Paper-17 - COST AUDIT & OPERATIONAL AUDIT

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

Section I (50 Marks)
(Cost Audit)

Answer Question No. 1 (carrying 14 marks) which is compulsory and answer any two (carrying 18 marks each) from the rest in this Section.

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

1. (a) State whether the following statements based on the quoted terms are "TRUE" or "FALSE" with justifications for your answer. No credit will be given for any answer without justifications. [6×1=6]

(i) In view of e-filing of Cost Audit Report, only one hard copy is required to be submitted to the Cost Audit Branch.
(ii) Cost Audit is to be conducted only when the shareholders of the company direct such an audit at the Annual General Meeting.
(iii) In case of appointment of Cost Auditor in Partnership firm's name, all the partners of the firm must be the Cost Accountants but the partners need not be the practicing Cost Accountants.
(iv) A Cost Accountant who has been appointed as Cost Auditor of the company can authenticate the Compliance Report of the same company.
(v) CAS -6 deals with determination of capacity of a unit.
(vi) As per CAS-12, fines, penalties, damages and similar levies paid to Statutory Authorities or third parties shall form part of repair and maintenance cost.

Answer:

(i) False. In view of e-filing of Cost Audit Report no hard copy is required to be submitted to the Cost Audit Branch.
(ii) False. Cost Audit is conducted when Central Government directs / approves such an audit.
(iii) False. All the partners of the firm must be the Cost Accountants in practice.
(iv) True. A cost auditor can authenticate the Cost Audit Report and the Compliance Report of the same Company.
(v) False. CAS-6 deals with the principles and methods of determining the Material Cost.
(vi) False. As per CAS – 12, Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall no form part of repairs and maintenance cost.

1. (b) Choose the most correct answer among four alternatives: [8×1=8]

(i) Cost Auditor should inform to the Central Government in Form 23D of his appointment within :
A. 90 days from receiving formal letter from the company.
B. 30 days from receiving formal letter from the company.
C. 90 days from the date of commencing of the current financial year.
D. 45 days from the date of commencing of the current financial year.

(ii) The structuring of Cost Audit includes
A. Audit Programmes
B. Audit working papers
C. Checking including test checking
D. All of the above.

(iii) Time limit for submission of Compliance Report is within
A. One hundred and twenty days
B. One hundred and eighty days
C. Forty five days
D. One hundred and thirty five days

(iv) CAS - 4 deals with
A. Determination of Cost of Production for Captive consumption
B. Determination of Average (equalized) Cost of Production
C. Determination of Capacity of a Unit
D. None of the above.

(v) As per ________________ Outward Transportation Cost shall form part of cost of sales.
A. CAS-5
B. CAS-6
C. CAS-9
D. CAS-10.

(vi) Cost Audit was initially introduced in the year
A. 1959
B. 1960
C. 1965
D. None of the above.

(vii) Excisable clearance means:
A. Only sale of goods from factory
B. Removal from godown
C. Dispatches from bonded warehouse
D. Total clearance from factory.

(viii) The main purpose of 'Efficiency Audit' is to ensure that
A. Every rupee invested gives optimum returns
B. Planned expenditure gives optimum returns
C. Various policies of management are implemented
D. Activities of business are beneficial to Society at large

Answer:

(i)	B.
(ii)	D.
(iii)	B.
(iv)	A.
(v)	A.
(vi)	C.
(vii)	D.

(viii) A.

2. (a) Write short note on - True and Fair Cost of Production. [5]

Answer:

True and Fair Cost of Production: A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The Cost Audit (Report) Rules, 1996 prescribe the rules regarding the cost audit report. The prescribed format of the report contains assertions regarding whether cost accounting records have been properly kept so as to give a true and fair view of the cost of production/ processing/ manufacturing/ mining activities and marketing of the product under reference. It may be noted that unlike in the case of audit of financial statements, the cost auditor does not have to state whether the cost statements reflect a true and fair view. In any case, the true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:

(i) Determination of cost following the generally accepted cost accounting principles and cost accounting standards;

(ii) Application of the costing system appropriate to the product;

(iii) Materiality;

(iv) Consistency in the application of costing system and cost accounting principles;

(v) Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents;

(vi) Elimination of material prior-period adjustments;

(vii) Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

2. (b) State the provision for maintaining cost records in case of company having its branch both within and outside India. [6]

Answer:

Section 209 of the Companies Act 1956 deals with the books of accounts to be maintained by a body corporate. The section provides as follows:

(1) Every company shall keep at its registered office proper books of account with respect to -

(a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;

(b) all sales and purchases of goods by the company;

(c) the assets and liabilities of the company; and

(d) In the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account.

