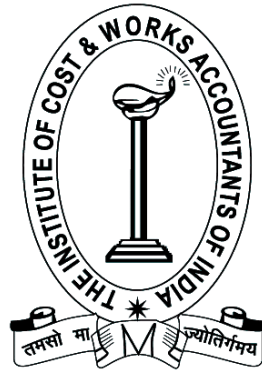


# REVISIONARY TEST PAPER

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GROUP IV



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## GROUP - IV

### Paper-17 : COST AUDIT & OPERATIONAL AUDIT



# FINAL EXAMINATION

## (REVISED SYLLABUS - 2008)

### GROUP - IV

#### Paper-17 : COST AUDIT & OPERATIONAL AUDIT

##### Section I : Cost Audit

- Q. 1. State whether following statements are "True" or "False". No reasons or justification is needed for the answer.
- (i) Every company required to maintain Cost Records under Section 209(1)(d) of the Companies Act is required to get such records audited under Section 233(B) of the Companies Act.
  - (ii) The Cost Auditor is not a member of the Audit Committee of the Company.
  - (iii) The Cost Audit Report(Amendment) Rules, 2006 provide for e-filing of Cost Audit Reports.
  - (iv) UK is the first country in the world in introducing the provisions of compulsory maintenance of Cost Accounting Records.
  - (v) The cost statements as prescribed under Cost Accounting Records Rules are not required to be attached with cost audit report submitted to Central Government.
  - (vi) Capital WIP is required to be shown in the Cost Records.
  - (vii) Valuation of inventory in Para 19A of the Annexure to the Cost Audit Report should be as on the last date of the financial year under audit.
  - (viii) Under Para 27 of the Annexure to Cost Audit Report, the Cost Auditor gives Reconciliation of only 2 years.
  - (ix) Royalty is an item of Cost of Production under Cost Accounting Record Rules.
  - (x) Depreciation in excess of that computed under Section 205(2) of the Companies Act cannot be taken for determination of cost under the Cost Accounting Record Rules.
  - (xi) 'CENVAT' availed as credit on purchased raw materials is to be deducted from the cost of raw materials as per Cost Records.
  - (xii) Nonmoving stocks means value of raw materials and components which have not moved for more than 24 months.
  - (xiii) Efficiency Audit ensures optimum return on Capital Employed.
  - (xiv) Value addition is the difference between gross sales and the cost of bought out materials and services.
  - (xv) Two companies simply having a common Director shall not be deemed as 'related party relationships.'
  - (xvi) Synthetic Rubber is covered by Cost Accounting Record (Chemical) Rules.

- (xvii) Cost Auditor has a statutory right to visit the Branch of the company.
- (xviii) CAS 6 deals with the principles and methods of classification, measurement and assignment of material cost, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.
- (xxi) As per CAS 10, Credits/ recoveries relating to the Direct Expenses, material and quantifiable, shall not be considered to arrive at the net Direct Expenses.
- (xx) 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.

**Answer 1.**

- (i) False
- (ii) True
- (iii) True
- (iv) False – India is the first country in the world in introducing the provisions of compulsory maintenance of Cost Accounting Records.
- (v) True
- (vi) True
- (vii) True
- (viii) False — The Cost Auditor gives Reconciliation of only the Current Year.
- (ix) True
- (x) False
- (xi) True
- (xii) False — Nonmoving stocks means value of raw materials and components which have not moved for more than 12 months.
- (xiii) True
- (xiv) False — Value addition is the difference between net sales and the cost of bought out materials and services.
- (xv) True
- (xvi) True
- (xvii) False
- (xviii) True
- (xix) False — Credits/ recoveries relating to the Direct Expenses, material and quantifiable, shall be deducted to arrive at the net Direct Expenses.
- (xx) True

**Q. 2A. Choose the most correct among four alternative statements.**

- (i) The maximum number of cost audits which can be accepted by a firm of Cost Accountants having three partners are —
  - (a) For 30 products.
  - (b) 60 companies, out of which not more than 10 companies shall be companies with paid up capital of more than Rs. 25 lacs.
  - (c) 60 products.
  - (d) 30 companies.

- (ii) Application for appointment of Cost Auditor should be sent to Department of Company Affairs within —
- (a) 30 days of commencement of financial year.
  - (b) 50 days of commencement of financial year.
  - (c) 45 days of commencement of financial year.
  - (d) 60 days of commencement of financial year.
- (iii) The time limit for making available cost records etc by the company to the cost auditor is:
- (a) 90 days from the end of financial year.
  - (b) 180 days from the end of financial year.
  - (c) 135 days from the end of financial year.
  - (d) 150 days from the end of financial year.
- (iv) For calculation of Capital Employed, average is considered for —
- (a) Current year and previous year
  - (b) Current year and previous 2 years.
  - (c) Current year only.
  - (d) Previous 5 years.
- (v) Under para 21 of the Annexure to the Cost Audit Report, information regarding margin per unit of output for the product under reference to be furnished for:
- (a) last year only.
  - (b) current year and previous 2 years.
  - (c) current year and previous year.
  - (d) previous three years.
- (vi) Para 12 of the Annexure to the Cost Audit Report Rules deals with —
- (a) Capital employed.
  - (b) Installed capacity and actual production.
  - (c) Wages and salaries.
  - (d) Overheads.
- (vii) Cost Accounting Records Rules are applicable to —
- (a) Investment Companies.
  - (b) Private Limited Companies
  - (c) Both of the above
  - (d) None of the above.
- (viii) Rectified Spirit is covered by —
- (a) Cost Accounting Records (Chemical Industries) Rules, 2004
  - (b) Cost Accounting Records (Formulations) Rules, 1988
  - (c) Cost Accounting Records (Industrial Alcohol) Rules, 1997
  - (d) Cost Accounting Records (Bulk Drugs) rules, 1974

- (ix) CAS 9 deals with —
- (a) Packing Material Cost
  - (b) Indirect Material Cost
  - (c) Direct Material Cost
  - (d) None of the above.
- (x) Copy of Cost Audit Report neednot be submitted to —
- (a) Company Law Board
  - (b) Board of Directors of the Company
  - (c) Members at Annual General Meeting of the Company.
  - (d) Income Tax Officer along with the Income tax Return.

**Answer 2A.**

- (i) (b) 60 companies, out of which not more than 10 companies shall be companies with paid up capital of more than Rs. 25 lacs.
- (ii) (c) 45 days of commencement of financial year.
- (iii) (c) 135 days from the end of financial year.
- (iv) (a) Current year and previous year
- (v) (c) current year and previous year.
- (vi) (d) Overheads
- (vii) (b) Private Limited Companies
- (viii) (c) Cost Accounting Records (Industrial Alcohol) Rules, 1997
- (ix) (a) Packing Material Cost
- (x) (c) Members at Annual General Meeting of the Company

**Q. 2B. Fill in the blanks :**

- (i) The ceiling on number of Cost Audits to be under taken by a Cost Auditor is laid down in Section \_\_\_\_\_ of Companies Act.
- (ii) Detailed provisions relating to Cost Audit are contained in Section \_\_\_\_\_ of the Companies Act.
- (iii) The debit balance in the Profit and Loss A/c is to be \_\_\_\_\_ in computing the Net Worth of the Company.
- (iv) Cost Accounting Record Rules were made first for \_\_\_\_\_ industry.
- (v) Para 13 of the Annexure to Cost Audit Report Rules deals with \_\_\_\_\_ .
- (vi) Phenol is covered by Cost Accounting Records \_\_\_\_\_ Rules.
- (vii) Pollution control expenses are being dealt with in Annexure to the Cost Audit Report Rules, vide \_\_\_\_\_ .
- (viii) Records relating to cost of utilities like water, power etc. shall be maintained in both \_\_\_\_\_ and value.
- (ix) As per CAS 12, fines, penalties ,damages and similar levies paid to statutory authorities or third parties \_\_\_\_\_ form part of repair and maintenance cost.
- (x) Outward transportation cost , as per CAS 5 shall form part of cost of \_\_\_\_\_ .

**Answer 2B.**

- (i) 224(1B)
- (ii) 233(B)
- (iii) deducted
- (iv) cement
- (v) Research & Development Expenses
- (vi) Chemical Industries
- (vii) para 16
- (viii) quantity
- (ix) shall not
- (x) sale

**Q. 3.(a) It is said that 'Cost Audit' is 'Efficiency Audit'. Explain the statement. What is the evidence from the Cost Audit Report that Cost Audit is 'Efficiency Audit'?**

**(b) Explain the meaning of propriety audit and how this aspect is covered by Cost Audit.**

**Answer 3.**

- (a) 'Efficiency Audit' is systematic appraisal of management methods and is intended to assess the actual performance levels relative to applicable benchmarks or standards. The main purpose of Efficiency Audit is to ensure –
- (i) that every rupee invested in capital or in other fields give optimum returns, and
  - (ii) the balancing investment between different functions and aspects designed to give optimum results. 'Cost Audit' may appropriately be called 'Efficiency Audit' as outlined above.

