonus**	**4% Salary and D.A**
on 1st ₹100 of Salary	**₹400**	**(e) Other Allowances**	**20% Salary and D.A**
on next ₹100 of salary	**₹100**		**₹ 2,725 per annum**
on balance every ₹10	**₹5 or part thereof**		

A works for 2,400 hours per annum, out of which 400 hours are non-productive but treated as normal idle time. A works for 18 effective hours in Job No. 15, where the cost of direct materials equals 'A's earnings and the overhead applied is 100%, of Prime Cost. The sale value of the job is quoted to earn a profit of 10% on such value.

You are requested to find out:

i) Effective hourly cost of A and

ii) The expected sale value of Job No. 15. [6]

c) A timber merchant purchased 1000 c.ft. of timber logs as on 1st April, 2012 @ ₹ 100 per c.ft. and stored them in his timber yard for seasoning. In the timber yard the following items of expenses were incurred during the period.

i) Rent @ ₹ 1,250 per month

ii) Salary of 4 guards @ ₹ 250 per month

iii) Incidental expense for maintenance ₹ 750 per month

iv) Annual share of administration overheads ₹ 10,000

50% of the floor areas of the godown and other connected operations were incurred for stocking the seasoned timber. Loss in volume of the logs due to seasoning should be taken at 10%. Calculate the selling price of timber at season, assuming a profit margin of 15% on cost [4]

Answer:

a) The following are the benefit of process Mapping :

a. Understanding of the process flow
b. Find where/what/when/who/how waste is being created
c. Define elements of cycle time
d. Eliminate or combine steps
e. Improve process flow
f. Re-layout the process
g. Reduce variation, cycle times, rework, waste and manpower
h. Allocate resources better

Process Mapping may also help in focusing to eliminate waste, like:

a. Unnecessary motions, steps
b. High volume of inventory, overstock
c. Overproduction
d. Transporting
e. Waiting, idle, queuing
f. Defects, scrap
g. Under-utilization of resources (people, equipment)

b) (a) A's earnings

1.	Salary		₹250 per month
2.	D.A. :		
	on first ₹100 of salary	₹400	
	on next ₹100 of salary	₹100	
	on balance ₹50 of salary	₹ <u>25</u>	<u>525</u> per month
3.	Total (Salary + D.A.)		<u>775</u> per month
4.	Annual Salary + D.A.		9,300 p.a.
5.	Employer's contribution to P.F. (8% of item 4)		744
6.	Employer's contribution to ESI (4% of item 4)		372
7.	Bonus @ 20% of item 4		1,860
8.	Other allowances		<u>2,725</u>
9.	Total yearly earnings (p.a.)		<u>15,001</u>
10.	Annual working hours		2,400
11.	Less: normal idle time		<u>400</u>
12.	Effective annual working hours		2,000
13.	Effective hourly cost of employee "A" (15,000 ÷ 2,000) = ₹7.50 per hours		

(b)	Statement showing effective sale value of job No. 15	

	Direct labour cost (₹7.50 x 18 hrs.)	₹135
	Direct materials	135
	Prime cost	270
	Overheads (100% of prime cost)	270
	Total cost	540
	Profit (10% of sale value or 1/9th of cost)	60
	Sale value	600

c) Computation of Selling Price during season

Quantity (c.ft.)	₹
Cost of Timber (1000 × ₹ 100)	1,00,000
Rent (₹ 1250 × 6× ½)	3,750
Salary of Guards (₹ 250 × 4 × 6× ½)	3,000
Incidental Expenses for maintenance (₹ 750 × 6× ½)	2,250
Administration Overhead (₹ 10,000 × ½ × ½)	2,500
Total Cost	1,11,500
Add: Profit @ 15% on cost	16,725
Selling Price of seasoned timber	1,28,225
Quantity of seasoned timber (after 10% less due to seasoning)	900 c.ft.
Selling price per c.ft.	142.47