Provided that all or any of the books of account aforesaid may be kept at such other place in India as the Board of Directors may decide and when the Board of Directors so decides, the company shall, within seven days of decision, file with the Registrar a notice in writing giving the full address of that other place.

(2) Where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarized returns, made up to dates at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place referred to in sub-section (1).

2. (c) (i) State the applicability of Companies (Cost Accounting Record) Rules,2011;
(ii) Define - Product ; Manufacturing Activity ; Turnover, as per the Companies (Cost Accounting Record) Rules,2011. [3+(1+2+1)]

Answer:

(i) The Companies (Cost Accounting Record) Rules, 2011, is applicable to every company including a foreign company engaged in production, processing, manufacturing or mining wherein:

- ❖ the aggregate value of net worth as on the last date of the immediately preceding financial year exceeds ₹ 5 crores, or
- ❖ the aggregate value of the turnover made by the company from all products or activities during the immediately preceding financial year exceeds ₹ 20 crores, or
- ❖ the company's equity or debt securities are listed or are in the process of listing on any stock exchange.

(ii) Product - "Product" means any tangible or intangible good, material, substance, article, idea, know-how, method, information, object, service, etc. that is the result of human, mechanical, industrial, chemical, or natural act, process, procedure, function, operation, technique, or treatment and is intended for use, consumption, sale, transport, store, delivery or disposal.

Manufacturing Activity - "Manufacturing Activity" includes any act, process or method employed in relation to -

(i) transformation of raw materials, components, sub-assemblies, or parts into semi-finished or finished products; or

(ii) making, altering, repairing, fabricating, generating, composing, ornamenting, furnishing, finishing, packing, re-packing, oiling, washing, cleaning, breaking-up, demolishing, or otherwise treating or adapting any product with a view to its use, sale, transport, delivery or disposal; or

(iii) constructing, reconstructing, reconditioning, servicing, refitting, repairing, finishing or breaking up of any products.

Turnover - "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;

3. (a) (i) State the areas covered under Cost Accounting Policy in the light of Companies (Cost Audit Report) Rules,2011.

(ii) Discuss the provisions relating to " Ceiling on Number of Cost Audits" as per Companies Act,1956. [5+7]

Answer 3 (a) (i):

In the light of Companies (Cost Audit Report) Rules,2011, the Cost Accounting Policy , inter alia, covers the following areas:

(i) Identification of cost centres/cost objects and cost drivers.

(ii) Accounting for material cost including packing materials, stores and spares etc., employee cost, utilities and other relevant cost components.

(iii) Accounting, allocation and absorption of overheads

(iv) Accounting for Depreciation/Amortization

(v) Accounting for by-products/joint-products, scarps, wastage etc.

(vi) Basis for Inventory Valuation

(vii) Methodology for valuation of Inter-Unit/Inter Company and Related Party transactions.

(viii) Treatment of abnormal and non-recurring costs including classification of other non-cost items.

(ix) In case the Company has adopted IFRS, variations (if any) in treatment of cost accounting arising out of adoption of IFRS in Financial Accounting.

(x) Other relevant cost accounting policy adopted by the Company

Answer 3 (a) (ii):

The provisions relating to "Ceiling on Number of Cost Audits" is prescribed vide sub-Section (2) of Section 233B inter-alia provides that before the appointment of any auditor is made by the Board, a written certificate shall be obtained by the Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with the provisions of sub-Section (1B) of Section 224.

Section 224(1)(B) provides that no company or its Board of directors shall appoint or re-appoint 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. The proviso to Section 224(1B) further provides that the provisions of this sub-Section shall not apply, on and after the commencement of the Companies (Amendment) Act, 2000, to a private company.

Explanation I to the Section 224 provides that for the purposes of sub-Sections (1B) and (1C), “specified numbers” means :

(a) in 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 to the Section 224 provides that 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.

In view of aforesaid provisions, the ceilings on the number of cost audits can be clarified as under:

(a) In the case of firm of cost accountants: Twenty companies for each such partner of the firm who is not in full time employment. However, not more than ten such companies should have a paid up share capital of Rs. 25 lakhs or more;

(b) In the case of an individual cost accountant, who is not in full time employment: Twenty companies, out of which not more than ten should have a paid-up share capital of Rs. 25 lakhs or more.