The following points may be considered in favour of the argument :

- (i) Cost Audit Report Rule, Para 4 deals with capacity utilization giving details of licensed capacity, installed capacity, actual production etc. to counter the problem of underutilization of capacity. Thus cost audit can help in improving efficiency by reducing the idle capacity.
- (ii) Information revealed by the Cost Audit Report under Para 7 can be highly useful in energy conservation and help firms to improve their efficiency in utilization of energy resources.
- (iii) Para 5(b) requires comparison of per unit actual consumption of major inputs with the standard. Such comparison is a very important control ratio and helps in analyzing the production efficiency by bringing to focus the areas where wastage of raw materials occur.
- (iv) Efficiency of industrial units is affected by abnormal / non-recurring costs. An analytical study of information given under Para 17 can provide useful information to management to improve its working.
- (v) Para 18 reveals information on slow and non-moving stock. This information will guide management in setting up of a sound inventory system and help in improving the inventory ratio.
- (vi) Information given under Para 8 helps to analyse the efficiency of the staff employed.
- (vii) Para 22 provides information on 'competitive margin against imports'. This helps Govt. not only to promote exports but also to protect Indian Industry from unlawful dumping by foreign units.

- (viii) Similarly other paras like para 24 on financial position, para 21 on margin per unit of output, para 23 on value addition, para 28 on profit reconciliation, Cost Auditor's observations- will go a long way for cost reduction, increasing productivity, efficiency of the firm etc.
- (ix) On basis of the above points, it can be established that cost audit is well designed to bring to light the efficiency aspect of performance of a company and is thus appropriately called 'Efficiency audit'.
- (b) The term 'propriety' has been defined by Kholer as "that which meets the tests of public interest, commonly accepted customs and standards of conduct and particularly as applied to professional performance, requirements of Government regulations, and professional codes." Thus propriety audit is verification of transactions in best interest of public, commonly accepted customs and standards of conduct. Thus propriety audit seeks to ensure that expenditure is not only appropriate to the circumstances, the objectives for which it was incurred are also achieved. In this context, Cost Audit may be termed as propriety audit as it also seeks to ensure that actual expenditure incurred at each stage of production is appropriate and optimum returns are achieved. The cost auditor has to report on matters which appear to him to be clearly wrong in principle, cases where company's fund have been used in negligent manner etc. These are the areas where the propriety aspect is involved and therefore the aspect is covered by cost audit.

**Q. 4. Give your understanding on:**

- (a) **Permanent File.**
- (b) **Flow Chart.**
- (c) **Supplementary Cost Audit Report.**

**Answer 4.**

- (a) Permanent File: The Audit Working Papers are kept in two files, 'permanent file' for all the years and 'variable file' for each year of Audit. Copies of 'Memorandum of Association', 'Articles of Association', 'collaboration agreements', 'process flow charts', 'list of cost centres', 'cost manual', 'accounting codes' etc belong to 'permanent file'. Thus 'permanent file' refers to information which is unlikely to change from year to year.
- (b) Flow chart is a diagrammatic representation of flow of information with help of documents. It is useful to record the 'decisions' at various levels, posting of data and recording of transactions on documents. Flow chart is used to indicate the analysis of systems and documents detailed as under:
  - (i) The number of copies of each document.
  - (ii) Movement of each document through different departments, sequence of such movements, and final destination of every copy.
  - (iii) The operations like giving approval, putting initial, done on the documents along with brief description and reason for the same.

Thus flow chart helps us in following ways:

- (i) Identifies the division of responsibilities in different departments.
- (ii) Locates the source document whose error may have far reaching consequences;
- (iii) Points out the occurrence of clerical error at each stage;
- (iv) Provides a bird's eye view of the system and acts as efficient documentation for the auditors;
- (v) It is the most efficient tool for doing actual analysis.



However details are sometimes omitted from a flow chart and as a result it may not give the desired result. Failure to standardize the symbols and incomplete nature of chart are also responsible for not having the desired results.

- (c) Supplementary Cost Audit Report : Where the cost audit report is finalized with provisional figures, a supplementary cost audit report should be submitted by the cost auditor to the Government as soon as audited accounts are available. According to sub-rule (2) of Rule 4 of Cost Audit Report Rules, 2001 the Cost Auditor shall also give clarifications required by the Central Government on Cost Audit Report submitted by him, within 30 days of the receipt of communication addressed to him calling for such clarifications.

**Q. 5. (a) Following data is available for a company relating to the cost of production of a product subjected to Cost Audit. Prepare the Export Profitability Statement to be included in the Annexure to the Cost Of Production of 10,000 units.**

	Rs.
Sales( local) 9000 units	202500
Sales (export) 1000 units	20000
Material consumed 20 tonnes @Rs. 5 kg.	100000
Imported Component @ Rs. 3/unit	30000
Direct Labour	10000
Factory Overhead	15000
Administrative Overhead	5000
Freight & Packing (local sales)	4500
Packing for export	2000
Handling at port	500
Opening Work-in-progress	10000
Closing Work-in-progress	5000

**Additional Information :**

- (i) Export incentive of 10% on F.O.B is receivables.  
(ii) Draw Back on duty paid on raw materials and components available on export is Rs. 2500/-

**Answer 5. (a)**

Taking into consideration the requirements under provisions of Cost Audit (Report) Rules, like showing separately local and export sales, with details like quantity, net realization, price per unit, packing charges etc., Profitability Statements have been prepared as follows :

**Statement of Cost of Production**

Production : 10000 units	Total cost (Rs)	Per unit cost (Rs)
Direct Materials (20000 Kgs . @ Rs. 5 per Kg)	100000	10.00
Imported components (10000 units @ Rs.3/unit)	30000	3.00
Direct Labour	<u>10000</u>	<u>1.00</u>
Prime Cost	140000	14.00
Factory Overhead	15000	1.50
Opening WIP	<u>10000</u>	<u>1.00</u>
	165000	16.50
Less: Closing WIP	<u>50000</u>	<u>0.50</u>
Works Cost	160000	16.00
Administrative Overhead	<u>5000</u>	<u>0.50</u>
<b>Cost Of Production</b>	<u>165000</u>	<u>16.5</u>

**Statement of Cost and Profit on Export Sales**

<b>Export Sales: 1000 units</b>	<b>Total cost (Rs)</b>	<b>Per unit cost (Rs)</b>
Cost of production	16500	16.50
Export packing	2000	2.00
Handling at port	<u>500</u>	<u>0.5</u>
(A) Cost of Sales	<u>19000</u>	<u>19.00</u>
Export Sales realisation	20000	20.00
Export incentive @ 10% of F.O.B	2000	2.00
Duty Drawback on components	<u>2500</u>	<u>2.50</u>
(B) Total realisation	<u>24500</u>	<u>24.5</u>
Profit on Export (B)-(A)	<u>5500</u>	<u>5.5</u>

**Q. 5. (b) (i) Why is Cost Audit Report not made public? State whether a member of Parliament have access to the Cost Audit Report?**

**(ii) A company, manufacturing Cotton Textile, wrote off in the same year, the expenditure in replacement of Copper Rollers used for printing fabrics and Stainless Steel frames used for Dying Yarn whose life are more than one year. State whether the Cost Auditor can qualify the report for these?**

**Answer 5. (b)**

(i) According to Cost Audit Report Rules, the Cost auditor is required to submit the Cost Audit Report to the Central Government and a copy thereof to the company concerned. The shareholders and the general public have no access to the Cost Audit Report unlike the Financial Audit Report. Cost Audit Report is treated as a confidential document as it contains vital information which if divulged would affect competitiveness of trade and business of the company whose information is so divulged. A Cost Audit Report contains important information such as :

- (I) A detailed note on manufacturing process of the Company.
- (II) Quantities and rates of various items of input materials, i.e the entire recipe is given.
- (III) Quantities and rates of utilities consumed.
- (IV) Average sales realization, sales promotion expenses including discount allowed.
- (V) Details regarding export market, quantity exported, F.O.B realization etc.
- (VI) Any other energy saving measure or technical improvement in process , which a company might have implemented arising out of its own research.

Such data, as a measure of business strategy should not be made available to the competitors who may take advantages and put the company to a disadvantageous position. As such cost data is a secret matter and the company secrets and management strategy contained therein should not be disclosed. There is a provision under subsection (10) of section 233-B of the Companies Act that Central Government can direct a company to make available the Cost Audit Report in full or in part to the shareholders. However this power has not been exercised so far.

It is for the same reason mentioned above that members of parliament are not allowed to access Cost Audit Report. It is the Parliament who has made the law under which Cost Audit Report is treated as confidential document other than for the Government and the company. So unless the law is changed, members, who are representatives of public cannot have access to Cost Audit Report .

But Government have agreed to give all non confidential information like overall profitability, capacity utilization etc from Cost Audit Report. In view of what has been stated above, there is no specific provision in the Companies Act or Cost Audit Report Rules to make the Cost Audit Report being made available to members of Parliament.

- (ii) The Cost Auditor is justified in qualifying his report since as per the Cost Accounting Records (Textiles) Rules, cost of items like Copper Rollers used for printing fabrics and the stainless steel frames used for dyeing yarn put into use in the relevant year shall be treated as deferred revenue expenditure and spread over the effective life of such items . Thus writing off such items in same year is not correct.

