Group – IV

Paper 19 – Cost and Management Audit

SECTION - A

1. (A) The Companies (Cost Accounting Records) Rules 2011 have not prescribed any specific formats for the cost statements. In what manner and format would the cost statements be kept under these Rules? (Taken from FAQ 1)

Answer:

As per sub rule (2) of Rule 4, the companies are required to maintain cost records on regular basis in such manner so as to make it possible to calculate per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly/quarterly/half-yearly/annual basis. The cost statements are to be prepared for every unit and every product produced, processed, manufactured or mined.

As per sub rule (3), the cost records are to be maintained in accordance with the generally accepted cost accounting principles and cost accounting standards issued by the Institute, to the extent these are found to be relevant and applicable.

These Rules have not prescribed any specific formats for the cost statement. A guidance note on the subject is under preparation by the Institute of Cost Accountants of India (ICAI), inter alia, containing model formats for cost records, statements, schedules etc.

(B) What does turnover mean under these Rules? Is gross turnover Inclusive of excise duty? (Taken from FAQ 4)

Answer:

As per Rule 2(p), "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 does not include any non-operational income.

The term "Turnover" defined in the Companies (Cost Accounting Records) Rules, 2011 shall exclude taxes & duties. It shall have the same meaning, wherever it appears, in all other orders/rules issued in connection with the cost accounting records and cost audit.

(C) Who can authenticate the Compliance Report as per the Companies (Cost Accounting Records) Rules 2011? (Taken from FAQ 1)

Answer:

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 the Compliance Report is to be duly approved by the Board of Directors.

A "cost accountant" within the definition of these Rules does not include:

a) A member holding a part-time certificate of practice; or
b) A member who is in full time employment whose membership fees are in arrears;

c) A member of the Institute of Cost Accountants of India (ICAI) who has been admitted as a member through reciprocal arrangement of membership by virtue of being a member of Institute of Management Accountants USA.

2. (A) Is there any ceiling on the number of Compliance Reports which can be authenticated by a practicing cost accountant or a cost accountant in permanent employment of the company? (Taken from FAQ 1)

Answer:

There is no ceiling on the number of Compliance Reports that can be authenticated by a cost accountant in whole-time practice. A cost accountant working as permanent employee can authenticate the Compliance Report of the company where he is employed provided his membership dues are not in arrears. He cannot authenticate Compliance Report of any other company even under the same group.

(B) What constitutes the cost records under Rule 2(e)? Whether the format of "Abridged Cost statement" prescribed in the Companies (Cost Audit Report) Rules, 2011 can be considered as a sample cost statement? (Taken from FAQ 1)

Answer:

Books of account and other records relating to utilization of materials, labour and other items of cost that provides data/ information to compute the cost of production, cost of sales and margin of each of the products/ activities of the company on monthly/ quarterly/ half-yearly/ annual basis are considered part of the cost records. It includes statistical, quantitative and other records which enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources. Cost records are required to be maintained on continuous basis from the basic stage of inputs to the final output.

There cannot be any exhaustive list of cost records. This would depend on the materiality of cost components in the cost of the product/activity.

The abridged cost statement can be used as a sample cost statement. This may be modified according to the need of the company.

(C) Whether product manufactured for 100% captive/ self consumption shall be covered under the Companies (Cost Accounting Records) Rules 2011? (Taken from FAQ 1)

Answer:

The test of inclusion under the Rules is whether it is a production, processing, manufacturing or mining activity resulting in a product [for definition of "product" refer to Rule 2(m)] intended for use, consumption, sale, transport, store, delivery or disposal and whether the company carrying out the activity falls within the criteria mentioned under Rule 3(1). If the company meets requirement of Rule 3(1), the activity – whether or not for captive/self consumption – will come under the ambit of these Rules.

3. (A) Will the companies subject to cost audit be also required to file Compliance Report under these Rules? (Taken from FAQ 4)

Answer:

a) If all the products/ activities of a company, excluding the exempted categories, are covered under cost audit, then the company will not be required to separately file the compliance report.

(b) If one or more product(s)/ activity(s) of a company is covered under Cost Audit and there are other products covered under Companies (Cost Accounting Records) Rules 2011 but not covered under Cost Audit as per company-wise or industry specific Cost Audit Orders dated 2nd May, 2011 and 3rd May, 2011 (amended by 30th June, 2011), the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

(c) If one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products not covered under Companies (Cost Accounting Records) Rules 2011, then the company will not be required to file a Compliance Report since the product(s)/activity(s) other than product(s)/ activity(s) under Cost Audit are in the exempted category.

(B) A company with multiple product range is having cost audit for some of its products. What would be the applicability of cost audit on other products now covered under Companies (Cost Accounting Records) Rules 2011? (Taken from FAQ 4)

Answer:

The cost audit on other products now covered under the Companies (Cost Accounting Records) Rules, 2011, will not be applicable until cost audit orders are issued for its other products/activities. However, Compliance Report is required to be submitted for the 'company as a whole' under different product groups.

If the company's remaining products belong to the exempted categories, then Companies (Cost Accounting Records) Rules 2011 will not be applicable on such exempted category products.

As discussed above, if one or more product(s)/ activity(s) of a company is covered under Cost Audit and there are other products covered under Companies (Cost Accounting Records) Rules 2011 but not covered under Cost Audit as per company-wise or industry specific Cost Audit Orders dated 2nd May, 2011 and 3rd May, 2011 (amended by 30th June, 2011), the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

Again, if one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products not covered under Companies (Cost Accounting Records) Rules 2011, then the company will not be required to file a Compliance Report since the product(s)/activity(s) other than product(s)/ activity(s) under Cost Audit are in the exempted category.

(C) Is it necessary to first prepare "unit wise" and "product/activity-wise" cost statements and then merge into product group-wise cost statement for the company as a whole? (Taken from FAQ 1)

Answer:

It is mandatory to prepare unit-wise and product/activity-wise cost statements as per the Companies (Cost Accounting Records) Rules 2011. For Compliance Certificate purposes, no cost statement is required to be submitted.

However, if any or all the products/activities of the company is also covered under Cost Audit, then for the purposes of submission of Cost Audit Report under the Companies (Cost Audit Report) Rules 2011, a consolidated cost statement for the product group(s) under cost audit is required to be prepared.

4. (A) Is it mandatory to submit Performance Appraisal Report to company management or can it be a NIL report? Can Form III relating to Performance Appraisal be modified or it has to be strictly followed as prescribed? (Taken from FAQ 2)

Answer:

Vide sub-rule 5 of Rule 4 of the Companies (Cost Audit Report) Rules, 2011, every cost auditor, who submits a cost audit report shall also furnish Performance Appraisal Report, duly authenticated by the cost auditor, to the Board/Audit Committee of the company in the prescribed format (Form III). There cannot be NIL report since list of the areas to be covered in the report as per Form III are relating to company's operations being audited by the cost auditor. However, the frequency of this report viz. half yearly/annual (or even quarterly) is to be decided by the Company Management.

The contents of the Performance Appraisal Report as given in Form III are "indicative". Depending on the nature of business and activity of the company, the management and the cost auditor in consultation with each other can add or delete the indicative areas to be covered under the Performance Appraisal Report. The intention of the law appears to assign a role to the cost auditor to provide an independent view of the performance of the company to enable the management to take corrective steps wherever necessary. The Institute is also going to bring out a Guidance Note on the subject.

(B) What is the time limit within which the central government can seek clarification from the cost auditor? (Taken from FAQ 2)

Answer:

There is no time limit within which the Central Government can seek clarification from the cost auditor. The Rules have now specified that the Company would be required to maintain the cost accounting records for the preceding eight financial years in good order. The cost auditor is required to provide reply to any clarification sought for by the Central Government from the cost auditor in writing within 30 days of the receipt of the communication addressed to him calling for such clarifications.

(C) The Information under Para 3, 4, 5 & 6 is required to be furnished for the Company as a whole. In case of companies manufacturing the same product or rendering same service at different units, should the "product group wise cost sheets" of all units be merged into one

and shown as a "cost sheet of single product group" or to be shown separately for each Unit? (Taken from FAQ 2)

Answer:

The unit-wise product-wise cost statements duly certified by the cost auditor and the management are to be kept in the Company. The "product group-wise" cost statement of all the products and all units combined together will form part of the cost audit report.

(D) For how many years, does a company under these rules require to preserve the Cost details? (Taken from FAQ 4)

Answer:

In respect of companies coming under the purview of the Companies (Cost Accounting Records) Rules, 2011 and the Companies (Cost Audit Report) Rules, 2011 for the first time, cost records and cost details, statements, schedules, etc. shall be kept in good order for the next eight financial years beginning with first year of application of the said Rules.

5. (A) What are the duties of the Company under the Cost Audit Report Rules, 2011? (Taken from FAQ 2)

Answer:

Every company as specified in sub-rule (1) shall, within ninety days of the commencement of every financial year, file an application with the Central Government seeking prior approval for appointment of the cost auditor, through electronic mode, in the prescribed form, along with the prescribed fee as per the Companies (Fees on Applications) Rules, 1999, and requisite enclosures. However, where a company is covered under cost audit for the first time vide cost audit order dated 30th June 2011, the period of 90 days shall be counted from the date of this order.

Every company shall follow the procedure prescribed vide Ministry of Corporate Affairs' General Circular No. 15/2011 [File No. 52/5/CAB-2011] dated April 11, 2011.

The company and every officer thereof, including the persons referred to in sub-section (6) of section 209 of the Companies Act, 1956 shall make available to the cost auditor, such cost accounting records, cost statements, other books and documents, and Annexure to the Report, duly completed, as would be required for conducting the cost audit, and shall render necessary assistance to the cost auditor so as to enable him to complete the cost audit and submit his report within the time limit specified in rule 5, i.e., within 180 days from the close of the Company's financial year to which the report relates.

The Annexure prescribed with the cost audit report shall be approved by the Board of Directors before submitting the same to the Central Government by the cost auditor.

(B) 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. Whether cost audit will become

applicable to the company even when its turnover is less than ₹100 crore? If yes, then from which financial year will cost audit become applicable? (Taken from FAQ 2)

Answer:

In the instant 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, 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.