4.

a) Your client, Mitra 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. [6]

b) Purchase of Materials $ 50,000 [Forward contract rate $ = ₹ 54.40 but $ = ₹ 54.60 on the date of importation] ; Import Duty paid ₹5,65,000; Freight inward ₹1,62,000 ; Insurance paid for import by road ₹48,000; Cash discount ₹33,000; CENVAT Credit refundable ₹37,000; Payment made to the foreign vendor after a month, on that date the rate of exchange was $ = ₹ 55,20. Compute the landed cost of material. [5]

c) A steel tube manufacturing company is having turnover of ₹ 80 crores from all its activities. The company has filed its prospectus with SEBI for a public issue of equity shares and it hopes to complete the public offering by September, 2011 end. State whether cost audit would become applicable to the company even when its turnover is less than ₹ 100 crore? If yes, then from which financial year will cost audit will become applicable? [4]

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 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 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 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.
- Investment shown at cost whose market value is much lower.
- Investment carrying very low rate of return.
- In fructuous project expenditure.
- Intangibles of no value.

b) Computation of Landed Cost of Material

	Particulars	**Amount (₹)**
	Purchase price of Material [50,000 x 54.60]	27,30,000
Add	Import Duties of purchasing the material	5,65,000
Add	Any taxes paid during the purchase of material	1,62,000
Add	Freight Inward during the procurement of material	48,000
	Total	**35,05,000**
Less	CENVAT Credit refundable	37,000
	Value of Receipt of Material	**34,68,000**

Note:

(i) Excess payment made to the vendor due to exchange fluctuation is not an includible cost, hence not considered.

(ii) Though the forward contract rate was $ = ₹54.40, but the exchange rate on the date of importation is considered. Hence, included in the cost of materials. Accordingly, the purchase cost is computed considering the $ = ₹ 54.60.

c) In the stated case, the company's equity is in the process of listing on a stock exchange in India. Hence, it meets the requirement of Rule 3(1) of the Companies (Cost Accounting Records) Rules 2011. Consequently, the said Rules are applicable to the company in place of erstwhile Cost Accounting Records (Steel Pipes & Tubes) Rules 1984.

The cost audit order no. 52/26/CAB – 2010 dated 3rd May, 2011 has brought under the ambit of cost audit every company engaged in 6 specific industries, which includes Steel Tubes & Pipes. Though the turnover criteria of ₹ 100 crores is not met by the company's equity is in the process of listing on a stock exchange in India. Hence, cost audit will be applicable to the company under the order dated 3rd May, 2011 on and from the financial year 2011-12.

5.

a) CMC Public Health Centre runs an Intensive Medical Care Unit. For this purpose, it has hired a building at a rent of ₹ 5,000 per month with the understanding that it would bear the repairs and maintenance charges also.

The unit consists of 25 beds and 5 more beds can be comfortably accommodated when the occasion demands. The permanent staff attached to the unit is as follows:

i) 2 Supervisors, each at a salary of ₹ 500 per month.

ii) 2 Nurses, each at a salary of ₹ 300 per month.

iii) 2 Ward boys, each at a salary of ₹ 150 per month.

Though the unit was open for the patients all the 365 days in a year, scrutiny of accounts in 2012 revealed that only for 120 days in the year, the unit had the full capacity of 25 patients per day and for another 80 days, it had on an average 20 beds only occupied per days. But, there were occasions when the beds were full, extra beds were hired at a charge of ₹ 5 per bed per day and this did not come to more than 5 beds extra above the normal capacity on any one day. The total hire charges for the extra beds incurred for the whole year amount to ₹ 2,000.

The unit engaged expert doctors from outside to attend on the patients and the fees were paid on the basis of the number of patients attended and time spent by them and on an average worked out to ₹ 10,000 per month in 2012.