**Q. 6. (a) From the following figures extracted from the financial and cost accounting records, you are required to compute:**

- (i) Value Added.  
(ii) Ratio of Operating Profit to Sales.  
(iii) Ratio of Operating Profit to Value Added.

Particulars	Rs. in lacs
Net Sales excluding Excise Duty	21000
Increase in Stock of finished goods	250
<b>Expenses :</b>	
Raw Materials consumed	2600
Packing materials consumed	1200
Stores and spares consumed	560
Power and fuel	4600
Repairs and maintenance	200
Insurance	120
Direct salaries and wages	480
Depreciation	885
Interest paid	1398
<b>Factory overhead :</b>	
Salaries and wages	240
Others	250
<b>Selling and distribution expenses :</b>	
Salaries and wages	120
Additional sales tax	457
Others	1700
<b>Administration overheads :</b>	
Salaries and wages	120
Others	80

**Answer 6. (a) (i)**

Computation of Value Added	Rs. in lacs	Rs. in lacs
Net Sales+ Increase in Stock of Finished Goods		21250
<i>Less:</i>		
<b>Cost of bought out materials and services:</b>		
Raw Materials	2600	
Packing Materials	1200	
Stores and Spares	560	
Power and fuel	4600	
Repairs and Maintenance	200	
Insurance	120	
Other factory overhead	250	
Other Selling & distribution overhead	1700	
Other Administration overhead	<u>80</u>	<u>11310</u>
i) Value Added		9940
Composition of Value Added:		
Depreciation	885	
Interest	1398	
Additional Sales tax	457	
Salaries and wages(480+240+120+120)	<u>960</u>	<u>3700</u>
Profit before tax (balancing figure)		<b>6240</b>
<b>Operating Profit :</b>		
PBT		6240
Interest paid		<u>1398</u>
		<u>7638</u>

(ii) Ratio of operating profit to net sales =  $\frac{7638}{21000} \times 100 = 36.37\%$

(iii) Ratio of operating profit to value added =  $\frac{7638}{9940} \times 100 = 76.84\%$

**Q. 6. (b) In dealing with the financial position of a company as per para 24 of the Annexure to the Cost audit Report, state your opinion regarding :**

- (i) Is the Capital Employed to be computed as at the beginning of the accounting period or at the end of the accounting period or average of both?
- (ii) Should investments like National Savings Certificates deposited with Government authorities for Sales Tax, Excise etc. as security be treated as investments outside the business?
- (iii) How is 'net worth' defined in this para? The para also states "if there is any change in the composition of the net worth during the year, special mention may be made along with the reasons there for." How would you take care of this provision?

(iv) Should the net sales figure include other service charges and jobbing income?

(v) In case the financial accounts of the company are yet to be finalized and audited, should the cost auditor provide the data under para 24?

**Answer 6. (b)**

- (i) Capital employed should be stated as at the close of the accounting period.
- (ii) Such investments are in normal course of business and for the business, therefore these cannot be treated as investments outside the business.
- (iii) The term 'net worth' has been defined as share capital plus reserves and surplus (excluding revaluation reserve) less accumulated losses and intangible assets. In other words it can be calculated as under:

Share Capital (paid up capital-equity and preference)	**
Add: Reserves and Surplus	**
Less: Revaluation Reserve	**
Less: Intangible Assets	**
Less: Profit and Loss A/c (Debit balance)	**
Less: Misc/deferred expenditure	**
A reconciliation of net worth in following form may be provided:	
Net worth at the beginning of the year	**
Add :increase in capital	
Add :increase in reserve	
Less: Decrease in reserves	
Less: Any loss	
Less: Any acquisition of intangible asset or incurrance of expenses treating as deferred	
Net worth at the end of the year	**

- (iv) If other service charges and jobbing income are a regular part of the activity and are of material value these can be treated as sales, otherwise not to be so considered.
- (v) Where the financial accounts have not been finalized at the time of submission of the Cost Audit Report, Cost Auditor may indicate in his report all financial data under para 24 are on the basis of the unaudited or provisional accounts. This is necessary as all cost statements contain a lot of data which have a linkage to the financial accounts. After the accounts have been finalized, a supplementary cost audit report should be submitted as soon as the audited accounts are made available.

**Q. 7. (a) Inspite of increase turnover continuously for three years, a company has started incurring cash losses, and has become sick. Is it possible to identify and pinpoint the factors which have led to this situation from Cost Audit Report? Explain quoting the relevant paragraphs in the Annexure to the Report.**

**Answer 7. (a)**

The factors that need to be taken into account for analyzing company's position are :

- (i) Turnover of the Company continuously increasing for three years; and

- (ii) the Company is incurring cash losses and has become sick. The various Annexure to Cost Audit Report that will provide an explanation to company's position are as follows:
- (i) Para 5(A)- Major input materials/components consumed. This will help in finding comparison of quantities used and price that is paid for materials—
    - A) Indigenous
    - B) Imported
    - C) Self- manufactured. Increase in raw material prices may result in increase in expenditure.
  - (ii) Para 5(B)-This para highlights the standard vs. actual consumption of input materials per unit, so usage inefficiency gets focused.
  - (iii) Para 6- In this para details of imported price is highlighted.
  - (iv) Para 7(A)- This para provides details of power and fuel consumption such as electricity purchased, electricity generated, HSD Oil, Gas etc.
  - (v) Para 7(B)- focuses on actual consumption of power, utilities etc. as against standard consumption.
  - (vi) Various Expenses: The following paras provide the details of various expenses incurred for producing the product. The figures are provided for the Current year and previous two years which enables to judge the increase in expenses.
 

Para 8 : Salaries and Wages of Direct, Indirect, Administrative and others

Para 9 : Repairs and Maintenance of Office Building, Staff Quarters, Plant and Machinery and others.

Para 12: Overheads which consists of Factory, Administrative, Selling and Distribution.

Para 13: Research and Development expenses.

Para 14: Royalty and technical knowhow charges.

Para 15: Quality control expenses.

Para 16: Pollution control expenses.
  - (vii) Para 17: Abnormal non-recurring expenses- This para deals with abnormal expenditure incurred during the year in respect of Strike, lockout, breakdown of machinery, stoppage of work due to raw material shortage , absenteeism.
  - (viii) Para-20 : This para provides details of Sales figures , both in quantity and value of the products under reference. This is an important para for analysis and ultimate result of the concern.
  - (ix) Para 21- provides information regarding 'margin per unit of output.' This will highlight profitability of the company (a) product wise (b)region wise. This will also help in finding whether there is an adverse change in product mix.

After analyzing the data contained in the Annexure, the causes for decline in profitability and cash losses may be derived. Some of the probable reasons are:

- A) Adverse change in product–mix, resulting in reduced contribution though there is increase in sales volume.
- B) Increase in expenditure due to increase in rates, inefficiency in use.
- C) Increase in Sales volume may be due to increase in credit period resulting in increase in interest cost.
- D) The company may have incurred huge capital expenditure benefit is less than cost incurred during initial period.

After studying the actual facts, correct analysis is possible.

**Q. 7. (b)** A company has following four operations undergone by a product under cost audit.

The input , output and labour costs process-wise are given below :

Process	Input M.T.	Output M.T.	Direct Labour cost of the process (Rs.)
A	48000	43200	129600
B	50000	44000	176000
C	72000	66240	331200
D	60000	55500	444000

Calculate “Direct labour cost per unit of the product under reference” as required in para 8(4) of the Cost Audit Report.

**Answer 7. (b)**

The total labour cost per tonne of the product under audit must be an aggregation of process-wise labour costs after taking into account the good units occurring in each process.

Process	Input	Output	Factor
A	48000	43200	$48000/43200 = 1.1111$
B	50000	44000	$50000/44000 = 1.1364$
C	72000	66240	$72000/66240 = 1.0870$
D	60000	55500	$60000/55500 = 1.0811$

Process wise labour costs per M.T of output are:

- A  $129600/43200 = \text{Rs. } 3$
- B  $176000/44000 = \text{Rs. } 4$
- C  $331200/66240 = \text{Rs. } 5$
- D  $444000/55500 = \text{Rs. } 8$

Charging all the above to the finished product from process D,

Process A = Rs. 3

Process B =  $(\text{Rs. } 3 \times 1.1364) + \text{Rs. } 4 = \text{Rs. } 7.4092$

Process C =  $(\text{Rs. } 7.4092 \times 1.0870) + \text{Rs. } 5 = \text{Rs. } 13.0538$

Process D =  $(\text{Rs. } 13.0538 \times 1.0811) + \text{Rs. } 8 = \text{Rs. } 22.1125$

Direct Labour cost per M.T. of Finished Product = Rs. 22.11

**Q. 8. (a)** How does the Cost auditor allocate and apportion the cost of caustic soda in a Chemical Industry where various products are produced?

**Answer 8. (a)**

Cost auditor may allocate and apportion the cost of Caustic Soda in a chemical industry before split-off point in any of the following basis:

- (i) Sales Value at split off point.
- (ii) Sales value minus post expenditure after split off point.