(C) A newly constructed cement factory will be operational from end June 2011. The projected turnover for the next 2 years is ₹500 crores per annum. Whether in coming years, the company will have to get cost audit done. If yes, then under which cost audit order number. (Taken from FAQ 2)

Answer:

The company will come into commercial production in 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 financial year 2011-12. In case the first year turnover is less that ₹100 crores but the company is a listed company or is in the process of getting listed, then also cost audit will be applicable from 2011-12. If both these criteria are not met during the first year of operation, the cost audit will be applicable from 2012-13.

The cost audit will have to be conducted under cost audit order No. 52/26/CAB-2010 dated 3rd May 2011 modified vide Order dated 30th June 2011.

(D) A company has 2 wind mills. Turnover from the two wind mills is ₹2 crores. The company's total turnover is more than ₹100 crores. None of the products of the company is covered under cost audit at present. Whether, the company will need to get cost audit done of electricity generation activities under Cost Audit Order 52/26/CAB-2010 dated 02.05.2011? (Taken from FAQ 4)

Answer:

Applicability of cost audit is based on turnover of the total company. Hence, any activity of a company, irrespective of the turnover of the particular activity, would be covered under cost audit if that particular activity is one of the activities listed in the cost audit order Nos. 52/26/CAB-2010 dated 2nd May 2011 or 52/26/CAB-2010 dated 3rd May 2011 (modified vide Order dated 30th June 2011).

If the power generated by the 2 wind mills is sold outside but the total turnover from the sale does not exceed 2% of the total turnover of the company or ₹20 crores, whichever is lower, then the power generation would be considered as an ancillary activity of the company incidental to its main operations (i.e. products/activities that do not constitute their main line of business) and the Cost Accounting Records (Electricity Industry) Rules 2001 will not be applicable. Consequently, the company will not be required to get cost audit conducted for the electricity activity in this case.

If the power generated by the 2 wind mills is captively consumed by the company, then Cost Audit Order No. 52/26/CAB-2010 dated 2nd May 2011 will not apply. [Please refer General Circular No. 67/2011 dated 30th November 2011]. For this purpose, the term "Captive Generating Plant" shall have the same meaning as assigned in Rule 3 of the Electricity Rules, 2005, which is annexed hereto.

6. (A) A company has one 1500 KVA captive Power Plant. Turnover of the company is more than ₹100 crores.

a) Whether Cost Accounting Records (Electricity Industry) Rules, 2001 shall be applicable to the company.

b) Whether cost audit is to be conducted for electricity activities under Cost Audit Order 52/26/CAB-2010 dated 2nd May 2011:

i) When the company is using the entire generated power for captive consumption;

ii) When the company is consuming part of the generated power for captive consumption and part is sold outside. (Taken from FAQ 4)

Answer:

(a) In the instant case, the Cost Accounting Records (Electricity Industry) Rules, 2001 is applicable to the company for its captive power plant and the cost of generation determined is to be considered for captive consumption of power.

b) Whether or not cost audit would be required to be conducted in case the entire generated power is used for captive consumption and where part is sold would be governed by definition of "captive generating plant" as defined in Rule 3 of Electricity Rules 2005, which has been explained in question no. 5(D) above.

(B) Whether a cost auditor can be appointed as Internal Auditor of the company. Whether there is any restriction on the cost auditor to accept assignments from a company where he is the cost auditor? (Taken from FAQ 5)

Answer:

Refer to MCA General Circular No. 68/2011 dated 30th November 2011.

A cost auditor cannot render any services to the company whether acting individually, or through the same firm or through other group firms where he or any partner has any common interest, relating to:

(i) design and implementation of cost accounting system; or

(ii) the maintenance of cost accounting records, or

(iii) act as internal auditor,

However, a cost auditor can certify the compliance report or provide any other services as may be assigned by the company, excluding the services mentioned above.

(C) 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? (Taken from FAQ 5)

Answer:

Refer to MCA Master Circular No. 2/2011 dated 11th November 2011.

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 the 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 that the term "auditors" includes cost auditor and hence "scope of audit including observations of the auditors" occurring. In the above sub-section includes the scope of cost audit including observations of the cost auditors as well. The presence of the cost auditor in such committees will 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 the 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 the Board of Directors is required to approve the Annexure to the Cost Audit Report and authorize by 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.

(D) Companies covered under any of the 6 Industry/Product Specific Cost Accounting Records Rules 2011 are also subject to cost audit. Will they be required to file Compliance Report also under these Rules? (Taken from FAQ 5)

Answer:

If one or more product(s)/activity(s) of a company is covered under cost audit and there are other products that are not covered under Cost Audit as per company-wise cost audit orders issued in the past or industry specific cost audit orders dated 2nd May, 2011 and 30th June, 2011, the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

If one or more product(s)/activity(s) of a company is covered under Cost Audit and the other product(s)/activity(s) belong to the exempted category, then the company will not be required to file a Compliance Report.

7. (A) The manufacturing process of a company generates Steel Scrap during production of its main products which may or may not be covered under cost audit. Such scrap is cleared under Chapter 72 of the Central Excise Tariff and sold in the market. Will the company be covered under cost audit for generation of scrap? (Taken from FAQ 5)

Answer:

The company is engaged in manufacture of products and coverage of its main products under cost audit would depend on whether or not such products are covered under company specific cost audit orders issued in the past or industry specific cost audit orders dated 2nd May 2011 or 30th June 2011.

The generation of steel scrap is not a production or processing or manufacturing but is incidental to manufacture of its main products. Even though steel scrap, when sold, is liable for payment of excise duty under Chapter 72, still, generation of scrap will not be covered under cost audit.

(B) 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? (Taken from FAQ 5)

Answer:

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.

(C) A Company having turnover above ₹100 crore undertakes works contracts for pipe line execution for Drinking, Sewerage and Irrigation purpose. The required pipes for the projects, falling under Chapter 68 of CETA, are manufactured by the Company itself. A part of the production is also sold outside. Whether Cost Audit is applicable for Pipe manufacture? (Taken from FAQ 5)

Answer:

Applicability of cost audit is based on turnover of the total company. Any activity of a company, irrespective of the turnover of the particular activity, would be covered under cost audit if that particular activity is one of the activities listed in the cost audit order Nos. 52/26/CAB-2010 dated 2nd May 2011 or 30th June 2011.

Whether the company under reference will attract cost audit for its pipe manufacturing activity will now depend on whether the captive consumption is made for a product which is under cost audit. In this case it is not so and the pipe manufacturing will attract cost audit under this test.

However, if the production of pipes is an ancillary activity as defined in MCA General Circular No. 67/2011 dated 30th November 2011, then pipe manufacturing would be outside purview of cost audit.

(D) A company is engaged in construction of Roads, Bridges, Marine facilities etc. having sites in India and abroad. The company also has Joint venture projects in India and abroad. Whether Companies (Cost Accounting Records) Rules 2011 would be applicable to the company? (Taken from FAQ 5)

Answer:

As per the provisions of MCA General Circular No. 67/2011 dated 30th November 2011, all companies engaged in the construction business either as contractors or as sub-contractors, who meet with the threshold limits laid down in Rule 3 of the Companies (Cost Accounting Records) Rules, 2011 and undertake jobs with the use of own materials [whether self-manufactured/produced or procured from outside] shall be required to maintain cost records and file a compliance report with the Central Government in accordance with the provisions of the Companies (Cost Accounting Records) Rules, 2011. This includes companies engaged in the construction and/or development of residential, commercial or industrial estates i.e. development of township, residential units, commercial complex, office blocks, industrial parks [including SEZ] etc. or construction of highways, rails, roads, bridges, industrial & non-industrial structures, or other infrastructure facilities etc.

The provisions of Companies (Cost Accounting Records) Rules, 2011 would also apply for construction activities undertaken under BOT/BOOT mode, or the projects undertaken as EPC contractor or the projects undertaken abroad by a company incorporated in India.

However, if a company is engaged in the contracting or sub-contracting activities and is paid only the job work or conversion charges, then the company will not be covered under Companies (Cost Accounting Records) Rules, 2011. Such contractors or sub-contractors who are doing construction jobs without using own materials and are thus paid either the job work charges or the conversion charges only will not be covered under the Companies (Cost Accounting Records) Rules, 2011.

These Rules also do not apply to such Joint Ventures that are non-corporate entities [i.e. not companies registered under the Companies Act] or to unlisted companies having net worth less than ₹5 crore & turnover less than ₹20 crore or to a body corporate governed by any special Act.

8. (A) Whether Ready Made Garments and textile articles like sewing thread are covered under Cost Audit? (Taken from FAQ 6)

Answer:

All products including intermediate products and articles or allied products of the industries covered under cost audit orders dated 2nd May 2011, 30th June 2011 and 24th January 2012 are covered under cost audit. Products falling under Chapter references mentioned in the orders are to be considered against the respective industry as applicable.

(B) Whether automotive parts used in 4 wheeled Motor Vehicles are covered or all automotive components including automotive parts for 2/3 wheelers are also covered under the cost audit? (Taken from FAQ 6)

Answer:

Motor Vehicle is a mechanically propelled vehicle adapted for use upon roads and includes a chassis to which a body has not been attached and a trailer. Therefore, motor vehicles includes 2 or more wheelers and components for all such motor vehicles are covered under cost audit. Automotive Components falling under Chapters 84, 85 & 87 used for motor vehicles are covered under cost audit.

(C) Whether film industry like film producing companies/studios registered under Indian Companies Act covered under Companies (Cost Accounting Records) Rules, 2011? (Taken from FAQ 6)

Answer:

Companies (Cost Accounting Records) Rules, 2011 is applicable to developing, fixing, and washing exposed photographic or cinematographic film or paper to produce either a negative image or a positive image. In case a film producing company is also engaged in these activities, the same would be covered.

(D) Whether readymade garment manufacturing companies exporting garments to overseas countries are covered under CARR and cost audit? (Taken from FAQ 6)

Answer:

Readymade garment manufacturing company meeting the threshold limit will be covered under the Companies (Cost Accounting Records) Rules 2011 and are required to maintain cost accounting records. The company would also be covered under cost audit as per cost audit order dated 24th January 2012 provided it is not a 100% EOU that have been exempted from cost audit only as per MCA General Circular No. 67/2011 dated 30th November 2011. In case the company is exempted from cost audit, the company will be required to file a Compliance Report.