The other expenses for the year were as under:	**₹**
Repairs and maintenance	**3,600**
Food supplied to patients	**44,000**
Janitor and other services for them	**12,500**
Laundry charges for their bed linen	**28,000**
Medicines supplied	**35,000**
Cost of oxygen, X-ray etc., other than directly borne for treatment of patients	**54,000**
General Administration charges allocated to the unit	**49,550**

Required

i) If the unit recovered an overall amount of ₹100 per day on an average from each patient, what is the profit per patient day made by the unit in 2012.

ii) The unit wants to work on a budget for 2012-13, but the number of patients requiring intensive medical care is a very uncertain factor. Assuming that same revenue and expenses prevail in 2013, in the first instance, workout the number of patient days required by the unit to break even. [7]

b) What is the role of Audit Committee, where applicable, in dealing with the Cost Audit Report? Can the Annexure to a Cost Audit Report be approved by the Audit Committee and /or the Board of Directors by circular resolution? [4]

c) Are there any sectors exempted under Companies (Cost Accounting Record) Rules, 2011? [2]

d) What is the period for which a cost auditor holds office as cost auditor of a company? [2]

Solution:

a)

(i) Number of Patient-days in 2012:

25 beds x 120 days	3,000
20 beds x 80 days	1,600
Extra bed-days	
(total hire charges of extra beds/ charges per bed per day	
=₹ 2,000 ÷ ₹5)	400
	5,000 patient-day

In order to calculate contribution, the profit per patient-day and the break-even point, it is necessary to classify the different costs into fixed and variable categories. It will be seen that while most of the items can be easily classified as fixed or variable, problem arises in respect of two items, viz. janitor and other services presumption that they are related to number of patient-days. On the other hand, cost of oxygen, X-ray etc., has been taken as a fixed cost since it has been stated that this cost is other than costs directly borne for treatment of patients.

Statement of Profit

Income received (₹ 100 × 5,000 patient days)		₹ 5,00,000
	₹	₹
Variable Costs:		
Food	44,000	
Janitor services	12,500	
Laundry	28,000	
Medicines	35,000	
Doctor's fees (₹ 10,000 x 12)	1,20,000	
Hire charges for extra beds	2,000	
Contribution		2.41.500
Contribution		2,58,500
Fixed Costs:		
Salaries (2 x ₹ 500 + 2 x ₹ 300 + 2 x ₹ 150) x 12	22,800	
Rent (₹5,000x12)	60,000	
Repairs and Maintenance	3,600	
General Administration	49,550	
Cost of oxygen, X-ray etc.	54,000	
		1.89.950
Profit		68.550

Profit per patient day = ₹ 68,550 ÷ 5,000 = ₹ 13.71

(ii) Total Contribution = 2,58,500
Total patient days = 5,000
Contribution per patient day = $\frac{2,58,500}{5000} = 51.7$
Break Even point = $\frac{Fixed\ Cost}{Contribution\ per\ unit} = \frac{1,89,950}{51.7}$ = 3,674 patient days

b) Sub-section (6) of section 292A of the Companies Act, 1956 states that the Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review of half yearly and annual financial statements before submission to the Board and also ensure compliance on internal control systems. Departmental circular No.6/2001 dated 20.08.2001, has already clarified the term 'auditors' include cost auditors and hence 'scope of audit including observations from auditors occurring in the above sub-section includes the scope of cost auditing observations of the cost auditors as well. The presence of the cost auditor in such committees would ensure overall cost management, efficiency in resource utilization, business vertical wise performance evaluation, proper pricing of inter-unit / inter-company transfers and valuation of inventories. Hence, the company must place the cost audit report before the audit committee first, which in its duty to ensure compliance of internal control system shall also discuss the suggestions made in cost audit report for implementation, wherever cost audit has been directed under section 233B of the Companies Act, 1956.