- (iii) Technical estimate i.e. percentage.
- (iv) Raw material cost can be identified and cost may be allocated and apportioned on basis of Raw Material cost.
- (v) Percentage of salaries and wages for the final product.
- (vi) On basis of Asset Value of various products.
- (vii) Machine Hours utilized for production of Caustic Soda and different products.
- (viii) Area occupied for production of Caustic Soda and different products.

**Q. 8. (b) What are 'waste multipliers' in textile costing? The following are the process wise wastages on inputs in the year 2009-10.**

Process	% age of Wastages on Input
Blow Room	9.18
Carding	7.17
Drawing	1.10
Roving(Simplex)	0.30
Ring Frame(Spinning)	7.21
Reeling and Winding	1.50

From the above, calculate the process wise waste multiplier factor.

**Answer 8. (b)**

Under Section 209(1)(d) rules for the Textile Industry, processing cost/kg of output is worked out first. These costs are then aggregated to arrive at total yarn cost. This is done by using a factor known as "waste multiplier". Accordingly, waste multiplier is that quantity of output from any process, which will be needed to get one unit of final output.

Process	%age of wastages on input	Net output for 100 units of input	Waste multiplier
Total	—	100	1.3161
Blow Room	9.18	100–9.18 = 90.82	1.1953
Carding	7.17	90.82–6.51 = 84.31	1.1096
Drawing	1.10	84.31–0.93 = 83.38	1.0974
Roving(Simplex)	0.30	83.38–0.25 = 83.13	1.0941
Ring Frame(Spinning)	7.21	83.13–5.99 = 77.14	1.0153
Reeling and Winding	1.50	77.14–1.16 = 75.98	1.0000

$$\text{Calculation} = \frac{1}{75.98} = 0.013161 .$$

**Q. 9. How will you treat the following items in the Cost Accounting Records?**

- (i) CENVAT availed as credit on purchased raw materials.
- (ii) Voluntary Retirement Compensation paid to workers included under 'wages'.
- (iii) Profit on sale of fertilizers to cane growers by a sugar company.



- (iv) Commission paid to the Managing Director as a percentage of profit.**
- (v) Interest received on security deposit with the Electricity Board.**

**Answer 9.**

- (i) CENVAT credit is to be deducted from the cost of raw materials, and only the net value should be taken in the priced stores ledger, which forms the basis for pricing material issues to cost centres.
- (ii) Voluntary retirement is a one time non-recurring expenditure. Even if it is included under salaries and wages in Financial Accounts, it should be excluded for Cost Accounts purposes. This is a item of reconciliation between Cost and Financial Accounts.
- (iii) This is purely a trading activity. Hence profit derived from such activity should be shown as a item of reconciliation between Financial and Cost Accounts.
- (iv) This is clearly an item to be excluded from cost. This should be shown as an item in the reconciliation statement in Para 28 between Costing and Financial Profit and Loss Account.
- (v) Interest on security deposit with the Electricity Board can be set-off against interest paid or alternatively, it can be taken as a credit against overheads.

**Q. 10. Comment on the following :**

- (i) A company has not maintained cost accounting records though having the obligation under 209(1)(d) notification. The management is of the opinion that necessary steps could be taken after the cost audit order is received from Government. Are the Directors of the Company absolved of the obligation to maintain cost accounting records?**
- (ii) A company receives the Cost Audit report for a period after filing of the Income Tax Return. Is the company required to submit a copy of the report to the ITO? If yes, what is the period by which the Report must be so filed?**
- (iii) During plant stoppages, the operational labour is being utilized by the company for cleaning, oiling, and such other routine jobs of the same plant. Their wages for the period also are treated as direct wages in cost of production.**
- (iv) Sugar mills use bagasse as fuel in the boilers. One sugar mill has not valued bagasse as according to the management it has incurred no cost in acquiring it. What is the requirement under 209(1)(d) regulations relating to sugar?**

**Answer 10.**

- (i) The obligation to maintain cost accounting records as per the rules provided under Section 209(1)(d) is a continuing one independent of whether cost audit is ordered or not. The financial auditor also has an obligation to certify under CARO that such records have been maintained. The directors of the company cannot be absolved of the obligation as per the Rules 3 and 4 of the 209(1)(d) regulation.
- (ii) Sections 139(9)(e) of the Income Tax Act, 1961 requires the filing of the Cost Audit Reports along with the Income Tax return wherein an audit is ordered. Where the cost audit report is delayed beyond the date for filing of the IT Return, the Company is bound by law to submit a copy of the report to the IT authorities. There is no time limit specified for this. This must be done within a reasonable time as per general construction of law.
- (iii) Where operating workers are required to perform certain type of work which otherwise falls in the category of indirect labour, like oiling, cleaning, maintenance etc., their wages should be treated as indirect wages and accordingly be included in overhead.

- (iv) Bagasse is a by product in sugar industry, which has a realizable value. As the company is using bagasse as a fuel to produce steam, the bagasse should be valued at its realizable value. In absence of a market price, bagasse may be valued on the basis of average pithead price of coal after converting the weight of bagasse into equivalent coal adopting a thermal equivalency.

**Q. 11. (a) The profit as per Financial A/cs of XYZ Cement Ltd. for the year 2009-10 was Rs. 13427516. The profit as per Cost Accounting records showed a different figure. You are required to prepare a reconciliation statement and arrive at a profit as per Cost Accounts. The following details were collected from Financial Accounting and Cost Accounting records.**

	Rs.	
	Financial A/cs	Cost A/cs
Opening WIP	2952315	2345720
Opening Finished Goods	24837410	27216930
Closing WIP	4172635	3635345
Closing Finished Goods	36751410	41524148
Interest income from inter corporate deposits	614250	-
Donations given	475250	-
Loss on sale of Fixed Assets	104148	-
Value of cement taken for own consumption	375920	345200
Cost of power drawn from own wind mill:		
At EB Tariff		4858415
At Cost	3410420	

**Answer 11. (a)**

**Reconciliation of Profit as per Financial Accounts and Cost Accounts:**

	Rs.	
	Rs.	Rs.
Profit as per Financial Accounts		134275165
Add: Difference in stock valuation	2462523	
Add: Loss on sale of Fixed Asset	104148	
Add: Donations not considered in Cost Accounts	475250	3041921
		<u>16469437</u>
Less: Interest income from inter corporate deposits	614250	
Less: Diff. in value of cement taken for own consumption	30720	
Less: Diff. in valuation of wind mill power	1447995	2092965
Profit as per Cost Accounts		<u>14376472</u>

**Working Note :** Computation of difference in valuation of stock

	Financial A/cs	Cost A/cs
Opening(WIP+F.G)	27789725	29562650
Closing(WIP+F.G)	40924045	45159493
	<u>13134320</u>	<u>15596843</u>

The increase is higher in Cost Accounts. Hence Profit as per Cost Accounts is more than Financial Accounts by Rs. 2462523 (15596843–13134320).

**Q. 11. (b)**

- (i) Can a Cost Accountant who is appointed as the Concurrent Auditor of a company be appointed as Cost Auditor of the same company?
- (ii) A person has been appointed as cost auditor for twenty products manufactured in seven companies. He is again proposed for appointment as Cost Auditor for three more products, manufactured by two other companies.

**Answer 11. (b)**

- (i) A Concurrent Auditor may be viewed as a person holding an office of profit of the company and so cannot be appointed as Cost Auditor of the same company.
- (ii) The person can be appointed as he has been Cost Auditor of only seven companies. A person can be appointed as Cost Auditor of twenty companies at a time of which not more than ten companies can have paid up capital of Rs. Twenty five lacs or more. In this case total number of companies for which his name has been proposed is nine only. Number of products is of no relevance at all.

**Q. 12. The following is the abridged Balance Sheet of PS Batteries Ltd:**

	Rs. in lacs	
	31.3.2010	31.3.2009
<b>Liabilities:</b>		
Share Capital	300	300
Debenture Redemption Reserve	25	30
Capital subsidy from State Government	30	30
Revaluation Reserve	125	140
General Reserve	160	120
Balance in Profit and Loss A/c	48	32
Secured Loans	275	295
Unsecured Loans	<u>123</u>	<u>117</u>
	<b><u>1086</u></b>	<b><u>1064</u></b>
<b>Assets:</b>		
Gross Block	725	680
Accumulated Depreciation	(315)	(290)
Capital WIP	43	37
Investments	15	15
<b>Current Assets:</b>		
Inventories	417	441
Sundry Debtors	182	195
Advances for Capital Equipment	24	17
Other Loans & Advances	144	137
Cash and Bank Balances	21	19
<b>Current Liabilities:</b>		
Sundry Creditors		
For Capital Expenses	(17)	(21)
For others	(185)	(197)
Provision for Taxes	(64)	(71)
Misc. Expenses	<u>96</u>	<u>102</u>
<b>Total</b>	<b><u>1086</u></b>	<b><u>1086</u></b>

**Notes :**

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

Calculate the following for the company as a whole :

- (i) Capital Employed for the year ended 31.3.10  
(ii) Net worth as on 31.3.09 and 31.3.10  
(iii) Debt Equity Ratio as on 31.3.2010

**Answer 12. (i)**

Capital Employed:

	31.3.10	31.3.09
Gross Block	725	680
Less: Depreciation	<u>315</u>	<u>290</u>
Net Block	410	390
Less: Goodwill	<u>122</u>	<u>137</u>
Net Fixed Assets	288	253
<i>Current Assets:</i>		
Inventories	417	441
Sundry Debtors	182	195
Other Loans & Advances	144	137
Cash and Bank Balances	<u>21</u>	<u>19</u>
(A)	<u>764</u>	<u>792</u>
<i>Current Liabilities</i>		
Sundry Creditors		
For others	185	197
Provision for Taxes	64	71
Misc. Expenses	<u>96</u>	<u>84</u>
(B)	<u>345</u>	<u>352</u>
Working capital (A-B)	419	440
Capital Employed (Net Fixed Assets+Working Capital)	707	693

Average capital employed =  $(707+693)/2 = 700$  lacs.