9. (A) A Company is manufacturing Asbestos sheets and using less than 50% of cement as an input. The product is covered under Chapter 25 of the Central Excise Tariff Act, 1985. Is Cost Audit applicable to Asbestos sheets? (Taken from FAQ 6)

Answer:

As per MCA General Circular No. 67/2011 dated 30th November 2011 the words "articles or allied products thereof" refer to such articles or allied products that are produced either wholly or predominantly [not less than 50% by weight or volume] by using the listed products as their primary inputs. In this case, Cement is the product under cost audit which is used as an input. Since Asbestos contains less than 50% of Cement, it will not be covered under cost audit as an allied product of Cement.

(B) A Company is manufacturing Cast Iron Casting and SG Iron Castings in foundry unit which are cleared under Chapter 73 of Central Excise Tariff Act 1985. The products are treated as Iron articles and not steel articles. The predominant input for the manufacture of the same is MS Scrap, Pig Iron. Whether covered for Cost Audit under order dated 30/06/2011? (Taken from FAQ 6)

Answer:

Steel Industry referred to in cost audit order dated 30th June 2011 includes iron, pig iron, sponge iron etc. Since Cast Iron and SG Castings are iron/steel products and is cleared under Chapter 73 of Central Excise Tariff Act 1985, the same would be covered under cost audit.

(C) An Automotive Industry is manufacturing multiple products like rear-view mirror, aluminum panels etc. for motor vehicles. The finished products of the Company are covered under Chapters 70, 72, 76, 84, 85 and 87 of Central Excise Tariff Act 1985 (CETA). The inputs are glass, steel, aluminum etc. which are covered under cost audit. Whether the automotive components manufactured by the Company would be treated as products of glass, steel or aluminum, as the case may be or will the components be treated as Automotive Components and covered under cost audit order dated 24th January 2012? (Taken from FAQ 6)

Answer:

As per the cost audit order dated 24th January 2012, all automotive components, irrespective of the input material and/or the CETA Chapter under which it is cleared, are classified as automotive components and covered under cost audit from the financial year commencing on or after 1st April 2012.

10. (a) How would you treat Self manufactured packing material as per CAS 9 related to Packing Material Cost?

Answer:
Self manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.

(b) How would you compute cost of utilities generated for the purpose of inter unit transfers as per CAS 8?

Answer:
Cost of utilities generated for the purpose of inter unit transfers shall comprise of direct material cost, direct employee cost, direct expenses, factory overheads and the distribution cost incurred for such transfers.

(c) How would you treat repairs and maintenance costs not traceable to a cost object as per CAS 12?

Answer:
Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following two principles:
(i) Cause and effect- Cause is the process or operation or activity and effect is the incurrence of cost.
(ii) Benefits received-Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

(d) How will you treat an item of Direct Expenses that does not meet the test of materiality as per CAS 10?

Answer:

If an item of Direct Expenses does not meet the test of materiality, it can be treated as part of overheads.

11. (a) How would you treat Separation cost due to voluntary retirement, retrenchment, termination etc. as per CAS 7 related to Employee Cost?

Answer:

The separation costs related to voluntary retirement, retrenchment termination etc shall be amortized over the period benefitting from such costs. The amortized separation costs for the period shall be treated as indirect cost and assigned to cost objects in an appropriate manner.

However unamortized amount related to discontinued operations shall not be treated as employee cost.

(b) What is 'equalised transportation cost' under CAS 5?

Answer:

The term 'equalised transportation cost' has been defined as average transportation cost incurred during a specified period. The standard requires the detailed record to be maintained w.r.t collection, allocation, and apportionment of transportation cost.

(c) How would you determine the cost of material consumed in production for captive consumption as per CAS 4?

Answer:

Material Consumed shall include materials directly identified for production of goods such as:

(i) indigenous materials
(ii) imported materials
(iii) bought out items
(iv) self manufactured items
(v) process materials and other items

Cost of material consumed shall consist of cost of material, duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement. Trade discount, rebates and other similar items will be deducted for determining the cost of materials. Cenvat credit, credit for countervailing customs duty, Sales Tax set off, VAT, duty draw back and other similar duties subsequently recovered/ recoverable by the enterprise shall also be deducted.

(d) What are the principles of measuring 'overheads' as per CAS 3?

Answer:

Principles of measuring 'overheads' are as follows:

(i) Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited.
(ii) Overheads other than those referred to in (i) shall be determined on the basis of cost incurred in connection therewith.
For example, machinery spare fabricated internally or a repair job carried out internally will include cost incurred on material, employees and expenses.
(iii) Any abnormal cost where it is material and quantifiable shall not form part of the overheads.
(iv) Finance costs incurred in connection with procured or self generated resources shall not form part of overheads.
(v) Overheads shall not include imputed cost.
(vi) Overhead variances attributable to normal reasons shall be treated as part of overheads. Overhead variances attributable to abnormal reasons shall be excluded from overheads.
(vii) Any subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.
(viii) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the overheads.
ix) Credits / recoveries relating to the overheads, material and quantifiable, shall be deducted from the total overhead to arrive at the net overheads. Where the recovery exceeds the total overheads, the balance recovery shall be treated as other income.
(x) Any change in the cost accounting principles applied for the measurement of the overheads shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an entity.

12. (a) What do you understand by the term 'collection of overheads' as per CAS 3?

Answer:

Collection of overheads means the pooling of indirect items of expenses from books of account and supportive/ corroborative records in logical groups having regards to their nature and purpose.
Overheads are collected on the basis of pre-planned groupings, called cost pools. Homogeneity of the cost components in respect of their behaviour and character is to be considered in developing the cost pool. Variable and fixed overheads should be collected in separate cost pools under a cost centre. A great degree of homogeneity in the cost pools are to be maintained to make the apportionment of overheads more rational and scientific. A cost pool for maintenance expenses will help in apportioning them to different cost centres which use the maintenance service.

(b) What is the value of Goods used for captive consumption as per CAS 4?

Answer:

According to the Central Excise Valuation (Determination of Price of Excisable Goods) Rules 2000, the assessable value of goods used for captive consumption is 110% w.e.f. 05-08-2003 of cost of production of such goods, and as may be prescribed by the Government from time to time.

(c) What do you understand by the term 'service cost centre' as per CAS 13?

Answer:

The cost centre which provides services to Production, Operation or other Service Cost Centre but not directly engaged in manufacturing process or operation is a service cost centre. A service cost centre renders services to other cost centres / other units and in some cases to outside parties.
Examples of service cost centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, welfare services, safety, transport, Component, Tool stores, Pollution Control, Computer Cell, dispensary, school, crèche, township, Security etc.

(d) How are 'inward' and 'outward' transportation cost treated as per CAS 5?

Answer:

Inward transportation costs shall form the part of the cost of procurement of materials which are to be identified for proper allocation/ apportionment to the materials / products.
Outward transportation cost shall form the part of the cost of sale and shall be allocated / apportioned to the materials and goods on a suitable basis.
Explanation:
Outward transportation cost of a product from factory to depot or any location of sale shall be included in the cost of sale of the goods available for sale.

13. (a) How would you treat the forex component of imported packing material as per CAS 9?

Answer:

The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.

(b) How would you treat overtime premium as per CAS 7 related to Employee Cost?

Answer:

Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and specific circumstances requiring such overtime.

(C) How would you assign administrative overheads as per CAS 11?

Answer:
Assignment of administrative overheads to the cost objects shall be based on either of the following two principles:
(i) *Cause and Effect* – Cause is the process or operation or activity and effect is the incurrence of cost.
(ii) *Benefits received*– Overheads are to be apportioned to various cost objects in proportion to the benefits received by them.
The costs of shared services should be assigned to user activities on the basis of actual usage. General management costs should be assigned on rational basis.

(D) How would you determine the cost of utilities generated for inter company transfers as per CAS 8?

Answer:
Cost of Utilities generated for the inter company transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.

14. (A) "Risk of material misstatement at the assertion level consists of two components" – explain.

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.

(B) What are the objectives and functions of the Cost Audit and Assurance Standards?

Answer:

The following are the objectives and functions of the Cost Audit and Assurance Standards Board:

a) To identify areas in which Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services need to be developed.

b) To develop Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services so that they may be issued under the authority of the Council of the Institute.

c) To develop Guidance Notes on issues arising out of any Standard or on auditing issues pertaining to any specific industry or on generic issues so that they may be issued under the authority of the Council of the Institute.

d) To formulate and issue Technical Guides, Practice Manuals and other Papers under its own authority for guidance of Cost Accountants in the cases felt appropriate by the Board.

e) To review the existing Standards, Guidance Notes, Technical Guides, Practice Manuals and other Papers to assess their relevance in the changed conditions and to undertake their revision, if necessary.

f) To provide Interpretations or formulate General Clarifications, where necessary, on issues arising from the Standards.

15. (A) Explain the statement with the help of Cost Audit and Assurance Standard (CAAS) – 101 "Cost Auditor includes audit partner"

Answer:

As per CAAS - 101 "Audit partner" means the partner or other person in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

(B) What are the matters that are relevant in formulating audit strategy and drawing up the audit plan?

Answer:

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

a. The cost reporting framework generally prescribed by the Cost Audit Report Rules on which the cost information to be audited has been prepared, including need for reconciliation with financial reporting framework.
b. The specific requirements of industry specific cost accounting record rules.
c. Industry regulators' requirement as to how costs will be handled.
d. Unique features of an industry that influence audit requirements e.g. definition of product in the newspaper industry.
e. Reliance that can be placed on the work of financial auditors, other cost auditors appointed by the entity and internal auditors for example their attendance in annual stocktaking
f. State of IT implementation, whether the entity is using an ERP system or internally developed systems and the reliance that can be placed on them.
g. Statutory timelines for cost reporting which can be modified by managements for early completion.
h. Timelines for Board/ audit committee meetings which can set the time limits for completion of audit work.
i. Resources required and available in terms of manpower, equipment and others and the assignment of these to specific parts of the work.