The Audit Committee, after due consideration of the Cost Audit Report is required to submit the same for approval of the Board. Since, Board of Directors is required to approve the Annexure to Cost Audit Report and authorize one of the Directors and the Company Secretary (two Directors in the absence of a Company Secretary) to sign the same. The Board should also consider the Cost Audit Report in a duly convened meeting and it would not be advisable to approve the same by circular resolution.

c) MCA General Circular No. 67/2011 dated 30th Nov 2011States that the Companies (Cost Accounting Record) Rules, 2011 are not applicable to wholesale & retail trading, banking, financial, leasing, investment, insurance, education, healthcare, tourism, travel, hospitality, recreation, transport services, business / professional consultancy, IT & It enabled services, research & development, postal / courier services etc. unless any of these have been specifically covered under any other Cost Accounting Record Rules.

d) MCA Master Circular No. 2/2011 dated 11th November, 2011 states that, a cost auditor shall be deemed to be holding office as cost auditor from the time he accepts the appointment and files Form 23D with the Central Government and shall be deemed to have concluded his appointment for the relevant financial year as soon as he renders a report to the Central Government in accordance with the Cost Audit Report Rules, as applicable, with a copy to the company.

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

6.

a) **What do you understand by 'Corporate Image' and 'Branding'? Are they inter-related?**
b) **What are the possible approaches to evaluate Corporate Image? [4+2+4]**

Answer:

a) **Corporate Image:**
The term "Image" indicates an idea or perception formed in the mind of a person about an individual or an institution. Corporations, like individuals, consciously build up images in the minds of the people with whom they come into contact. In developing a 'Corporate Image', an enterprise has to ensure an overall consistency, as regards the quality of the products, the ethics of its management, employee relations, attitudes towards customers, quality and service to customers etc. The Public have different perceptions of "Corporate Image".

i) Customers measure it by the product quality, prompt and courteous after sales service, regularity in maintaining supplies; etc.
ii) Shareholders, measure it by the consistency in financial performance and prospects of growth.
iii) Supplier measure it by the company's liquidity and ability to honour commitments.
iv) Banks and Financial Institutions measure it by the financial health, net worth and history of servicing debts.
v) Government looks at it from the point of view of revenue generation and as an honest tax payer.
vi) Employees look for steady career growth and smooth Industrial Relations.

Corporate Branding:
Corporate branding is the process of creating and maintaining a favorable reputation of the company and its constituent elements. It is an important organizational resource that enables to create, strengthen and sustain competitive advantage. It is a strategic asset that creates competitive advantage and favorable climate for survival and development of an organization.
The purpose of corporate branding is to:

- Make the organization known as unique, distinct and creditable in the mind of potential customer.
- Facilitate the building of relationships and trust.
- Portray the benefits of the organization to the customer

Yes. Both Corporate Image and Branding are interrelated concepts. The factors which contribute to build up a 'corporate image' also substantially help in building a 'corporate branding'.

b) **Evaluation of Corporate Image**
Evaluation of Corporate Image is a very complex process and it involves a critical examination of events and trends concerning business environment – both internal as well as external.
The following are the steps to evaluate Corporate Image.

- Prepare a list of desirable attributes.
- Group them functionally and specify the qualifications

- Assign weights to each attribute based on their relative importance.
- Involve experts in the respective fields in rating the qualifications and attributes – based on facts, judgments and interpretations.
- Summarise the rating under the selected groups and present a composite evaluation to the management.

The summary should throw light on what the company has been able to do for itself and for the public in general.