It can be seen from above that Section 224(1B) and Explanation I to Section 224 refers to the ceilings for the number of companies and not to the number of cost audit orders or products. Therefore, if more than one products of a particular company are covered under cost audit for the same year, a cost auditor should count their number as one company only, since the audits for all the products relate to the same company despite the fact that separate cost audit orders have been issued with respect to each such product. Similarly, if that company appoints different cost auditors for different products, each auditor shall count the company as one company for counting their individual quota for number of audits.

It should be noted that the Companies (Amendment) Act, 2000 has inserted a provision (Explanation II) to Section 224, whereby the provisions of sub-section 1-B shall not apply to a Private Company.

It means that for computing the limit on number of companies for audit, Private Companies should not be counted.

3. (b) X Ltd. claims "Turnover" for the purpose of Cost Records to be ₹20,00,00,000 for the financial year 2013-14. The company claims that since the turnover has not exceeded ₹20 crores during the financial year, they are excluded from the ambit of maintaining cost accounting records. The company is listed not listed in any stock exchange and has a net worth of ₹4 crores. On examination of financial records, the following relevant information was identified:

Particulars	**Amount (₹)**
Income from Operating Activities - Sale of Goods (exclusive of taxes) **- Rendering of Services**	**5,00,00,000** **15,00,00,000 (inclusive of service tax)**
Income from Job Work	**2,17,93,000**
Income from Loan License operations	**1,43,45,000**
Subsidies received from the Government	**41,50,000**
Export Incentives received from Government	**31,20,000**
Profit on sale of Non-current Assets	**12,50,000**
Discount received in Cash from Vendor (15 days after full payment was made)	**3,20,000**

Calculate "Turnover" as per Companies (Cost Accounting Record) Rules,2011. [6]

Answer:

As per Companies (Cost Accounting Record) Rules,2011, "Turnover" means total turnover made by the company from the sale or supply of all products or services during the financial year and it includes any turnover from job work or loan license operations and the subsidies or grants or incentives received but does not include any non-operational income.

Computation of "Turnover" as per Companies (Cost Accounting Record) Rules,2011 for the financial year 2013-14

Particulars	**Amount (₹)**
Income from Operating Activities - Sale of Goods (exclusive of taxes)	5,00,00,000
- Rendering of Services - [(15,00,00,000 x 100)/112.36] (net of service tax)	13,34,99,466
Add: Income from Job Work	2,17,93,000
Add: Income from Loan License operations	1,43,45,000
Add: Subsidies received from the Government	41,50,000
Add: Export Incentives received from Government	31,20,000
Turnover	**22,69,07,466**

Note:
The following Non-operational Incomes are not considered:
(i) Profit on sale of Non-current Assets ₹2,50,000;
(ii) Discount received in Cash from Vendor (15 days after full payment was made) ₹20,000

4. (a) Z Ltd. furnished the following information related to the net margin (profit/loss) as per cost records, which is different from such as per financial records.

Particulars	**Prod A**	**Prod B**	**Prod C**	**Prod D**	**S1**	**S2**	**S3**
Product/Service Group	**0401**	**0401**	**0405**	**0405**	**XA**	**XB**	**XB**
Turnover (excluding Excise Duty and/or other statutory levies (₹ crores)	**10.50**	**11.25**	**14.75**	**18.60**	**3.69**	**7.91**	**12.45**
Cost of Sales (₹ crores)	**8.39**	**9.98**	**11.37**	**21.75**	**2.08**	**4.27**	**8.67**
Margin (₹crores)	**2.11**	**1.27**	**3.38**	**(3.15)**	**1.61**	**3.64**	**3.78**

Other information:

(i) Discount allowed by vendor was subsequently received in cash for products A,B,C & D to the extent of ₹0.15 crores; ₹0.07 crores; ₹0.02 crores and ₹0.07 crores respectively, not considered in cost accounts.
(ii) Premium on forward contract for Product A ₹0.03 crores not considered in cost accounts;
(iii) Liquidated damages paid to vendor for Product A - ₹0.15 crores not considered in cost accounts;
(iv) Dividends received on investment outside the business ₹0.30 crores considered in financial records only;
(v) Profits on sale of non-current assets ₹ 0.15 crores considered in financial accounts only;
(vi) Unabsorbed Administrative Overheads due to under-utilization of capacities ₹0.27 crores not considered in cost accounts;
(vii) Margin from Trading Activities ₹4.05 crores both as per financial and cost records;
(viii) Value of Stock

Value of Stock as per	As per Cost Records	As per Financial Records
Opening Balance	**3.98 crores**	**4.15 crores**
Closing Balance	**2.67 crores**	**2.12 crores**