(C) Mr. Jalan, a practicing cost accountant, doing Cost Audit of M/s. ABC Ltd since last three years. During the year M/s. ABC Ltd requested him to develop his Cost Accounting System. Can Mr. Jalan accept the proposal and do Cost Audit & system development for the same period. Suggest

Answer:

Refer to MCA General Circular No. 68/2011 dated 30th November 2011.

A cost auditor cannot render any services to the company whether acting individually, or through the same firm or through other group firms where he or any partner has any common interest, relating to:

(i) design and implementation of cost accounting system; or

(ii) the maintenance of cost accounting records, or

(iii) act as internal auditor,

However, a cost auditor can certify the compliance report or provide any other services as may be assigned by the company, excluding the services mentioned above.

(D) While doing Cost Audit, the Cost Auditor should hold professional skepticism. Explain

Answer:

As per Cost Audit and Assurance Standard on Overall Objectives of the Independent Cost Auditor and Conduct of an audit in Accordance with Standards on Auditing (CAAS) – 103, an attitude of professional skepticism means the cost auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and be alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. An attitude of professionalism is necessary throughout the cost audit process for the auditor to reduce the risk of overlooking unusual circumstances, of over generalizing when drawing conclusions from cost audit observations, and of using faulty assumptions in determining the nature, timing and extent of the cost audit procedures and evaluating the results thereof. When making inquiries and performing other cost audit procedures, the cost auditor is not satisfied with less – than - persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the cost auditor's opinion.

16. (A) What is the Qualification of Cost Auditors?

Answer:

Qualification of Cost Auditors:

Section 233(B) of the Companies Act, 1956 provides that the Central Government may, if it considers necessary, direct that the audit of cost accounts kept by a company for a specified product or activity under Section 209(1)(d) shall be conducted by an auditor who shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959. In other words, the Sec. 233B(1), in so far as it relates to qualifications of cost auditor provides that a person holding certificate of practice from the Institute of Cost Accountants of India only can be appointed as a cost auditor. The cost auditor may be an individual cost accountant or a firm of cost accountants with at least two partners. A firm of cost accountants can be constituted with the previous approval of the Central Government/Institute as required under the regulation 113 of the Cost and Works Accountants Act, 1959 as amended from time to time and in which all the partners are cost accountants holding certificate of practice issued by the Institute of Cost Accountants of India. Section 224 (1-B) of the Companies Act, 1956 further provides that a person can be appointed as a cost auditor only if he is not in full time employment elsewhere.

A proviso to Section 233B(1) lays down that if the Central Government is of opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act, 1959 are not available for conducting the audit of the cost accounts of companies generally, the Government may, by notification in the Official Gazette, direct that, for such period as may be specified in the said notification, such Chartered Accountant within the meaning of the Chartered Accountants Act, 1949, as possesses the prescribed qualifications, may also conduct the audit of the cost accounts of companies. It may be clarified here that the Central Government has not so far issued any notification under the above proviso.

However, it is only in the background of the aforesaid proviso that Section 233B (5)(b) provides that a person appointed under Section 224 as an auditor of the company (financial auditor) shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company (cost auditor of the same company).

(B) Explain Disqualification of Cost Auditors.

Disqualifications of a Cost Auditor

The disqualifications of a person for being appointed or re-appointed for conducting the cost audit are detailed in sub-Sections (a), (b) and (c) Section 233 (5) of the Companies Act, 1956 detailed as under:

(a) The sub-Section (5)(a) provides that a person referred to in sub-Section (3) or sub-Section (4) of the Section 226 shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company.

(b) The sub-Section 5(b) provides that a person appointed under Section 224 as an auditor of a company shall not be appointed or re-appointed for conducting the audit of the cost accounts of that company.

(c) The sub-Section (5)(c) provides that if a person, appointed for conducting the audit of cost accounts of a company, becomes after his appointment, to any of the disqualifications specified in clause 5(a) or 5(b) above, he shall on and from the date on which he becomes disqualified, shall cease to conduct the audit of the cost accounts of the company.

Section 226 of the Companies Act, 1956 provides for the qualifications and disqualifications of the auditors. Reading of sub-Section (3) of Section 226 implies that the following persons cannot be appointed or reappointed as cost auditor of a company –

(a) a body corporate;

(b) an officer or employee of the company;

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

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

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

The sub-Section (4) of Section 226 provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-Section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company. In other words, if a person is disqualified under any of the aforesaid classes from being appointed as an auditor of any company or body corporate, he cannot be appointed as auditor of its holding company, subsidiary or 'co-subsidiary'; and

A person, who is in full time employment elsewhere [Section 224(1B)]. If an auditor becomes disqualified after his appointment, under any of the above provisions he shall be deemed to have vacated his office.

17. (A) Who can be appointed as a cost auditor?

Answer:

A Cost Accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under sub-section (1) of section 6 of that Act and including a Firm of Cost Accountants can be appointed by a Company as cost auditor. However, the cost accountant or partners of a firm of cost accountant should be in whole-time practice and not holding any other employment.

(B) Who is competent authority in companies to appoint cost auditor?

Answer:

As per provisions of section 233B(2), the Board of Directors of a Company can appoint a cost auditor after obtaining prior approval of the Central Government.

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

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

(C) Is a cost auditor required to give any certificate in respect to his independence and arm's length relationship with the appointing company? (Taken from FAQ 1A)

Answer:

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

18. (A) How many cost audits can be allotted in the name of one practicing cost accountant? (Taken from FAQ 1A)

Answer:

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.

(B) What will happen if Central Government doesn't give its approval within 30 days of submission/ re-submission of the application? (Taken from FAQ 1A)

Answer:

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

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

(C) What is the obligation of the cost auditor after receipt of formal appointment letter? (Taken from FAQ 1A)

Answer:

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

Click here to download e-Form 23 D:

ht tp://www.mca.gov.in/MCA21/dca/downloadeforms/eformTemplates/1101-Form23D.zip

Click here to download instruction for filling up Form 23D:

http://www.mca.gov.in/MCA21/dca/downloadeforms/eformTemplates/1101-Form23D_help.zip

(D) What disclosures are required to be made by a Company in respect of cost audit in its Annual Report? (Taken from FAQ 1A)

Answer:

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

Since the cost audit report of a particular financial year may not have been submitted before publication of the Annual Report, relevant details of due and actual date of filing for the last financial year and the due date of filing for the current year may be published in the Annual Report.

(E) What are the penal provisions for non-compliance of any of the provisions of the Act regarding cost audit? (Taken from FAQ 1A)

Answer:

Non compliance by Companies

If a Company contravenes any provision of this circular, the company and every officer thereof who is in default, including the persons referred to in sub-section (6) of Section 209 of the Act shall be punishable as provided under sub-section (2) of Section 642 read with sub-section (5) and (7) of Section 209 and sub-section (11) of Section 233B of Companies Act, 1956.

Relevant provisions of Section 209 of the Companies Act, 1956 are as follows:

Sub- section (5) of Section 209 provides that if any of the persons referred to in sub-section (6) fails to take all reasonable steps to secure compliance by the company with the requirements of this section, or has by his own willful act been the cause of any default by the company thereunder, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both:

Provided that in any proceedings against a person in respect of an offence under this section consisting of a failure to take reasonable steps to secure compliance by the company with the requirements of this section, it shall be a defense to prove that a competent and reliable person was charged with the duty of seeking that those requirements were complied with and was in a position to discharge that duty:

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed willfully. Sub- section (6) of Section 209 provides that the persons referred to in sub-section (5) are the following, namely:—

where the company has a managing director or manager, such managing director or manager and all officers and other employees of the company; and

where the company has neither a managing director nor manager, every director of the company;

Sub- section (7) of Section 209 provides that if any person, not being a person referred to in sub-section (6), having been charged by the managing director, manager or Board of directors, as the case may be, with the duty of seeing that the requirements of this section are complied with makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which my extend to six months, or with fine which may extend to ten thousand rupees, or with both.

Relevant provision of Section 642 of the Companies Act 1956 is as under:

Sub-section (2) of Section 642 provides that any rule made under sub-section (1) may provide that a contravention thereof shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first during which such contravention continues.

Non compliance by Cost Auditor

If default is made by the cost auditor in complying with the aforesaid provisions, he shall be punishable with fine, which may extend to five thousand rupees.

SECTION - B

19. (A) What are the features of a good Internal Control System?

Answer:

A good Internal Control System should possess the following features -

i. Proper Organisation Structure:
   (a) A good Internal Control System should involve segregation of duties in such a manner that error or fraud cannot take place.
   (b) Proper division of duties, with respect to access to assets, authorisation of transactions, execution of transactions and record keeping should be based on the organisation structure.
ii. Scheme of authorisation and procedures: A good Internal Control System should define proper authorizations and procedures. *The* scheme of authorisation should ensure that -
   (a) Every transaction is duly authorised by the competent official,
   (b) Every transaction is properly accounted in the books, and

(c) Supervisory procedures are laid down based on the responsibilities of each official.

iii. Internal Check:

(a) Accounting Procedures should be designed in such a manner that no single person is authorised to carry out all the operations involved in a transaction.

(b) The system should institute a prompt and independent verification of an individual's work by prescribing cross-checks and cross-reconciliations as a part of the operating procedure itself and also provide for complimentary allocation of duties.

iv. Suitable Personnel:

(a) Competent and honest persons alone should be employed in the organisation so that the system operates effectively.

(b) The qualification, experience and personal characteristics of the personnel involved arc important in establishing and maintaining a system of Internal Control.

v. Internal Audit System:

(a) The Management may establish an Internal Audit Department and delegate some of its supervisory functions like review of Internal Control.

(b) Internal Audit constitutes a separate component of Internal Control System undertaken by specially assigned staff with the objective of determining whether Internal Controls are well designed and operating properly.

(B) What is the role of Management with regard to Internal Control?