7.

a) A management consultant has undertaken an assignment to conduct a Management Audit of the production function of a medium-scale engineering unit. You are requested to prepare a checklist of the points on which he needs to undertake the study. [5]

b) Discuss about the restrictions, ceiling limits and legal procedures related to appointment of a cost auditor. [5]

Answer:

a) Management Auditor needs to have an extensive checklist as follows:

i) How is the production plan prepared? Is it based entirely on market forecast, or does it also take into account limitations of material, personnel and finance?

ii) Are the product-mix decisions based on optimum profitability? What is the proportion of standard product and tailor made items?

iii) Whether all infrastructures like machinery, materials, manpower and money have been assured at the scheduled time for uninterrupted production?

iv) Are there any constraints in achieving maximum capacity utilization? Are there any imbalances in the plant? If So, what steps are being contemplated to set right the imbalance?

v) Is it possible to sub-contact some jobs to increase production capacity or to maintain production in times of power cuts?

vi) What is the percentage of scrap, waste and rejects and whether it is reasonable?

vii) Is the idle time being monitored regularly? Is it being analysed reason-wise? How much of it is due to machinery break-down which is controllable by production department?

viii) Is there excess or shortage of man-power? How is the control exercised – time & motion study, incentives, labour budgets or any other means?

ix) Is there any wastage in consumption of utilities like power, fuel, steam, compressed air etc?

x) How effective is the material handling system? Are there any avoidable movements of materials?

xi) What is the system of preventive maintenance? If the in-house maintenance capacity is not adequate, are there annual maintenance contracts for all important items of plant and machinery?

xii) How is the control exercised on inventory of stores and spares?

xiii) What is the procedure to handle breakdown emergencies?

xiv) Are all statutory requirements in regard to safety measures complied with?

xv) Are history cards available for all plant and machinery giving details of downtime, replacement of parts etc?

xvi) Does the system provide for flexibility or changes in production schedules to execute urgent orders or changes in the product mix?

b) Section 224 (1B) stipulates "On and from the financial year next following the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), no company or its Board of directors shall appoint or reappoint any person who is in full-time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies:

Provided that in the case of a firm of auditors, "specified number of companies" shall be construed as the number of companies specified for every partner of the firm who is not in fulltime employment elsewhere:

Provided further that where any partner of the firm is also a partner of any other firm or firms of auditors, the number of companies which may be taken into account, by all the firms together, in relation to such partner shall not exceed the specified number, in the aggregate.

Provided also that where any partner of a firm of auditors is also holding office, in his individual capacity, as the auditor of one or more companies, the number of companies which may be taken into account in his case shall not exceed the specified number, in the aggregate.

Provided also that the provisions of this sub-section shall not apply, on and after commencement of the Companies (Amendment) Act, 2000, to a private company.

Explanation I: For the purposes of sub-sections (1B) and (1C), "specified number" means,

a. in the case of a person or firm holding appointment as auditor of a number of companies each of which has a paid-up share capital of less than rupees twenty-five lakhs, twenty such companies;
b. in any other case, twenty companies, out of which not more than ten shall be companies each of which has a paid-up share capital of rupees twenty-five lakhs or more.

Explanation II: In computing the specified number, the number of companies in respect of which or any part of which any person or firm has been appointed as an auditor, whether singly or in combination with any other person or firm, shall be taken into account.

8.

a) Explain whether the following activities amount to professional misconduct on the part of a Cost Accountant: [2x3=6]

i) CMA Amit, a Cost Accountant in practice, published a book and gave his personal details as an author. These details also mentioned his professional experiences and his association as partner with SKR and Associates, a firm of Cost Accountants.

ii) M/s. J.K. Bharua & Associates, a firm of Cost Accountants in practice, develops a website "bharua.com". The colour chosen for website was very bright yellow where the names of the partners of the firm along with their various professional attainments and the major clients were to be displayed on the website.

iii) CMA D.R.RADHAKRISHNAN a Cost Accountant in practice takes up the appointment as Managing Director of ANKRIT LTD., a public limited company.

b) State the functions of the Audit Committee. [4]

Answer:

a) (i) A Cost Accountant in practice shall be deemed to be guilty of professional misconduct, if he solicits clients or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

CMA, Amit being a Cost Accountant in practice has committed a professional misconduct by mentioning that at present he is a partner of M/s SKR & Associates, a firm of Cost Accountants (Clause 6 of part I of First Schedule to the Cost and Works Accountants Act, 1959)

(ii) The Council of the Institute of Cost Accountants of India had approved posting of particular on website by Cost Accountants in practice under clause (6) of Part-I of First Schedule to the Cost and Works Accountants Act, 1959 subject to the prescribed guidelines. The relevant guidelines are:

- No restriction on the colours used in the website.
- Names of clients and fees charged not to be given.