Prepare Margin (Profit/Loss) Reconciliation Statement considering cost accounts and financial accounts. [8]

Answer:

Reconciliation Statement

Net Margin (Profit/Loss) as per Cost Accounts	₹ Crores
A. From Product/ Manufactured Product Groups	
(i) Product Group 0401 (2.11 + 1.27)	3.38
(ii) Product Group 0405 (3.38 - 3.15)	0.23
B. From Services Groups	
(i) Service Group XA	1.61
(ii) Service Group XB (3.64 + 3.78)	7.42
C. From Trading Activities	4.05
Total as per Cost Accounts	**16.69**
Add: Incomes not considered in Cost Accounts (if any)	
Profits on sale of non-current assets ₹ 0.15 crores considered in financial accounts only	0.15
Dividends received on investment outside the business ₹0.30 crores considered in financial records only	0.30
Discount allowed by vendor was subsequently received in cash for products A,B,C & D to the extent of ₹0.15 crores; ₹0.07 crores; ₹0.02 crores and ₹0.07 crores respectively, not considered in cost accounts	0.31
Less: Expenses not considered in Cost Accounts (if any)	
Premium on forward contract for Product A ₹0.03 crores not considered in cost accounts	(0.03)
Liquidated damages paid to vendor for Product A - ₹0.15 crores not considered in cost accounts	(0.15)
Unabsorbed Administrative Overheads due to under-utilization of capacities ₹0.27 crores not considered in cost accounts	(0.27)
Less: Difference in Opening Stock Valuation	
Understated cost of opening stock as per Cost Records by ₹ (3.98 - 4.15) crores = ₹0.17 crores. This leads to a decrease in cost of sales as per cost records. Hence, there is an overstatement of profit as per cost records, as	(0.17)

the sales realization is same under both cost records and financial records	
Less: Difference in Closing Stock Valuation	
Overstated cost of closing stock as per Cost Records by ₹ (2.67-2.12)crores = ₹0.0.55 crores. This leads to a decrease in cost of sales as per cost records. Hence, there is an overstatement of profit as per cost records as the sales realization is recorded same under both cost records and financial records	(0.55)
Profit/ (Loss) as per Financial Accounts	**16.28**

4. (b) In a factory, the production department has worked at 50% of its normal capacity on account of shortages of skilled labour and raw materials during the year. The cost records contain the following information among other :

Particulars	**Amount (₹)**	**Amount (₹)**
Direct Labour Cost		**5,00,000**
Works Overhead - Fixed	**2,00,000**	
Works Overhead- Variable	**2,50,000**	**4,50,000**

The company charges the works overhead to work –in-process as a percentage of direct labour cost. Accordingly, its Accounts Officer claims that 90% should be charged ; whereas you (as a cost auditor) claim that it should be much than this.

A. Establish your claim with reasons, and
B. Give your opinion, if any. [4]

Answer :

(A) Computation to establish claim :

Particulars	Amount (₹)	Amount (₹)
Works Overhead- Variable	2,50,000	
Works Overhead - Fixed (50% of Rs.2,00,000)	1,00,000	
Amount chargeable to work -in- process		3,50,000

So, the Rate of Overhead application (according to the company 's practice) should be:

$$\frac{₹\ 3,50,000}{₹\ 5,00,000} \times 100 = 70\% \text{ of Direct Labour Cost.}$$

This percentage should be charged to the work - in - process, the reason being that the department worked only 50% of its normal capacity and that the fixed overhead is to be absorbed on the basis of the capacity level attained.

(B) Opinion

The balance of the fixed works overhead (i.e. 50% of ₹ 2,00,000 =₹1,00,000) amounting to ₹ 1,00,000 represented the idle capacity cost and was therefore not a part of the manufacturing cost. It was a loss on account of non –functioning of the department to its normal capacity.