The responsibility of Management with regard to Internal Control can be summarized as under -

i. Creation of system: Management is responsible for maintaining an adequate accounting system incorporating various Internal Controls to the extent appropriate to the size and nature of the business. The Management is vested with the responsibility of carrying on the business, safeguarding its assets and recording the transactions in the books of account and other records.

ii. Review of System: The system installed should be reviewed by the Management to ascertain whether -

(a) The prescribed Management policies are being properly interpreted by the employees and are faithfully implemented,

(b) The prescribed procedures need a revision due to changed circumstances or whether they have become obsolete or cumbersome, and

(c) Effective corrective measures are taken promptly when the system appears to break down.

iii. Internal Audit: It is desirable that the Management also installs an Internal Audit System as an independent function to check, amongst other things, the actual operation of the Internal Control System and report any deviations or non-compliances.

20. (A) Outline the Internal Control aspects in relation to Fixed Assets.

Answer:

(a) Authorisation for Capital Expenditure: Expenditure for purchase or in-house construction of fixed asset should be authorised by responsible officials. It should be evidenced by way of Board Resolution, Budget Sanction, Notes in the Asset File, etc.

(b) Accounting for Assets: Fixed Assets purchased should be properly accounted for by making suitable entries in the Fixed Assets Register and also the General Ledger. While recording cost, revenue-capital distinction should be observed.

(c) Ownership Rights: Documents evidencing the ownership e.g. Title deeds of properties, RC Book for vehicles etc. should be in the custody of responsible officials. A tracking register may be used in case of deposit of ownership documents with Bankers / Lenders.

(d) Asset Registers: Arrangements should be made for maintaining Plant and Property Registers. They should be frequently agreed with the relevant accounts and physically verified. Care should be taken to distinguish between Fixed Assets and Current Assets (e.g. A Company engaged in manufacturing and selling vehicles, may have vehicles as part of Fixed and Current Assets).

(e) Physical Verification: Arrangements should be made to ensure that Fixed Assets are properly maintained and applied in the service of the Company (e.g. by periodic physical checks as to their location, operation and condition).

(f) Asset Transfers: Where Fixed Assets are transferred between branches or members of the same group, guidelines should be laid down in respect of pricing, depreciation and accounting.

(g) Sale, Scrapping of Assets: Sale, scrapping or transfer of Fixed Assets should be properly authorised and evidenced. Receipts from such disposals should be controlled and properly dealt with in the accounts.

(h) Safeguarding: Adequate insurance cover should be made available for all relevant Fixed Assets.

(i) Depreciation: The accounting policy of the Company should specify the method and rate of depreciation. It should be properly authorised and evidenced. Responsible persons should carry out the calculation of depreciation and asset values.

(B) What are the internal control aspects relating to Investments?

(a) Dealings in Investments: Responsible persons should authorise purchases and sales of investments. These are to be evidenced by proper documents. Those responsible for authorisation should not be in-charge of cash or the custody of documents of title.

(b) Investment Register: A detailed investment register should be maintained and all dealings in investments should be immediately recorded therein. This register should be periodically agreed with the investment control account. Documents of title should be physically verified.

(c) Accounting for accretions: Arrangements should be made for checking contract notes against authorised purchase or sales instructions to ensure that charges are correctly calculated. Share transfer formalities should be initiated to ensure that share certificates are duly received or delivered. Bonuses, Rights, Capital Repayments and Dividends or Interests received should be properly accounted for.

(d) Custody: Property documents, share certificates and other documents of title should be under the authority and control of atleast two responsible persons, with the object of protecting them against loss and irregularities. Access to or withdrawals of such documents should be permitted only on the authority of such persons acting jointly.

21. (A) What are the objectives of Management Audit?

Answer:

Management audit is carried out to –

a. appraise the management performance at all the levels;

b. spotlight the decision or activities, that are not in conformity with organizational objectives.

c. ascertain that objectives are properly understood at all levels;

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

e. evaluate plans which are projected to meet objectives.

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

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

(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.

(B) What are the pre-condition for initiating Management Audit?

Answer:

Pre -conditions for Management Audit

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

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

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

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

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

(C) What aspects should know by the Management Auditor before commencing Audit?

Answer:

Different aspects should know by the Management Auditor before commencing his Audit

i. Aims or Purpose for which the organization has been created. Profit motive should be properly balanced with said objects like creation of employment opportunities, development of backward areas, etc.
ii. Management Structure including delegation of authority, planning and budgeting.
iii. Internal Control, system of work, methods and procedures together with authority & sanction procedures,
iv. MIS Reports, decision -making process, reports required for proper Management and the reports actually received.
v. Personnel Policy and Personnel Management including requirements, training, welfare incentives and disincentives.
vi. Purchase Aspects like Materials Management including sources of important Raw Materials, receipt of materials of the required quality and quantity, storage, supervision and safe custody, insurance and procedure for issue of materials.
vii. Production Aspects, e.g. nature of production technology, production planning, factory layout, design and installed capacity.
viii. Sales Aspects, e.g. Sales Management and Sales Planning, including advertisement policy.
ix. Accounts and Finance matters, Financial Management of the organization, books and records including Cast Accounting Records, Cost Accounting System and financial accounting policies.

22. (A) Bring out the need for Management Audit.

Answer:

Need for Management Audit -

The importance for Management Audit may be understood from the following points -

i. Management Index: Management Audit serves as a tool to improve Management performance. It recognizes facts and information about Management, presented after an appropriate examination, verification and evaluation, by professionally qualified and competent people.

ii. Efficiency Analysis: Management Audit focuses on a comprehensive and constructive examination of the organizational structure, its components i.e. divisions, departments, ventures, plans, policies, its financial control system, its method of operation, its appropriate use of human, physical and financial resources.

iii. Detecting Managerial Deficiencies: Management Audit is required for detecting and overcoming current managerial deficiencies (and resulting operational problems) in ongoing operations. If certain Managers are ineffective in their present positions, appropriate corrective action should be taken.

iv. Forward Looking: Management Audit represents a positive, forward-looking approach that evaluates -
   (a) how well Management accomplishes its stated organizational objectives,
   (b) how effective Management is in planning, organizing, directing, and controlling the organisation's activities, and
   (c) how appropriate Management's decisions are for reaching the stated organisation objectives.

v. System Flow: A Management Audit Questionnaire helps to evaluate managerial performance. This questionnaire helps in understanding the flow of systems, procedures and method of work within the organisation.

vi. Current Control and Pre-control: Managerial problems and related operational difficulties can be spotted immediately in Management Audit, unlike a Financial Audit. Periodic Management Audits pinpoint problems as they develop from a small scale.

vii. Business Re-Engineering: Management Audit helps ailing industries to identify their problems & overcome them. Management Audit is more relevant in the case of Industries which face problems like - (a) High volume of Stocks and Stores, (b) Machine Breakdowns, (c) Operational Failures, and (d) Under-utilisation of capacities, etc.

(B) Explain the Scope of Management Audit.

Answer:

Scope of Management Audit

i. Objectives: The Auditor should reach to the root of Management efficiency. This consists of the functions of Top Management, which lay down objectives and policies, provide means and procedures of implementation and control and which actually engage in direction and control on a continuous basis.

ii. Effectiveness: Management Audit encompasses the relevance and effectiveness of the aims, duties, and decisions Management at various levels.

iii. Efficiency: The Management Auditor should review the efficiency in Management decisions and functions. He has to judge whether - (a) Management is doing the correct things, and (b) Management is doing those things correctly.

23. Distinguish the following –

(A) Financial Audit and Management Audit

(B) Cost Audit and Management Audit

(C) Management Audit and Internal Audit

Answer:

(A) Distinguish between Financial Audit and Management Audit.

Aspects	Financial Audit	Management Audit
Legal Requirement	It is compulsory in the case of enterprises like Companies, Trusts, Societies, etc.	There is no legal compulsion as regards Management Audit. It is voluntary.
Periodicity	Financial Audits are conducted annually.	Management Audits are conducted once in 2 or 3 years.
Time Period Covered	It covers business transactions of the past financial year.	There is no limitation as to the period to be covered.
Scope	To express an opinion on the true and fair view of the Financial Statements.	To express an opinion on performance of the Management during a particular period, and to suggest remedial measures, if required.
Audit Focus	It is concerned with financial aspects of business transactions, for the year under audit.	It is concerned with review of the past performance, to ascertain whether it is in tune with the objectives, policies and procedures of the enterprise.
Reporting Authority	The Statutory Auditor reports to the Owners, i.e. Shareholders in case of a Company.	The Management Auditor reports to the Management.

(B) Distinguish between Cost Audit and Management Audit

Aspects	Cost Audit	Management Audit
Legal Requirement	Cost Audit is compulsory for Companies engaged in production, processing, manufacture or mining, and covered u/s 209(1)(d) of the Companies Act.	There is no legal compulsion as regards Management Audit. It is Voluntary.
Qualification of Auditor	It shall be done by an Auditor who shall be a cost accountant within the meaning of the Cost and Works Accounts Act, 1959.	It may be done by any independent person. However, professional Accountants are more suitable on account of their knowledge.
Focus	It involves verification of Cost Records, to determine internal efficiency of the Enterprise.	It involves a review of the past performance of the enterprise to ascertain whether it is in tune with the objectives, policies, etc.
Time period	Financial Year of the enterprise.	May be longer than the entity's

		financial year.
Reporting Authority	Cost Auditor reports to the Central Government, with a copy to the Company.	The Management Auditor reports to the Management.
Contents of Report	These are governed by the Companies Cost Audit (Report) Rules, notified by Central Government.	The contents of the Report are based on the Management Auditor's findings. There is no specific format for the same.
Time Limit for reporting	Cost Audit Report should be submitted within the prescribed time.	There is no rigid timeframe as regards submission of Management Audit Report.