(ii) Net worth :

	Rs. in lacs	Rs. in lacs
	31.3.10	31.3.09
Share Capital	300	300
Debenture Redemption Reserve	25	30
Capital Subsidy	30	30
General Reserve	160	120
Balance in P&L A/c	48	32
Equity	563	512
Less: Intangible Assets	122	137
Less: Misc. Expenditure	96	102
Net worth	345	273

(iii) Debt- Equity Ratio :

	31.3.10	31.3.09
Debt (Secured & Unsecured Loans)	398	412
Less: Due in 12 months	96	84
Long term debt	302	328
Equity	563	512
Debt Equity Ratio	0.54:1	0.64:1

Q. 13. (a) The following data have been collected by you, as a Cost Auditor of a Company :

Particulars	07-08	08-09	09-10
Installed Capacity (lac MT)	2.5	2.5	2.5
Production (lac MT)	2.4	2.3	1.25
Cost/MT of the product (Rs.)	1000	1077	1660

The poor capacity utilization in 2009-10 was due to abnormal power cut. The escalation in costs were 5% in 08-09 and 2% over 08-09 in 2009-10.

- (i) Calculate the abnormal cost due to power cut.
- (ii) How would you treat these abnormal cost?

**Answer 13. (a)**

Particulars	07-08	08-09	09-10
Installed Capacity (lac MT)	2.5	2.5	2.5
Production (lac MT)	2.4	2.3	1.25
% of Capacity Utilisation	96	92	50
Cost per unit (Rs./MT)	1000	1077	1660
Escalation factor	100	105	107
Cost at Base Year price	1000	1025	1551
Total cost of production (Rs. in lacs)	2400	2359.8	1938.75
Variable cost /MT	402	402	402
Fixed cost /MT	598	623	1149
Fixed cost @100% utilisation	574		

Hence, increase in Fixed Cost/MT due to poor capacity utilization in 2009-10 is =  $1149 - 574 = \text{Rs. } 575$ .

(i) Abnormal cost due to power cut =  $575 \times 1.25 = \text{Rs. } 718.75$

(ii) The abnormal cost must be excluded from computation of Cost and shown under Para 17 of the Annexure to the Cost Audit Report.

**Working Notes :**

(i)

As compared to 07-08	08-09	09-10
(A) Difference in total cost (Rs. in lacs)	$2400 - 2359.8 = 40.2$	$2400 - 1938.75 = 461.25$
(B) Difference in Production (lac MT)	$2.4 - 2.3 = 0.1$	$2.4 - 1.25 = 1.15$
Variable Cost/MT (Rs) (A)/(B)	402	402 approx

**Q. 13. (b) Distinguish between “Notes” and “Qualifications” in Cost Audit Report. Give suitable examples.****Answer 13. (b)**

Section 227(2) of the Company's Act, 1956, requires the auditor to make report to the shareholders on the accounts examined by him. When in any of the matters as required to be stated, the Auditor feels that satisfactory compliance was not done by the company, the auditor shall state the fact of non-compliances and suitably qualify the point with reason.

The same principle also holds good for the Cost Auditor, though the report is to be submitted to the Central Government. Wherever a particular statement or basis of costing needs some explanation or clarification, the auditor shall add suitable “Notes” at appropriate places by way of explanation. For example, if a company has added a new activity, on account of which a portion of overhead charges to a product gets reduced during a year, this may be explained by way of “Notes”.

On other hand if a company has deviated from the accepted Cost Accounting principles, in order to inflate costs, the auditor shall make a qualified report to the Government.

For example, if a company has spent a huge amount on evaluation of new product ideas and has charged the entire amount to the Administrative Overhead, the Cost Auditor should qualify the excess amount and the impact on each unit of Cost of Production of the products under audit. Such report will be a “qualified report”.

**Q. 14. How would you treat the following as per CAS 7 related to Employee Cost?**

- (i) Recruitment cost.
- (ii) Overtime premium
- (iii) Separation cost due to voluntary retirement, retrenchment, termination etc.
- (iv) Idle time cost

**Answer 14.**

- (i) Recruitment, training and other such costs shall be treated as overheads and dealt accordingly.
- (ii) 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.
- (iii) 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.
- (iv) Idle time is the difference between the time for which the employees are paid and the employees' time booked against the cost object. Idle time cost shall be assigned to the cost object or treated as overheads depending on economic feasibility and specific circumstances causing such idle time.

**Q. 15. (a) How would you assign administrative overheads as per CAS 11?**

**Answer 15. (a)**

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.

**Q. 15. (b) (i) What is meant by stand by utility? What would be the normal capacity of a standby utility under CAS 8?**

**(ii) How would you determine the cost of utilities generated for inter company transfers?**

**Answer 15. (b)**

- (i) Any utility created to safeguard against the failure of the main source of inputs is called standby utility. In case of any standby utility the normal capacity will be the same as actual production of the utility.
- (ii) 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.

## Section II : Operational Audit

**Q. 1. State whether following statements are True or False. Justify your answer.**

- (i) Management Audit Report is to be submitted to Cost Audit Branch.
- (ii) Main objectives of Internal audit is prevention of error and frauds.
- (iii) Position Analysis is one of the techniques used by Management Auditor for evaluation of corporate image.
- (iv) There are no fixed items of evidence to be checked by Management Auditor.
- (v) The concept of Financial Audit was developed by T. G Rose.
- (vi) Management audit can assist in SWOT analysis of an organisation.
- (vii) Ergonomics deals with man-machine relationship.
- (viii) In ABC system the concept of 'cost centre' is very important.
- (ix) Dumping is an 'illegal' practice.
- (x) Excise Audit 2000 was initiated from 1<sup>st</sup> April 2000.
- (xi) Conventional accounting systems are unable to adequately compute the 'environmental costs.'
- (xii) The Secretariat of WTO is headed by Director- General.
- (xiii) GATT and its agreement are permanent.
- (xiv) ICWAI is a member of IFAC.
- (xv) A certificate is a detailed description of a situation.
- (xvi) For stock hypothecation to the Bank, insurance Coverage is required for seventy-five percent of stock as margin money.
- (xvii) "Firm of Cost accountants" should have at least two partners who are practicing Cost Accountants.
- (xviii) ISO 9000 certification is an 'assurance service'.
- (xix) Assurance engagements involve three separate parties.
- (xx) Physical verification is not a part of Stock Audit conducted by a Bank.

**Answer 1.**

- (i) False — Management Audit Report is to be presented to the Management.
- (ii) False — The main objective is to improve managerial control by measuring and evaluating the effectiveness of other controls.
- (iii) True — Position Analysis helps in determining market share, market stability, etc
- (iv) True — A Management Auditor has to rely more on his experience and acumen to identify areas of review
- (v) False — T. G. Rose developed the concept of Management Audit as a logical system of evaluating the quality of Management.)
- (vi) The statement is true.
- (vii) The statement is true.



- (viii) False — In ABC system the concept of 'activity centre' is relevant.
- (ix) False — Dumping is an 'unfair' practice.
- (x) False — Excise Audit 2000 was initiated from 1st December 1999.
- (xi) The statement is true.
- (xii) The statement is true.
- (xiii) False — GATT was ad hoc and provisional
- (xiv) The statement is true
- (xv) False — A certificate is a written declaration consisting of facts and or opinion capable of being verified subsequently.
- (xvi) (False. For stock hypothecation to Bank, insurance Coverage is required for the full value.)
- (xvii) False — "Firm of Cost accountants" means sole proprietorship concern, the sole proprietor of which is a Cost Accountant in Practice or a firm, wherein all partners are Cost Accountants and such firm is approved by the Council.
- (xviii) The statement is true.
- (xix) True — The parties are a public accountant in practice, a responsible party and intended users.
- (xx) False — Physical verification of stock is the most important part of stock audit conducted by a Bank.