Clause (7) of Part-I of First Schedule to the Cost and Works Accountants Act, 1959 prohibits a member not to advertise his professional attainments or services other than Cost Accountant professional documents, visiting cards, letter heads or sign boards.

In view of the above, M/s J.K. Bharua & Associates would have no restriction on the colours used in the website but failed to satisfy other guidelines.

Thus M/s J.K.Bharua & Associates would be held guilty of professional misconduct under clause (6) and clause (7) of Part-I of First Schedule to the Cost and Works Accountants Act,1959.

(iii) Clause 10 of Part-I of the First Schedule to the Cost and Works Accountants Act, 1959 aims to restrain a member in practice from engaging himself in any business or occupation other than that of a Cost Accountant except when permitted by the Council to be so engaged. Accordingly, in the absence of specific and prior approval, the Cost Accountant would be held guilty of professional misconduct. Thus in the instant case CMA Dr. Radhakrishnan would be held to be guilty of professional misconduct.

b) Functions of Audit Committee : The functions of the Audit Committee shall include the following :

i) Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
ii) Recommending to the Board, the appointment, re-appointment and if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
iii) Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
iv) Reviewing, with the management, the annual financial statements before submission to the Board for approval.
v) Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems. Reviewing the adequacy of the internal audit function.
vi) Reviewing the findings of any internal investigations, where there is suspected fraud or irregularity.
vii) Post-audit discussion with statutory auditors.

viii) To look into the reasons for substantial defaults in the payment to the depositors, debenture holders and creditors.

ix) Carrying out any other function, as mentioned in the terms of reference of the Audit Committee.

Section C

Answer any two Questions [2x10=20]

9. NENA Ltd. Has received an enquiry for the supply of 2,00,000 numbers of Special Type of Machine Parts. Capacity exists for the manufacture of the machine parts, but a fixed investment of ₹ 80,000 and Working Capital to the extent of 25% of Sales Value will be required if the job is undertaken.
The Costs are estimated as follows:
Raw Materials – 20,000 kgs @ ₹ 2.50 per kg.
Labour Hours – 9,000 of which 1,000 would be overtime hours payable at double the labour rate.
Labour Rate – ₹ 2/- per hour.
Factory Overhead – ₹ 2/- per direct labour hour
Selling and Distribution Expenses – ₹ 23,000.
Material Recovered at the end of the operation will be ₹ 6,000 (estimated).
The company expects a Net Return of 25% on Capital Employed.

You are the Management Account of the Company. The Managing Director requests you to prepare a Cost and Price Statement indicating the price which should be quoted to the Customer. [10]

Answer:

Cost Sheet Showing Cost of Production

Particulars		₹
Materials (20000kg × ₹ 2.5)	50,000	
Less: Scrap	6,000	
Total Cost		44,000
Labour Cost Normal time (8000hrs ×₹ 2)	16,000	
Overtime (1000hrs × ₹ 4)	4,000	20,000
Total Prime Cost		64,000
Add: Factory overheads (9,000hrs× ₹2)		18,000
Factory Cost		82,000
Selling and Distribution Cost		23,000
Cost of Sales		1,05,000
Expected Profit (25% of Capital employed) (Bal fig)		28,333
Sales Value (Cost of Sales +Profit) (W note)		1,33,333
Total units		2,00,000

Selling price/unit		0.67

Working Note:

Let sales = A

Sales = Total cost + 25% of Capital employed

A = $1{,}05{,}000 + \frac{25}{100}\left(80{,}000 + \frac{A}{4*}\right)$

Resolving, we get,

A = 133333.33333 = assumed sales value

* A is divided by four to add the profit element.