(C) Distinguish between Management Audit and Internal Audit

Aspects	Management Audit	Internal Audit
Definition	Management Audit is - (a) the systematic independent appraisal activity, (b) within an organisation, (c) for a review of the Management's efficiency, (d) in its decision-making function.	Function of internal control with the objective of determining whether other internal controls are well designed and properly operated.
Relationship to Internal Control	It is not a part of Internal Control. It is over and above the regular internal control system.	This operates as a part of Internal Control System.
Objectives	It is concerned with appraising - • Management's accomplishment of organizational objectives, • Management functions of planning, organizing, directing, and controlling, and • Adequacy of Management's decisions and action in moving towards its objectives.	• To determine whether internal controls are well designed and properly operated, and • To assist all members of Management in the objective of discharging of their responsibilities by reviewing activities and procedures.
Function	Constructive Function, i.e. to provide suggestions for improvement.	Protective Function, I.e. to safeguard the assets of the Enterprise.
Areas	All aspects of managerial decision-making are analysed, to see whether they are in tune with Management policies, objectives and goals.	The traditional field of Internal Auditors is restricted to financial accounting and internal control.
Aspect	Qualitative aspects of decision-making are analysed.	Internal Audit Function focuses more on quantitative aspects when compared to Management Audit.

24. (A) Explain the needs and objectives of Operational Audit?

Answer:

Need for Operational Audit

Operational Audit overcomes the following problems / gaps faced by the Management in operational areas -

i. Information Needs: Managers require full, objective and current information about conditions prevalent in their operational areas, and also in areas beyond their direct observation. Operational Audit provides the required information to them.

ii.. Fill up Communication Gaps: Conventional sources of Management information are -

(a) Departmental Manager's routine performance report,
(b) Internal Audit Reports,
(c) Periodic Special Investigation, and
(d) Survey.

These sources create communication gaps on activities, which do not come under the direct observation of managers. Hence, Operational Audit is required.

iii. Effectiveness of Managers: Executives and Managers are too pre-occupied with implementation of plans and achieving targets. They are left with very little time to collect information and locate problems. Hence, an independent Operational Audit team should provide them data inputs on the effectiveness of operations.

iv. Undetected Cracks: Even when a department is working well and smoothly, there may be some crack or gap in operations or in controls. Operational Audit is a management information source since it will find out the possibilities of such undetected gaps / lapses in control.

v. Analytical Evaluation: Departmental Managers and their aides generally routine transmit information. But an Independent Operational Audit Team will be able to evaluate the operations analytically.

vi. Unbiased Reports: Performance Reports contained in the annual accounts and routine reports prepared by the operating departments have their own limitations, may be subjective, manipulated or biased. Hence, Operational Audit is required.

vii. Shortcomings of Internal Audit: Conventional Internal Audit reports are often routine and mechanical in character and have definite leaning towards accounting and financial information. They are historical in nature. Operational Audit overcomes this limitation of Internal Audit.

viii. Need for Current Control: Surveys and special investigations are occasional in character. They are costly, time consuming and keep the departmental key personnel busy during that period. They are undertaken mostly to find causes of certain affairs or to fix responsibility for certain undesirable happenings. These basically attempt to carry out a post-mortem rather to give a signal for dangers and forthcoming disasters. Operational Audit is required to ensure day-to-day control of activities.

ix. Environment Changes: Operational Audit is required to analyse whether the activities, operations, procedures, methods and objectives of the enterprise are in tune with its present environmental conditions. There is a need for an instrument, which should signal change in advance.

Objectives of Operational Auditing

The general objectives of Operational Audit are -

i. Appraisal of Controls:

(a) Internal Controls provide the essential tools / measures to ensure proper performance in each functional or organizational area for accomplishing the desired organizational objective.

(b) The purpose of operational Audit is to determine whether the controls are - (i) adequate, and (ii) effective in accomplishing Management's objectives or plans or operations.

(c) The Operational Auditor reviews internal controls and reports to ascertain whether they bring the performance, qualitatively and quantitatively, to the notice of the Management, also within the organisation's policies and plans are being carried out.

ii. Evaluation of Performance: In the area of performance appraisal, the Operational Auditor is basically concerned with -

(a) Analysing the technical efficiency of the operations,

(b) Accumulating information and evidence to measure the effectiveness, efficiency and economy of operations, and

(c) Comparing actual performance with applicable standards, procedures, rules, policies and plans.

(d) Performance Evaluation is generally based on - (i) Productivity, (ii) Personnel, (iii) Workload, (iv) Cost, & (v) Quality.

iii. Appraisal of Management objectives and plans:

(a) Every Activity in an organization is the product of basic plans and objectives set by the Management. Hence, Management policies, plans and objectives should be evaluated properly.

(b) The aim of operational Auditing is to appraise operations and controls and adherence to prescribed and laid-down policies and not to go into the question of appropriateness of plans and objectives. But, the Operational Auditor may look into aspects like -

- Clarity of objectives,
- Proper communication of objectives to the personnel responsible for implementation,
- Feedback from personnel, i.e. whether they have understood the objectives in the same sense as meant by the Management, and

- Apparent conflict in the objectives and its effect on operations.

iv. Appraisal of Organisation Structure:

(a) Organisational structure, an essential element of internal control design, provides the line of relationships and delegation of authority and tasks.

(b) The Operational Auditor should consider the following in evaluating the organisation structure -

- Conformity with Management objectives,
- Proper match between responsibility and authority,
- Clear definition of Scalar Line of Authority from top to bottom, and
- Possibility of defective delegation, overlapping or duplication of work.

(B) Distinguish the followings –

(i) Operational Audit and Internal Audit

(ii) Financial Audit and Operational Audit

(iii) Operational Audit and Management Audit

Answer:

(i) Distinguish between Operational Audit and Internal Audit.

Particulars	Operational Audit	Internal Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	Function of internal control with the objective of determining whether other internal controls are well designed and in place.
Link with Internal Control	This is not a part of Internal Control. This is over and above the regular internal control system.	This operates as a part of Internal Control System.
Objectives	1. Appraisal of controls. 2. Evaluation of performance. 3. Appraisal of objectives and plans. 4. Appraisal of organizational structure.	1. To determine whether internal controls are well designed and properly operated, and 2. To assist all members of Management in the objective discharge of their responsibilities by reviewing activities and procedures.
Function	Constructive Function, i.e. to provide suggestions for improvement.	Protective Function, i.e. to safeguard the assets of the enterprise.
Areas	All aspects of operations are analysed to see whether they are in tune with Management Policies, Objectives and Goals.	The traditional field of internal Auditors is restricted to financial accounting and internal control.

Aspect	Qualitative Aspects are analysed. For example in Cash Management, the Operational Auditor would analyse - 1. Whether quantum of cash in hand is related to requirement of cash? 2. Whether surplus cash is promptly invested in short-term securities for maximizing return? 3. Whether maximum possible protection has been given to cash?	1. The Internal Audit Function is said to focus more on quantitative aspects when compared to Operational Audit. 2. Internal Auditors view and examine internal controls in financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not found. 3. They check the accounting books and records to see whether the internal checks work properly and the resulting accounting data are reliable.

(ii) Distinguish between Financial Audit and Operational Audit.

Particulars	Financial Audit	Operational Audit
Purpose	Concerned with opinion that whether the historical information recorded is correct or not.	Emphasizes on effectiveness and efficiency of operations for future performance.
Area	Restricted to the matters directly affecting the appropriateness of the presented Financial Statements.	Covers all activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.
Reporting	Financial Audit Report is sent to all Shareholders, Lenders, Stakeholders and Regulatory Authorities.	Operational Audit report is primarily for the Management and internal use.
Scope	Limited to reporting the findings of audit to the persons entitled to the Report, i.e. Shareholders.	Operational Auditing is not limited to reporting, it also includes suggestions for improvement.

(iii) Distinguish between Operational Audit and Management Audit.

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

(C) Give brief notes on -

(i) Operational Audit of Research and Development Activities

(ii) Operational Audit of Marketing Function

Answer:

Operational Audit of Research and Development Activities

Need for R and D Activities

The rapid strides in technological progress and increasing danger of obsolescence today prompt every company, regardless of size, to discover and utilise the concepts and procedures to survive. The following guidelines will help to gauge whether research will keep the organization abreast of the technological changes and face the market with confidence:

(i) A budget should be set for research and development and a definite sum should be set aside every year for this purpose.
(ii) The extent of research and development necessary to keep the company young should be decided.
(iii) The research concepts should be broad in spectrum and be within the capabilities of the organisation.
(iv) The research projects should be selected on the basis of decisions taken as a team rather than being on one man's decisions.
(v) A definite goal should be set.
(vi) A pilot scheme should be set and tested before a full scale commitment is made.

Evaluation of R and D Activities

In evaluating the R and D activities of the management the following factors should be considered:

(i) There should be a duly approved budget for R and D activity based on a detailed report of each project.
(ii) The actual expenditure incurred on each project should be collected in a systematic manner and be compared with the budget authorization. Similarly, physical progress should be monitored.
(iii) There should be a system of authorization of various R and D projects within the scope of the budget.
(iv) There should be control on material requisition and consumption.
(v) The recruitment of R and D personnel should be based on merit and competence.
(vi) As and when a project is completed and found to be successful, suitable decisions for commercialization should be takers.
(vii) As soon as a project is found to have failed, further expenditure on it should be stopped forthwith.
(viii) All R and D projects should be well coordinated and be within the overall objectives of the company.
(ix) The laboratory and library should be well-equipped. A team of experts should decide on

the additions to equipment and library.

(x) Investigation into the causes of failure of projects made immediately after the failure will lead to the organization taking corrective steps for the future.

(ii) Operational Audit of Marketing Function

Scope of Marketing Function

The concept of the marketing function embraces the following activities, each of which will form a separate field for management audit investigation:

(i) Sales analysis, market research and product design activities are used for discovering the customers needs.
(ii) Sales promotion, sales training and selling activities are used for getting in touch with customers, both potential and regular, to secure orders.
(iii) Customer service is provided to help the customer to derive the benefit for which they purchase the products.
(iv) Trade and industry research and allied studies, to understand the economic trends, customer patterns and competitor's actions/ activities.
(v) Sales management to effectively utilise the marketing resources.

The various marketing activities can be further analysed into:

(i) Strategic or planning activities involving sales analysis, sales forecasting, market research etc.
(ii) Tactical or creative activities such as advertising, sales promotion, sales management, customer services, etc.

The analyses of sales should be made on the following basis with comparative data relating to the previous period to assess the sales potential of the company:

(i) Product mix analysis giving information relating to product mix on customer class/ group wise or territory wise.
(ii) Sales by territory or customer class wise.
(iii) Profit or contribution earned salesman wise, territory wise, customer group wise, and product group wise.
(iv) Variances from sales forecast and analysed by product mix, territory and salesmen.