**Q. 2. (a)** Fill in the blanks with appropriate word/words.

- (i) \_\_\_\_\_ is the evaluation of every resources declared in the industry.
- (ii) Management Audit can be a \_\_\_\_\_ for managerial control.
- (iii) The main emphasis of Management Audit is problem \_\_\_\_\_ rather than problem \_\_\_\_\_ .
- (iv) Margin of Dumping means the difference between \_\_\_\_\_ and \_\_\_\_\_ .
- (v) Corporate objectives represent the \_\_\_\_\_ that the organization has laid down for itself.
- (vi) Section 292 A of the Companies Amendment Act ,2000 provides for constitution of \_\_\_\_\_ .
- (vii) \_\_\_\_\_ is the highest body of WTO.
- (viii) SALVAGE is considered as \_\_\_\_\_ by insurer against what is owed under the policy for an insured loss.
- (ix) The origin of the term 'Due Diligence' owes to \_\_\_\_\_ .
- (x) Excisable goods must come out of \_\_\_\_\_ process.

**Answer 2. (a)**

- (i) Productivity Analysis
- (ii) potent tool
- (iii) identification, solving
- (iv) normal value, export price of goods
- (v) Charter
- (vi) Audit Committees.
- (vii) The Ministerial Conference
- (viii) credit

- (ix) US Securities Act, 1933
- (x) production.

**Q. 2. (b) What do the following abbreviations stand for?**

**Answer 2. (b)**

- (i) MAR — Management Audit Report.
- (ii) BIFR — Board for Industrial Finance and Reconstruction.
- (iii) CPSEs — Central Public Sector Enterprises.
- (iv) CII — Confederation of Indian Industry.
- (v) SOX — Sarbanes Oxley Act of 2002.
- (vi) CBEC — Central Board of Excise and Customs.
- (vii) CERA — Central Revenue Audit.
- (viii) SWOT Analysis — Strength Weakness Opportunities Threats Analysis.
- (ix) IFAC — International Federation of Accountants.
- (x) EVA — Economic Value Added.

**Q. 3. What are the qualities and functions of a Management Auditor? A Management Audit team should be multidimensional. Discuss and elucidate.**

**Answer 3.**

Management audit is the systematic and dispassionate examination, analysis and appraisal of management's overall performance. In this context the essential qualities of a Management Auditor are :

- (i) Ability to grasp the business problems.
- (ii) General understanding of the motive, purpose ,and objects of the organization.
- (iii) Ability to assist the program of the organization.
- (iv) Knowledge about the principles of delegation of authority.
- (v) Power of understanding different internal control devices, flow charts, flow of work etc.
- (vi) Sufficient knowledge about engineering , statistical techniques , cost and management etc.
- (vii) General understanding of all economic legislations like Company Law , Customs, Central Excise , IT etc.
- (viii) Ability to prepare reports to various levels of management.
- (ix) Capacity to adjust with personnel of different types with tact. Management Auditor should be able to elicit information and capable of discovering intelligently in a meeting and should not disclose own ignorance on any issue.

The functions of Management Auditor are as follows :

- (i) He should ensure that all pertinent information needed for planning reaches the higher management.
- (ii) He should ensure that decisions are based on the objectives of the management.
- (iii) He should ensure that key functions or operations which are profit making are given maximum attention.
- (iv) The implication of changes in the budgetary proposals should be projected by him adequately both in respect of direct and indirect taxation, to the top levels of management . Similarly changes in the laws should also be studied by him and implications ascertained.

- (v) He should keep himself abreast with developments in information technology and introduce latest methods of information and communication system, consistent with cost benefit studies needed to improve the systems.

Management Audit is a service function with the object of assisting management in achieving the most efficient administration. Management audit involves multidisciplinary and multidimensional approach and requires systematic and dispassionate review of analysis and appraisal of overall performance. It takes into account the techno-economic study of the Industry. As a management auditor is concerned with all aspects of business and the organization, ranging from manufacture to marketing and finance, the management audit team should be multidisciplinary to make multidimensional approach to audit function.

**Q. 4. A nationalized bank which has extended cash credit to a manufacturing company on the security of the inventory holding, is periodically receiving stock statements from the company indicating the value of stocks held. The company is sick and the Bank wants to reassure itself that its loans are fully covered by stocks. You have been appointed by the Bank to certify the value of the inventory. How would you proceed to conduct the 'inventory audit?'**

**Answer 4.**

Inventory Audit involves the following aspects :

- (i) Physical verification of stocks.
- (ii) Method of valuation adopted.
- (iii) Currency of stocks (i.e movement)
  - (i) *Physical verification of stocks*—Physical verification of stocks will normally be 100 percent. However, depending upon the nature of items and material flows, it may be done by sampling. This will require proper sampling procedures to ensure the samples verified represent the characteristics of entire stock. An ABC categorization may be done so that right emphasis is given to each item of stock.
  - (ii) *Method of valuation adopted*— The main thrust of inventory audit is to check the accuracy of the costs, to verify the market rates and to see that the values adopted for stock valuation are cost price or net realisable value which ever is lower. Basis of valuation adopted for Raw Materials, Work-in process, Finished Goods and Spares and Consumables must be examined and reasonableness verified to ensure the realizable values. For imported items foreign exchange translation rate for conversion will be :
    - (a) as per bank debits under LC, or
    - (b) rate prevalent as evidenced by Bill of Entry (or Forward Rate if Forward Contract has been taken (for imports on D.A. terms or on account).
  - (iii) *Currency of stocks*— Currency of stocks will be ensured by analyzing all items by fast, slow and non-moving characteristics. In respect of slow and non-moving items, fall in value, if any, due to obsolescence, deterioration etc. will also have to be examined and reported.

In respect of spare parts, care must be taken to segregate items of spares relating to scrapped or replaced plant/machinery, as these may not have any value.

In finished goods also, returns from customers for defects in quality must be given special consideration in valuation.

- (iv) The basis of the unit rates adopted must be consistent and include :
  - (a) Freight, insurance, octroi, packing, loading and unloading and other incidental charges incurred.
  - (b) Manufacturing costs upto stages of completion in case of finished product.

The report may be designed by the bank or designed by the Cost Auditor. In any case some items which need to be highlighted should be shown separately. The report should contain lacuna, if any, improvements required, and suggestions for improvement. Needless to say the report should not only be useful to client, i.e bank but also to the unit whose audit is carried out to enable them to improve their performance.

**Q. 5. Today's customer is more demanding than the customer of yesterday. In view of the this, how would you evaluate, as a management Auditor, the performance of "Customer Services Department"?**

**Answer 5.**

A customer is the most important person for a business because it is he who provides the profit. Therefore, the starting point in marketing strategy is identifying the customers, their needs and organizing the efforts of the company towards satisfying such needs. In order to create and sustain the customers, right quality of goods must be supplied to them at right price and right time. If the customers are rightly and properly attended, it will stimulate the demand for the products of the company and help to establish product acceptability and widen the scope of potential customers. Performance of "Customer Services Department" may be evaluated on the following lines :

**(i) Product related policies and practices :**

- (a) Do products manufactured meet the needs of the customers of different classes, different taste and different purchasing power.
- (b) Whether prices include reasonable profit?
- (c) Whether prices are reasonable , consistant with quality and efficiency variations?
- (d) Whether prices fixed are based on market conditions or Government regulations?
- (e) Whether customers derive maximum benefit from after sales service?
- (f) Whether the details of information given to customers regarding company profile , service, policy etc. adequately disseminated?
- (g) Whether the department undertakes adequate research with regard to product, consumer behaviour so as to enhance customer satisfaction?
- (h) Whether constant efforts are made to improve use value of the product?
- (i) Whether product development program undertaken meet only short term needs or long term goals? Do the development programs consider the factors of standardization, simplification and specialization?
- (j) Whether company policies and practices relating to distribution of products among different sections of customers are fair and reasonable?

**(ii) Customer relationship :**

- (a) Whether the customer's complaints are handled promptly and efficiently?
- (b) Whether the department is prompt in replying to the queries of customers relating to the product or service?
- (c) Whether the labels of the products contain adequate information to help customers to appreciate the quality and other characteristics of the product?
- (d) Whether the company is co-operative with consumer associations?
- (e) Whether the company provides useful guidance and render necessary assistance to Consumer' Co-operatives for distribution of quality products at reasonable prices?

**(iii) General considerations :**

- (a) Whether safety norms relating to the product are as per accepted standards laid down by statutory bodies such as ISI, BSS etc?
- (b) Whether performance guarantees are explicitly stated?
- (c) Whether the technical data given in sales promotional media specific and not ambiguous?
- (d) Whether features of the product conform to the merits as per advertisements?
- (e) When the distribution network is large, how does the department handles customer complaints?
- (f) How does the department combat artificial scarcities?

- (g) Whether all warranties and procedure for invocation of them explicitly stated?
- (h) Whether the fundamental aspect of servicing responsibility to customers recognized by the department as a policy measure?
- (i) Whether there are instances of relaxation of policy norms in respect of responsibilities to customers even when distribution of goods is made through middlemen?

**Q. 6. What is the basic difference between :**

- (i) **Internal audit and Management audit.**
- (ii) **Data and Information.**
- (iii) **Corroborative evidence and Circumstantial evidence.**
- (iv) **Sales and Marketing.**
- (v) **Job-enrichment and job-rotation.**

**Answer 6.**

- (i) Internal audit and Management audit.