10. Given below are the abridged Balance Sheets and Profit & Loss Accounts of AB Spinning Mills Ltd.:

	2012-2013 (₹ in lakhs)	2011-2012 (₹ in lakhs)	2010-2011 (₹ in lakhs)
Balance Sheet:			
Share capital	245	245	245
Reserves and Surplus	726	1,077	1,313
Long term borrowings	287	180	160
Working capital loans	1,639	451	672
Sundry creditors	1,616	1,255	1,015
Other Provisions	389	315	305
Total	4,902	3,523	3,710
Net block	1,009	541	612
Investments	19	19	19
Current assets:			
Inventory	1,160	1,521	1,641
Book Debts	11	114	172
Loans and advances	2,641	1,286	1,231
Cash and bank balances	62	42	35
Total	4,902	3,523	3,710
Profit & Loss Account:			
Sales	5,091	3,938	4,215
Other income	446	365	342
Total	5,537	4,303	4,557
Raw materials, stores and spares consumed	3,728	2,775	2,964
Factory wages	162	215	206
Salaries	377	322	295
Power and fuel	826	673	710
Repairs and maintenance:			
Buildings	7	18	75
Plant and Machinery	38	54	48
Vehicles	43	33	24
Depreciation:			
Buildings	11	14	16
Plant and machinery	57	43	48
Vehicles	66	16	30
Interest	277	130	152

Other overheads(excluding salaries and depreciation)			
Factory overheads	**138**	**94**	**82**
Administrative overheads	**71**	**59**	**41**
Selling and distributing overheads	**87**	**83**	**80**
Loss for the year	**351**	**236**	**154**
Total	**5,537**	**303**	**4,557**
Sales for the year (Kgs.)	**4350890**	**3436921**	**3725405**

The bankers to the company appointed you as a Consultant for identifying the factors which have contributed to the continuing losses. Prepare a short note highlighting the factors which have prima facie led the company to sickness. [10]

Answer:

Working notes	**2012-13**	**2011-12**	**2010-11**
Sales - quantity (kgs)	43,50,890	34,36,921	37,25,405
Sales Value (₹ - Lakhs)	5,091	3,938	4,215
Average sales realization per Kg.- (₹)	117	115	113
Raw Materials, stores & spares consumed (₹- Lakhs)	3,728	2,775	2,964
Factory Wages (₹- Lakhs)	162	215	206
Material cost as a % of sales value (%)	73.2	70.5	70.3
Direct wage cost as a % of sales value (%)	3.2	5.4	4.9

Observations:

From the above figures, it is apparent that the Company's declining profitability is NOT due to market conditions as revealed by the following factors:

(a) The sales price has been marginally increasing year to year.

(b) The very small increase in material cost is also in step with the increase in sales realization.

(c) The company has been able to control direct labour cost effective.

(d) The level of production has been maintained and has in fact improved in the latest year.

(e) Inventory and book debt levels have been brought down considerably.

On the other hand, the following factors present a disturbing picture and lead to the inference that the financial management is either incompetent, or the management was diverted the borrowed working funds to some other activity or invested in unproductive assets like vehicles:

	2012-13	**2011-12**	**2010-11**
Long term borrowings	287	180	160
Working capital loans	1639	451	672
Net block	1009	541	612
Loans & advances	2641	1286	1231
Depreciation, repairs & maintenance of vehicles	109	49	54
Interest	277	130	152

The increase in working capital borrowings and the consequent interest thereon were not warranted, especially when the funds blocked in inventory and book debts have come down. The additional interest burden and additional expenses on vehicles amount to

₹207 lakhs [(277 – 130) + (66 – 16) + (43 – 33)] whereas the increase in loss as compared to the previous year is only ₹ 115 lakhs (351 – 236).