Besides the above data, the sales staff should be provided with such information as product specification and uses, discounts which they can offer, inventory position, etc. to enable them to increase the sales. The management auditor should see that the above information is used to the maximum advantage of the company.

Sales forecast is an important activity which should be looked into by the management auditor because it forms the basis for production planning, purchasing and inventory control. Every forecast includes certain assumptions which should be stated explicitly. The management auditor should understand the assumptions underlying the forecasts and test them for validity and relevance. There are several methods of forecasting sales like, for example, trend analysis, correlation analysis, etc., and the management auditor should see that the company is able to make use of the computers for properly assessing the sales forecasts.

A review of the marketing plans in use may reveal that the company has lost economies due to failure to manage marketing and sales effort on an integrated basis. If the company has a marketing plan, it has to be seen whether its implementation has been controlled and review of the performance is made periodically.

Market research consists of information on customers, sales prospects, competitor's activities, product specifications and sales activities. The management auditor examining the market research activities should see that the company is able to achieve cost effectiveness.

Trade journals, companies' annual reports, circulars from trade associations etc. provide information about products, competition, sales potential, etc. The management auditor should see how far these documents are used by the company to their best advantage.

Companies spend huge sums of money on advertising and sales promotion. It is necessary to evaluate how effective are these programmes. The management auditor's investigation in this direction will be somewhat as under:

(i) Who are the final consumers?
(ii) What are the segments in markets to which the products are catered?
(iii) What is the relation between the budget allocation and sales achieved?
(iv) Is the advertising directed towards that class of customers for whom the product is intended?
(v) What priorities are assigned for sales promotion?
(vi) Does the advertisement appeal to the customers?
(vii) Is the budget allocation to the different channels of advertisement adequate and commensurate with the benefits?

Based on the above information, the management auditor is expected to evaluate the effectiveness of the advertisement programme.

The sales management is responsible for managing the sales and marketing activities. The skill with which the resources are used by the sales management is important. In reviewing the performance of the sales department the management auditor should ensure that the sales management uses the systems concept and computer technology to solve the problems. Moreover, the programme for recruitment and training of salesmen will bring about an increase in turnover. The management auditor should evaluate the performance of each salesman and the sales department as a whole in terms of the actual achievement of sales as compared to the budget and past performance. A customer service cell is introduced to attend to the complaints received from the customers. Although the management auditor may not be able to quantify the services rendered by this section, a scrutiny of the complaints will give him an idea of the nature of the complains say, about the product quality, product life, packaging problems, defects, etc. and efforts can then be directed to see whether corrective action is taken to improve the product performance and marketability of the goods to ensure enhanced sales.

SECTION - C

25. (A) Explain the Impact of IFRS on the Cost Structure, Cash Flows and Profitability.

Answer:

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

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

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

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

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

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

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

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

- Construction contracts – there could be changes in contract revenues and profit measurement thereon
- Impairment of assets-recognition of provisions may impact profitability
- Intangible assets-certain existing assets may have to be derecognized
- Business combinations – some costs of M & A cannot be capitalized

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

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

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

(B) State the application of Management accounting Tools.

Answer:

The performance measurement involves collection of information, analysing the same by establishing the interrelations between them, interpreting the results and then arriving at meaningful conclusion. The collection of information depends upon various sources of data and other reports for various systems used by the organisation.

The data input is generally made in the accounting system used by the company e.g. the ERP systems. Most of the ERP systems facilitate input and capturing of even the non-financial data which can be then processed to produce desired reports. There is a lot of information to be accessed from outside of the ERP system. The cost auditor should identify such sources within and outside of the organisation and use information drawn from the same.

The management accounting tools could be used to analyse the performance with different purposes. The cost auditor should verify the tools and techniques used by the company and comment on appropriateness and adequacy thereof. The cost auditor could recommend more appropriate management accounting tool.

The following table shows various management accounting tools that are used to serve different objectives:

Purpose	Management Accounting Tool
Control	Budgetary control, standard costing, variance analysis
Cost computation	Full(absorption) Costing, Job, batch, process or contract costing Activity based costing, Time Driven ABC
Cost reduction	Total Quality management, Quality costing, Kaizen costing, Lean manufacturing, Value Analysis and Value Engineering, Six Sigma
Pricing and decision making	Target costing, Life cycle costing, Throughput accounting, Variable or marginal costing
Total performance management	Balanced Scorecard, Performance Prism, Performance pyramid, Business Objects, Business Intelligence

The cost auditor should be acquainted with the intricacies of these and such other tools and what it takes to successfully implement and use them. The success of Performance Appraisal Report would depend upon not how many performance measure are considered, but upon how they are evaluated and assessed with the help of various management accounting tools.

26. (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.

Answer:

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
Total cost of labour turnover	**5,00,000**

Computation of productive hours **(Hours)**

Actual hours worked	4,45,000
Less: Unproductive hours (for training)	15,000
Productive hours worked	**4,30,000**

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

(B) Jain 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 age 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.

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 p.m.)	-	9
Total number of direct labourers employed	1,250	1,278
Expected production (lakh metres p.m.)	18	22.5

(*1008/48)

Profit Statement (per month) (₹)

Particulars		Present	Proposed
Sales Revenue	(a)	54,00,000	66,15,000
Costs:			
Production Cost (@ ₹2.25)		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 = 1000 looms/48 looms = 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

27. (A) From the following figures decide whether it is worthwhile to investigate the variance:

	₹
1. Cost of investigation of variance	**6,400**
2. Cost of correction of out-of-control process	**20,000**
3. Cost of allowing the process to remain out of control	**95,000**
4. Probability of being in control	**0.90**

Answer:

A. Expected Cost of investigation

(i) Cost of investigation of variance (This will have to be incurred, if this decesion is taken)	₹ 6,400
(ii) Total cost of correction of out control situation is ₹ 20,000, but only 10% of this will be incurred, because probability of control is 90%. Therefore, expected cost of correction. (10% of ₹ 20,000)	₹ 2,000
Total	₹8,400

B. Expected Cost of allowing the process to remain out of control

Total cost of allowing the process to remain out of control is ₹95,000. Probability of control is 90%
∴ Expected cost of allowing the process to remain out of control- ₹95,000 x 10% = 9.500

∴ From above, it is clear that expected cost of investigation is less than expected cost of allowing the process to remain out of control. Therefore, advice to management will be to investigate the variance.

(B) Manufacture's specification capacity for a machine per hour = 1500 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.

Answer:

Installed capacity for the machine	= 365 x 8 x 3 x 1500 = 131.40 lakhs units
Available capacity	= (365 – 52 - 8) x (8 -1) x 3 x 1500 = 305 x 7 x 3 x 1500 = 96.08 lakhs units
Normal capacity	= (76.2 + 78.5 + 76.6)/3 = 77.1 lakhs units.
Actual capacity utilization	= 76.4 lakhs units = 76.4/131.4 x 100 = 58.14%
Idle capacity	= (131.40 - 76.4) lakhs units = 55 lakhs units = 55 /131.4 x 100 = 41.86%
Abnormal idle capacity	= (77.1 - 76.4) lakhs units = 0.70 lakhs units

28. (A) X Ltd presented the following particulars on 31.3.2009.
You are asked to compute the Inventory Turnover Ratio of each material:

	Material X	**Material Y**
	₹	**₹**
Stock (as on 1.4.2008)	**12,000**	**16,000**
Purchases	**60,000**	**1,00,000**
Stock (as on 31.3.2009)	**18,000**	**24,000**

Answer:

Computation of the Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods}}{\text{Average Stock}}$$

	Material X	Material Y
	₹	₹
(a) Cost of Goods Sold		
Opening Stock	12,000	16,000
Add: Purchases	60,000	1,00,000

	72,000	1,16,000
Less: Closing Stock	18,000	24,000
Cost of Goods Sold	54,000	92,000
(b) Average Stock		
Opening Stock	12,000	16,000
Add: Closing Stock	18,000	24,000
	30,000	40,000
∴ Average Stock	$\frac{30,000}{2}$	$\frac{40,000}{2}$
	= 15,000	= 20,000
∴ Inventory Turnover Ratio = $\frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$ =	$\frac{54,000}{15,000}$	$\frac{92,000}{20,000}$
	= 3.6 times	= 4.6 times

(B) A chemical manufacturing unit uses ingredient A 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.

Answer:

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

Cost of Material of: (Per Kg)

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

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

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

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

29. (A) A firm can produce three different products from the same raw material using the same production facilities. The requisite labour is available in plenty at ₹8 per hour for all products. The supply of raw material, which is imported at ₹8 per kg., is limited to 10,400 kgs. for the budget period. The variable overheads are ₹5.60 per hour. The fixed overheads are ₹50,000. The selling commission is 10% on sales.

(a) From the following information, you are required to suggest the most suitable sales mix, which will maximize the firm's profit. Also determine the profit that will be earned at that level:

Product	Market demand (units)	Selling price per unit (₹)	Labour hours required per unit	Raw material required per unit (kgs.)
X	8,000	30	1	0.7
Y	6,000	40	2	0.4
Z	5,000	50	1.5	1.5

(b) Assume, in above situation, if additional 4,500 kgs. of raw material is made available for production, should the firm go in for further production, if it will result in additional fixed overheads of ₹20,000 and 25 per cent increase in the rates per hour for labour and variable overheads.