Particulars	Internal audit	Management audit
1) Expectations :	Assisting management to identify problems.	Appraising management.
2) Attitude	Policeman/ judge	Friend, philosopher, guide.
3) Agency	Internal/external	Outside team/ management
4) Force	Statutory in some cases	Voluntary
5) Area	Mainly past/ procedural	Complete management or specific problems
6) Evaluation	Quality of procedures, operations, data.	Effectiveness/quality of management policies.
7) Period covered	Past and present	Past, present and future.
8) Procedures	Structured	Flexible
9) Reporting level	Operational	Higher
10) Time span	Current and immediate	Futuristic

- (ii)

Data	Information
i) Data is the information in raw material form.	Information is data that has been processed into meaningful form so that it can be effectively interpreted and help the user in decision making. Information consists of data, text, images, voice etc. Top management should be fed with information only as they have no time to fiddle with data.

- (ii) Corroborative evidence and Circumstantial evidence

Corroborative evidence	Circumstantial evidence
It is evidence gathered from sources independent of the first source- the subject matter of issue. For e.g Auditor confirming balances appearing in Debtor's Ledgers from the customers directly.	It is evidence gathered from in and around the place of incidence, which is incidental to or connected to main issue. It is not authentic and depends on presumptions.

(iv) Sales and Marketing

Sales	Marketing
Sales covers execution of order and collection of money from customer.	Marketing involves creation demand for the product by advertising and other sales promotion techniques. Sales is one of the activities in marketing area.

(v) Job-enrichment and job-rotation

Job enrichment	Job rotation
Redesign of jobs to introduce more variety and less routine work so as boost morale of the employees.	Practice of changing people from one job to another so that the individual jobs that the employees perform remain as devoid of any personal interest or gains.

**Q. 7. (a) Give an 'Audit Programme' as a Cost Auditor after being appointed for Cenvat Credit Audit.**

**(b) What are the possible areas of misuse of Cenvat Credit of Duty.**

**Answer 7. (a)**

Audit programme is a plan of action drawn in advance of taking up the audit to help the auditor to cover the entire area of his function thoroughly. An efficient audit programme regarding Cenvat Credit Audit shall comprise the following :

- (i) Basic information about the auditee —
  - (A) Name of the auditee- Management controlling the unit.
  - (B) Address and location of registered office and factories (with phone numbers, FAX numbers, e-mail id etc.)
- (ii) Period to be covered.
- (iii) Estimated time (number of days) required.
- (iv) Audit team comprising of Partners, Qualified/Semi-qualified staff.
- (v) Aspects to be covered in the report—
  - (A) Review of the manufacturing processes.
  - (B) Review of Bill of Materials- information regarding major supplies of inputs, mode of ordering and receipt and accounting for inputs.
  - (C) Yield Analysis-Input consumption and output yield.
  - (D) Review of Statutory details- (i) Classification of input to output (ii) MSN nomenclature etc.
  - (E) Documents to be checked- Notices, Show cause, Litigation matter in respect of Cenvat Credit.
  - (F) Cenvat records-(i) PLA Register (ii) Amount claimed and claimable against Raw Material and Capital Goods (iii) Summary Statement of Cenvat Credit (iv) Vendor Invoices etc.
  - (G) Review of the correlation of Cenvat credit documents with financial accounts
  - (H) Last three years trend of 5% of Cenvat Credit to total duty paid- significant variation to be investigated.
  - (I) In case of Capital Goods for CENVAT availed – whether depreciation has been claimed on the element of Cenvat included in the cost of capital goods.
- (vi) Report to be submitted to the representative of the company.

**Answer 7. (b)**

The possible areas of misuse of Cenvat Credit are as follows:

- (i) Consumption of inputs shown in higher side than norms and corresponding higher wastage/ scrap/loss. This results in paying duty on lower production and availing CENVAT on higher input.
- (ii) Claiming CENVAT on inputs used for production of goods exempted from duty.
- (iii) Claiming CENVAT on capital goods which are specially excluded.

**Q. 8. Write short notes on :**

- (a) **Safeguard Duty.**
- (b) **Audit Committee.**
- (c) **Management Frauds.**

**Answer 8. (a)**

Safeguard Duty is a step in providing a need based protection to domestic industry for a limited period with ultimate objective of restoring free and fair competition. Central Government is empowered to impose 'safe guard duty' on specified imports if it is satisfied that goods are being imported in large quantities and are causing serious injury to domestic industry. Such duty is permissible under WTO agreement, only condition is that discrimination cannot be done among imports from different Most Favoured Nations.

Government has to conduct an enquiry and then issue notification [Section 8B(1) of Customs Tariff Act.] Total period of duty cannot be more than 10 years [sec 8B(4) of Customs Tariff Act]. Once imposed the duty is valid for 4 years unless revoked earlier. In case of imports from developing countries, such duty can be imposed only if value is more than 3% of total imports of the article in India. [sec 8B (10) of Customs Tariff Act.]

**Answer 8. (b)**

The Companies (Amendment) Act, 2000 provides for constitution of Audit Committees in case of every public company having paid up capital of Rs. 5 crore and above. The salient features of the Audit Committee are as follows :

- (i) The audit committee shall have minimum three directors as members.
- (ii) All the members must be financially literate.
- (iii) The Chairman shall be an independent director.
- (iv) The Company Secretary shall act as secretary to the committee.
- (v) The Chairman of the committee shall be present at the Annual General Meeting to answer shareholders' queries.
- (vi) The committee shall have powers as follows :
  - (1) To investigate any activity.
  - (2) To seek information from an employee
  - (3) To obtain outside legal or other professional advice.
- (vii) The role of the committee shall include the following :
  - (1) Reviewing the adequacy of internal control systems.
  - (2) Reviewing the performance of statutory and internal auditors.
  - (3) Recommending to the Board appointment , reappointment, replacement of Statutory and Internal auditors.
  - (4) Reviewing with management the annual financial statements before submission to the board for approval.

- (5) Discussion with statutory and internal auditors before commencement of audit as well as post audit discussions to ascertain any area of concern.
- (6) Carrying out any other function as is mentioned in terms of reference of the audit committee.

**Answer 8. (c)****Management Frauds :**

Fraud is an intentional misrepresentation of facts. In general, it is seen that top executives like Managing Directors, Directors, General Managers and other such executives occupying the positions in an organization are found to commit management frauds. These frauds are the deception practiced by these managers so as to show their performance better than what they actually are.

The frauds may be committed in cash or in kind for personal benefit of the managers. Such frauds may take the form of misappropriation of assets and manipulation of records. Because of their fiduciary position, the managers have greater control over preparation of accounting and financial statements and better opportunities to defraud the company and others. Prevention of frauds is the duty of management. But when top management itself is perpetuating frauds, it becomes very difficult for anyone else to detect it. The following measures may be adopted for control and prevention of management frauds :

- (i) Introduction of adequate internal control system.
- (ii) Conducting system audit to improve systems and procedures.
- (iii) Sound personnel policies – reviewed and if necessary, revised periodically.
- (iv) Tightening supervision at all levels.
- (v) Significant variations from budgets or standards should be checked in detail.

**Q. 9. Evaluation of the personnel function of an organization by management auditor is by no means an easy task. In your view what areas are to be covered and points to be kept in mind while assessing the personnel function of an organization?**

**Answer 9.**

The personnel management is concerned with managing people at work for development of efficient and loyal employees for attainment of organization goals. So evaluation personnel function is not an easy task. The important areas to be covered by management auditor while evaluating personnel function are as follows :

- (i) Methods followed for manpower planning, recruitment, training, promotion and transfers.
- (ii) Action plan for reducing absenteeism.
- (iii) Procedure for analysis of labour turnover and steps taken for reduction of the same.
- (iv) Method adopted for developing wage and salary structure.
- (v) Incentives plan—both financial, i.e. bonus, increment etc and non financial e.g. job enrichment, promotion etc.
- (vi) Welfare and safety measures adopted including social security measures and community development programmes.
- (vii) Performance appraisal system of the organization.
- (viii) Measures undertaken to boost employee morale.

The following points to be kept in mind while assessing the personnel function of an organization :

- (i) It is difficult to exactly quantify the influence of human factors and its contribution to success or failure of the organization.
- (ii) Development of a uniform yard stick for measurement of performance of a large group of workers is also not easy.



- (iii) Workers get influenced by the overall industrial environment.
- (iv) Motivating the employees towards achievement of organization goals is a very important as well as difficult task.
- (v) The management auditor should assess whether the managers possess necessary leadership qualities and dynamic ideas to motivate their personnel.
- (vi) The personnel function is a very important function because in the absence of a well organized personnel function, the company will not be able to utilize the other resources in optimum manner. Human resource is the most important resource in any organization.

**Q. 10. You are appointed by the Chief Commissioner of Customs to carry out a Special Audit of Accounts of a company which manufactures goods in Customs Bonded Warehouse. Detail the procedures involved and points to be covered in your report.**

**Answer 10.**

The procedure for Special Audit of Accounts for goods manufactured in Bonded Warehouse has been laid down in the Board's regulations issued in 1966. The procedures have not been considerably simplified since then but physical control and supervision of customs officer on the bonded warehouse has been done away with since July 1998.