Conclusion:
(i) Prima facie, it appears that the unit has become sick due to diversion of funds by the management to other activities or for personal expenditure.
(ii) The fixed assets have doubled. But there is no profit accruing by the increased assets.

11. Das Textiles Ltd. has been having low profits. A special task force appointed for reviewing performance and prospects has the following to report:
The company has 1,200 looms working 2 shifts per day. There are 25 sections of 48 looms each. Each section has 24 weavers and a jobber. Thus there are 1,250 direct labourers, other than indirect labourers and service hands. The working time is between 7 a.m. and 12 mid-night, comprising 2 shifts of 8 hours each, with half hour interval between shifts. The production is 18 lakh metres per month and the realization is ₹3 per metre. The average wage of the direct labourer is ₹800 per month and the fixed costs amount to ₹1,75,000 per month. The product cost is ₹2.25 per metre in addition to direct wages.

The following suggestions are to be considered:
(i) Labour productivity can be improved by changing the layout of the machines.
(ii) Given the space available, with the proposed change in layout, only 1,008 looms can be re-installed, with 48 looms in each section.
(iii) Technically, a section of 48 looms can be run with 12 weavers, a helper and a jobber. It will be necessary to increase the wage of direct labour, for such sections, by ₹110 per head per month. There will be some drop in production per loom. The company is not for retrenchment of labour.
(iv) The company can run a third shift between 12 mid-night and 7 a.m., with a half hour interval. However, for the six and half hours' work, eight hours' wage will have to be paid.
(v) Only 18 lakh metres can be sold at the present price of ₹3 per metre. There is an export offer for ₹4.5 lakh metres at ₹2.70 per metre.
(vi) As an initial step, the company can switch to 3 shift working, with 12 sections having 25 direct labourers each and 9 sections having 14 direct labourers each. Progressive conversion to 14 hands per section, for all sections, can be planned, as direct labourers retire or voluntarily leave the job. The production with three shift working will be 22.5 lakh metres. Additions to fixed costs will amount to ₹50,000 per month.

Examine the implications of the proposals for the company's profits and give your advice. [10]

Answer:

Statement of Profitability

Particulars	Present	Proposed
No. of Looms	1,200	1,008
No. of shifts	2	3
No. of sections	25	21
No. of sections (with 25 hands in each section @ ₹800 p.m.)	25	12
No. of sections (with 14 hands in each section @ ₹910 per head	-	9

p.m.)		
Total number of direct labourers employed	1,250	1,278
Expected production (lakh metres p.m.)	18	22.5

Profit Statement (per month)

Particulars		Present (₹)	Proposed (₹)
Sales Revenue	(a)	54,00,000	66,15,000
Costs:			
Production Cost (@ ₹2.25 p. mt)		40,50,000	50,62,500
Direct Wages		10,00,000	10,63,980
Fixed Costs		1,75,000	2,25,000
Total Costs	(b)	52,25,000	63,51,480
Profit	(a) – (b)	1,75,000	2,63,520

With the proposed plan of action the profit of the company has increased by ₹88,520 (₹2,63,520 - ₹1,75,000). Hence, the proposal is recommended for implementation.

Working Notes:

1. No. of Sections = No. of Looms/Looms per section = $\frac{1008}{48}$ = 21 sections.
2. No. of labourers employed
   No. at present (25 persons x 25 sections x 2 shifts) = 1250 persons
   Proposed [(25 x 12 x 3) + (14 x 9 x 3)] = 1278 persons

3. Direct Wages (per month)
   Present (1,250 x ₹800) = ₹10,00,000
   Proposed [(900 x ₹800) + (378 x ₹910)] = ₹10,63,980

4. Sales revenue per month
   Present (18, 00,000 x ₹3) = ₹54,00,000
   Proposed [(18, 00,000x ₹3) + (4, 50,000 x ₹2.70)] = ₹66,15,000