Answer:

Working Notes

(i) Calculation of Direct Material Consumption (per unit)

Product	Kgs. per unit	₹ per kg.	Amount (₹)
X	0.7	8	5.60
Y	0.4	8	3.20
Z	1.5	8	12.00

(ii) Calculation of Variable Overhead Per Unit (₹)

Product	Hours	Rate per hour (₹)	Amount (₹)
X	1	5.60	5.60
Y	2	5.60	11.20
Z	1.5	5.60	8.40

Statement of Contribution per unit and Ranking based on Contribution per kg. of Raw Material

(₹)

Particulars		Products		
		X	Y	Z
Selling price	(a)	30.00	40.00	50.00
Direct material		5.60	3.20	12.00
Direct labour		8.00	16.00	12.00
Variable overhead		5.60	11.20	8.40
Selling commission		3.00	4.00	5.00
Total variable cost	(b)	22.20	34.40	37.40

(i) Contribution	(a)-(b)	7.80	5.60	12.60
(ii) Raw material requirement per unit (kgs.)		0.70	0.40	1.50
Contribution per kg. of raw material	(i)/(ii)	11.14	14.00	8.40
Ranking		II	I	III

Since, the raw material supply is restricted to 10,400 kgs., it is to be allocated to each product based on its ranking and market demand as follows:

Product	Units	Raw material requirement per unit (kgs.)	Total Raw material requirement (kgs.)
Y	6,000	0.40	2,400
X	8,000	0.70	5,600
Z	1,600	1.50	2,400*
			10,400

*Balancing figure=2,400 kgs./1.5 kgs. = 1,600 units

Statement of profit (₹)

Contribution			
X	(8,000 x 7.80)	62,400	
Y	(6,000 x 5.60)	33,600	
Z	(1,600 x 12.60)	20,160	1,16,160
Less: Fixed Cost			50,000
Profit			66,160

(b) If additional 4,500 kgs. of raw material is made available, the production will be as follows:

Product	Units	Raw material requirement (per unit/kg.)	Total Raw material requirement (kgs.)
Y	6,000	0.40	2,400
X	8,000	0.70	5,600
Z	4,600	1.50	6,900*
			14,900

*Balancing figure=6,900 kgs./1.5 kgs. = 4,600 kgs.

Statement of Profit (₹)

Contribution			
X	(8,000 x 7.80)	62,400	
Y	(6,000 x 5.60)	33,600	
Z	(4,600 x 12.60)	57,960	1,53,960
Less: Increase on additional units			
Labour Cost	(3,000 units x 25% x ₹12)	9,000	
Variable overhead	(3,000 units x25%x ₹8.40)	6,300	15,300
Net contribution			1,38,660
Less: Fixed Cost		50,000	
Add: Increase		20,000	70,000
Profit			68,660

Analysis: By using additional raw material of 4,500 kgs. in production of product Z by another 3,000 units will increase the profit by ₹2,500 (i.e. ₹68,660 - ₹66,160). Hence, production of additional 3,000 units of Z is suggested.

(B) Compur Ltd manufactures two parts 'X' and 'Y' for computer Industry.

- **X: Annual production and Sales of 1,00,000 units at a Selling price of ₹100.05 per unit.**
- **Y: Annual production and Sales of 50,000 units at a Selling price of ₹150 per unit.**

Direct and Indirect Costs incurred on these two parts are as follows:- (₹ in thousands)

Particulars	X	Y	Total
Direct Material Cost (Variable)	4,200	3,000	7,200
Labour Cost (Variable)	1,500	1,000	2,500
Direct Machining Costs (See Note)	700	550	1,250
Indirect Costs:			
Machine set Up Cost			462
Testing Cost			2,375
Engineering Cost			2,250
Total			16,037

Note: Direct Machining Costs represent the cost of machine capacity dedicated to the production of each product. These costs are fixed and are not expected to vary over long-run horizon.

Additional information is as follows:-

Particulars	X	Y
Production Batch Size	1,000 units	500 units
Set up time per batch	30 hours	36 hours
Testing time per unit	5 hours	9 hours
Engineering Cost incurred on each product	₹8,40,000	₹14,10,000

A foreign Competitor has introduced product very similar to 'X'. To maintain the Company's share and profit, Compur Ltd. has to reduce the price to ₹86.25. The Company calls for a meeting and comes up with a proposal to change design of product 'X'. The expected effect of new design is as follows:

- **Direct material Cost is expected to decrease by ₹5 per unit.**
- **Labour Cost is expected to decrease by ₹2 per unit.**
- **Machine time is expected to decrease by 15 minutes, previously took 3 hours to produce 1 unit of 'X'. The machine will be dedicated to the production of new design.**
- **Set up time will be 28 hours for each set up.**
- **Time required for testing each unit will be reduced by 1 hour.**
- **Engineering Cost and Batch Size will be unchanged.**

Required:

(a) Company Management identifies that cost driver for Machine Set-Up Costs is 'set up hours used in batch setting' and for Testing Costs is 'testing time'. Engineering Costs are assigned to

products by special study. Calculate the full cost per unit for 'X' and 'Y' using Activity-Based Costing.

(b) What is the Mark-up on full cost per unit of X?

(c) What is the Target Cost per unit for new design to maintain the same mark up percentage on full cost per unit as it had earlier? Assume cost per unit of cost drivers for the new design remains unchanged.

(d) Will the new design achieve the cost reduction target?

(e) As a Cost Auditor of the company list out the possible management actions that the Compur Ltd. should take regarding new design.

Answer:

a. Computation of Quantities of Cost drivers

Particulars	X	Y	Total
a. Quantity	1,00,000 units	50,000 units	
b. Batch Size	1,000 units	500 units	
c. Number of Batches (a ÷ b)	100 batches	100 batches	
d. Set Up Time per batch	30 hours	36 hours	
e. Total Set Up Time for production (c x d)	3,000 hours	3,600 hours	6,600 hours
f. Testing Time per unit	5 hours	9 hours	
g. Total Testing Time for production (a x f)	5,00,000 hours	4,50,000	9,50,000 hours

b. Computation of ABC Recovery Rates

Activity	Activity Cost Pool	Cost driver	Cost Driver Quantity	ABC Rate
Machine Set Up	₹4,62,000	Set Up Hours	6,600 set Up Hours	₹70 per hour
Testing	₹23,75,000	Testing Hours	9,50,000 Testing Hours	₹2.50 per hour

Note: Engineering Costs are assigned by special study. Hence ABC Rate is not Calculated.

c. Computation of Cost per unit using ABC system

Particulars	X	Y
Direct Costs:		
Direct Material	42,00,000 ÷ 1,00,000 = 42.00	30,00,000 ÷ 50,000 = 60.00
Direct Labour	15,00,000 ÷ 1,00,000 = 15.00	10,00,000 ÷ 50,000 = 20,000
Direct Machining	7,00,000 ÷ 1,00,000 = 7.00	5,50,000 ÷ 50,000 = 11.00
Sub Total Direct Costs	64.00	91.00
Indirect Cost:		
Machine Set Up	(₹70 x 30hrs) ÷ 1,000 uts = 2.10	(₹70 x 36 hrs) ÷500 uts = 5.04
Testing	(₹2.5 ph x 5 hours) = 12.50	(₹2.5 ph x 9 hours) = 22.50
Engineering	8,40,000 ÷ 1,00,000 = 8.40	14,10,000 ÷ 50,000 = 28.20
Sub Total Indirect Costs	23.00	55.74
Total Costs	87.00	146.74

d. Markup (or) profit per unit of X = Selling price - Full Cost = ₹100.05 - ₹87.0 =₹13.05 p.u.
Percentage of Markup to full Cost = ₹13.05 ÷ ₹87 = 15% on Cost.

e. New Selling Price (given) = ₹86.25
Less: Target Profit at 15% on Cost i.e. 15/115 on SP = 86.25x15/115 = ₹11.25
Target Cost for New Design of X = ₹75.00

f. Computation of Cost per unit of New Design X

	Particulars	X
Direct Costs:	Direct Material	42.00 - 5.00 = 37.00
	Direct Labour	15.00 - 2.00 = 13.00
	Direct Machining (dedicated machine, hence time saved is not relevant, as the costs continue to be fixed)	7,00,000 ÷ 1,00,000=7.00
	Sub Total Direct Costs	57.00
Indirect Costs:	Machining Set Up (₹70 x 28 hours) ÷ 1,000 units	1.96
	Testing (₹2.5 ph x 4 hours)	9
	Engineering (8,40,000 ÷ 1,00,000 units)	8.40
	Sub Total Indirect Costs	20.36
	Total Estimated Costs of New Design X	77.36

Target cost is ₹75.00 only. Hence, the new design will not achieve the cost reduction target.

Note:
It is assumed that output of X will remain at 1,00,000 units, inspite of the reduction in machine time. To maintain 15% profit margin, probable SP of New Design X will be ₹77.36 + 15% = ₹88.96

g. Possible management actions for new design
(i) Value Engineering and Value Analysis to reduce the Direct Material Costs.
(ii) Time and Motion Study in order to redefine the Direct Labour time and related costs.
(iii) Exploring possibility of cost reduction in costs of Direct Machining.
(iv) Identifying non-value added activities and eliminating them in order to reduce Overheads.
(v) Analysis of effect of sale of New Design X on sale of Y.
(vi) Analysis of sensitivity of sale quantity of New Design X to price from ₹86.25 to ₹88.96.

30. (A) A company manufactures two products X and Y. Product X requires 8 hours to produce while product Y requires 12 hours. In April, of 22 effective working days of 8 hours a day, 1,200 units of X and 800 units of Y were produced. The Company employs 100 Workers in production department to produce X and Y. The budgeted hours are 1,86,000 for the year. Calculate capacity, Activity and Efficiency Ratio and establish their inter-relationship.

Answer:

When FOH Volume Variance related ratios are to be computed, the working notes are as under:-

(1)	(2)	(3)	(4)	(5)
AO x SR = SH x SR	AFOH	BFOH = BH x SR	SO x SR =AH x R	PFOH = PH x SR
(1,200 x 8)+(800 x 12) =19,200 hours	N.A	1,86,000÷12 =15,500 hours	22 days x 8 hours x100 men =17,600 hrs	N.A in this question

Capacity Ratio = (4) ÷ (3) = 17,600 ÷ 15,500 =113.55%
Efficiency Ratio = (1) ÷ (4) =19,200 ÷ 17,600 =109.09%
Activity or volume Ratio = (1) ÷ (3) =19,200 ÷ 15,500 =123.87%
Relationship: Activity Ratio = Capacity Ratio x Efficiency Ratio =113.55% x 109.09% = 123.87%.

(B) What are the Characteristics of a good Performance Appraisal Report?

Answer:

Characteristics of a good Performance Appraisal Report are as follows –

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

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

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

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

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

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

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

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

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

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

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