- (i) The owner has to make an application giving full details of the description of warehouse, process of manufacture, imported and other goods used etc.
- (ii) Manufacture or physical removal will not be under the supervision of the of the Custom officers but proper records should be maintained. The officers have right to visit the warehouse and control and supervise the process.
- (iii) The basic records to be maintained are as follows :
  - (A) Bond register showing receipts and issues of goods.
  - (B) Issue Notes
  - (C) Manufacturing Register
  - (D) Finished product Register
  - (E) Reject/Scrap Register
  - (F) Export Register
  - (G) Subcontract Register
  - (H) DTA Sale Register
  - (I) Indigenous Goods Register

The Audit Report should cover the following :

- (i) Basic information about the manufacturer like management controlling unit, capital structure, major raw materials, location of registered office and factories etc.
- (ii) Details of manufacturing process and major capital equipment.
- (iii) Input output ratios-norms vis-a-vis actual.
- (iv) Documents checked
- (v) Correlation of Customs documents of Input and Export of Final products with financial accounts.
- (vi) The details of scrap sales.
- (vii) Sales in Domestic Tariff Area (DTA)
- (viii) Any other specific observation which is relevant for the audit.

However no comment should be made on admissibility or otherwise of any Cenvat credit, as it is the function of the adjudicating authority alone.

**Q. 11. Define the following :**

- (i) Green Room Meetings
- (ii) Sun Set Clause
- (iii) Trade Facilitation
- (iv) Salvage in relation to insurance claim.

**Answer 11.**

**(i) Green Room Meetings :** The “Green Room” is a phrase taken from the informal name of the WTO’s director-general’s conference room. It is used to refer to meetings of 20-40 delegations, usually at the level of heads of delegations. These meetings can take place elsewhere, such as at Ministerial Conferences, and can be called by the minister chairing the conference as well as the director-general. These meetings help in initiating informal meeting within the WTO (World Trade Organisation).

**(ii) Sun Set Clause :** A sunset clause or provision is part of a law or statute that can repeal the law or parts of it at a specified time period. The history of using sunset clauses is lengthy, dating to the Roman Republic’s use of it to pass temporary laws when specific things like tax increases or extra military spending were needed for a short period of time. The phrase *ad tempus concessa post tempus censeatur denegata* was added to numerous laws and roughly translates to the statement that a clause was admitted for a short period of time and then denied after that time period had ended. Such clauses are specifically directed at keeping a constant review of restrictive measures like Anti dumping, Countervailing measures.

**(iii) Trade Facilitation :** *Trade facilitation* looks at how procedures and controls governing the movement of goods across national borders can be improved to reduce associated cost burdens and maximise efficiency while safeguarding legitimate regulatory objectives.

Understanding and use of the term “trade facilitation” varies in the literature and amongst practitioners. “Trade facilitation” is largely used by institutions which seek to improve the regulatory interface between government bodies and traders at national borders. The WTO in an online training package, once defined trade facilitation as: “The simplification and harmonisation of international trade procedures” where trade procedures are the “activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade”.

**(iv) Salvage :** *Salvage value* is the estimated value of an asset at the end of its useful life. In relation to insurance claim Salvage is the residual value of a damaged item. Salvage is a very critical issue under any insurance claim. Every damaged item has some *salvage* depending on the item, exact usability, market value, time and place of loss and options available of new item. The salvage is considered as ‘credit’ by the insurer against what is owed under the policy for an insured loss. The professional salvors who are expert in this field can clean, repair and put back the damaged item in operating condition.

**Q. 12. What is the scope of work for Cost Accountant in Practice as a loss assessor ? Give an illustrative list of type of claims and the role of the Cost Accountant in assessing the quantum of loss.**

**Answer 12.**

The Controller of Insurance, Govt. of India, has recognized the Cost Accountancy qualification as equivalent additional technical qualification for granting license u/s 64 UM of the Insurance Act for appointment as a Surveyor or loss assessor. The scope of work of a Surveyor is to assess loss independently, impartially in the event of claim reported to the underwriters. There are various types of General Insurance policies like Fire, Marine, Fidelity Guarantee, Malicious Damage, Loss of Profit etc.

The Surveyor should thoroughly study the terms and conditions of the policy and understand the types of risks covered, restrictions on claims, conditions to be fulfilled by the policy holder etc.

Loss may arise due to the following reasons :

- (i) Marine – Loss in transit due to leakage, pilferage etc.
- (ii) Damage in transit due to accident or improper packaging.

- (iii) Fire- Loss of stock or plant & machineries.
- (iv) Strikes, Riots, etc
- (v) Accident in transit, in factories etc
- (vi) Malicious damage – willful damage of properties by militant trade unions etc.
- (vii) Fidelity guarantee – misappropriation of cash/stock by the in-charge
- (viii) Cash-in transit, cash-in-safe etc.

In all the above cases it is the duty of the Surveyor to assess the quantum of loss strictly as per conditions laid down in the policy. The Insurance Surveyors measure and assess and report on the insured's financial loss. Their report is the basis in which the insurance companies compensate the insured. The ethics of the insurance surveyor's profession are broadly laid down in Subsection 7 of section 64 UM of the Insurance Act. The Surveyor shall not suppress any material fact having a bearing on the claim.

In all the above spheres the Cost Accountant can play an effective role in assessing the actual quantum of loss and assist in settlement of claim.

**Q. 13. Explain whether the following amounts to professional misconduct by a Cost Accountant :**

- (a) A is a shareholder in WYZ Ltd. holding 100 shares. The company's paid up capital is Rs. 5 crores. (50 lac shares @ Rs. 10 each). A accepts a certification work from the company.
- (b) A Cost Accountant in practice holds personal discussions /correspondence with prospective clients relating to his achievements and capabilities.
- (c) A firm of Cost Accountants undertakes Cost Audit of a company. The Report is signed by a partner who has not actually supervised the Cost Audit work.
- (d) A Cost Accountant practicing in India enters into partnership with a CMA,U.S.A.
- (e) A practicing Cost Accountant uses a visiting card in which he designates himself besides as Cost Accountant, as Tax Consultant.

**Answer 13.**

- (a) A does not have any substantial interest in WYZ Ltd. So his undertaking certification work is not a professional misconduct.
- (b) Holding personal discussions/correspondence with prospective clients relating to his achievements and capabilities is permitted and does not amount to professional misconduct.
- (c) The Cost Audit Report may be authenticated by signature of any one of the partners of the firm conducting the Cost Audit. There is no such regulation that the partner actually doing the work must sign it. In the present case the report was signed by a partner of the firm undertaking the audit. So this does not amount to professional misconduct.
- (d) As per MOU with IMA, USA a member of ICWAI can get enrolled as a member of IMA USA and vice versa. However, an IMA member enrolling as a member of ICWAI will not be allowed to hold a certificate of practice to undertake any statutory work in India. A Cost Accountant practising in India and entering into partnership with a CMA, U.S.A. amounts to professional misconduct.
- (e) Section 7 of the Cost Accountants Act, 1949 read with Clause 7 of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Cost Accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than Cost Accountant for a Cost Accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council. Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council.

**Q. 14. (a) State the function of IAASB.**

**(b) What does the following ISAs stand for?**

**(i) ISA 210**

**(ii) ISA 500.**

**Answer 14. (a)**

International Auditing and Assurance Standards Board (IAASB) is an independent standard-setting body within the International Federation of Accountants (IFAC). The IAASB develops International Standards on Auditing and International Standards on Review Engagements, which deal with the audit and review of financial information; and International Standards on Assurance Engagements which deal with assurance engagements other than audit and review of financial information. The IAASB also develops related practice statements. These standards and statements serve as guidelines for high quality of auditing and assurance statements world wide.

In addition the ISSAB develops quality control standards for firms and engagement teams in practice areas of audit, assurance and related services.

**Answer 14. (b)**

**(i) ISA 210- Agreeing the Terms of Audit Engagements**

This ISA deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present.

**(ii) ISA 500- Audit Evidence**

This ISA explains what constitutes audit evidence in an audit of Financial Statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This ISA is applicable to all the audit evidence obtained during the course of the audit. Other ISAs deal with specific aspects of the audit (for example, ISA 315), the audit evidence to be obtained in relation to a particular topic (for example, ISA 570), specific procedures to obtain audit evidence (for example, ISA 520), and the evaluation of whether sufficient appropriate audit evidence has been obtained (ISA 200 and ISA 330).

**Q. 15. How the work of an expert should be evaluated by Auditor before accepting the same as an Audit evidence?**

**Answer 15.**

As per ISA 620, when the auditor intends to use the work of an expert , he should evaluate the following before accepting the same as audit evidence :

- (i) Professional qualification of the expert;
- (ii) Experience and reputation of expert in related field;
- (iii) Independence and objectivity of the expert;
- (iv) The objectives and scope of the expert's work;
- (v) Expert's relationship with the client, if any;
- (vi) The source data used;
- (vii) Assumptions and method used;
- (viii) The results of the expert's work in the light of auditor's overall knowledge of the business and of the result of his audit procedures.