4 . (c) Following are the sales and cost data of a manufacturing firm for two years :

Particulars	2012-13 (₹crores)	2013-14 (₹crores)
Mfg. Cost of goods sold	**14.5**	**16.0**
Selling expenses	**0.9**	**1.2**
Administration expenses	**1.2**	**1.5**
Financial Charges	**0.4**	**0.3**
Excise Duty	**2.0**	**2.0**
Sales (including excise)	**20.0**	**22.0**

Required : (i) Prepare a Profit Variation Statement and (ii) Account for the cause-wise changes in profit. [6]

Answer: (i) Profit Variation Statement (₹in crores) :

Particulars	2012-13		2013-14		Profit Variation	
					Increase	**Decrease**
Sales		20.0		22.0	2.0	
Less: Excise Duty		2.0		2.0	-	-
Net Sales		18.0		20.0	2.0	-
Less: Mfg Cost		14.5		16.0	-	1.5
Gross Profit		3.5		4.0	-	0.5
Less: Expenses					0	0.5
Selling	0.9		1.2			0.3
Administrative	1.2		1.5			0.3
Financial	0.4	2.5	0.3	3.0	0.1	
Net Profit	**1.0**		**1.0**			

Note : Net increases in sales and in expenses being equal, there has been no change in 'net profit' position.

(ii) Statement of changes in Profit (Cause-wise) :

	₹ (in crores)	₹ (in crores)	₹ (in crores)
Increase in Profit by			
Net Sales	2.0		
Less: Mft. Cost	1.5		
		0.5	
Add: Financial Charges (savings)		0.1	
Total increase			**0.6**
Decrease in Profit by			
Selling Cost	0.3		
Administration Cost	0.3		
Total decrease			**0.6**
Profit Increase/Decrease (Net)			**NIL**

Section II (50 Marks)
(Operational Audit)

Answer Question No. 5 (carrying 14 marks) which is compulsory and
Answer any two (carrying 18 marks each) from the rest in this Section.

5. (a) Fill in the blanks in the following sentences by using appropriate word(s)/phrase(s)/ number(s): [6×1=6]

(i) Management Audit requires ________ approach.
(ii) Excise-Audit-2000 was initiated from _________ .
(iii) Section 292A of the Companies (Amendment) Act 2000, provides for Constitution of ____________.
(iv) India had to remove ________ on imports as per WTO stipulations.
(v) ______________ is transfer of goods to an alien market at a price which is less than marginal cost of its production in the home country.
(vi) Central Excise Revenue Audit (CERA) is conducted by the organization of__________.

Answer:

(i) Inter-disciplinary
(ii) 1st December 1999
(iii) Audit Committees
(iv) Quantitative restrictions
(v) Dumping
(vi) Comptroller and Auditor General of India

(b) State whether the following statements based on the quoted terms are 'True' or 'False', with justifications for your answer. No credit will be given for any answer without justifications: [8×1=8]

(i) The Consumer Service Audit critically examines the outstanding payment of consumer.
(ii) GATT and its agreement are permanent.
(iii) Sarbanes-Oxley Act of 2002 is a U.K. Federal Law enacted on July 30, 2002.
(iv) Interest Cost should be included in inventory valuation for purposes of Bank Audit.
(v) Management Audit Report is to be submitted to the Cost Audit Branch of Central Government.
(vi) Audit Committee should meet at least three times in a year as per Clause-49 of the listing agreement.
(vii) The secretariat of WTO will be headed by a secretary.
(viii) Physical verification of stock is not a part of Stock Audit conducted by a bank or their authorized person.

Answer:

(i) **False**. The Consumer Service Audit critically examines and appraised management of responsibility of a business enterprise towards consumers at right time, in right quantity at the right place and price.
(ii) **False**. GATT and its agreements are provisional.
(iii) **False**. Sarbanes-Oxley Act of 2002 is a United States Federal Law enacted on July 30, 2002.
(iv) **False**. Interest cost is finance cost and is to be excluded for valuation of inventories.
(v) **False**. Management Audit Report is to be submitted to the Management of the concern and not to the Cost Audit Branch of Central Government.

(vi) False. Audit committee should meet at least four times in a year as per clause 49 of the listing Agreement.
(vii) False. The Secretariat of the WTO will be headed by a Director-General.
(viii) False. Physical verification of stock is the most important part of Stock Audit conducted by a bank or their authorized person.

6. (a) A company undertakes manufacture of Steel Pipes and Steel Tubes. Its sales and profit data for the financial year ended 31st March, 2014 are :

Total Net Sales ₹2,70,40,000

Gross Profit ₹59,20,000

Net Profit ₹17,70,000

The Balance Sheet as at 31st March, 2014 (not in Revised Schedule VI)

Liabilities	₹ (crores)	Assets	₹ (crores)
Capital	1,14,00	Cash in hand	1,20
Reserves and Surplus	17,70	Cash at Bank (SBI)	10,20
Secured Loans (IFCI)	1,77,30	Bills Receivables	1,90
Unsecured Loans	52,00	Sundry Debtors	90,00
Sundry Creditors	37,40	Finished Goods—	
		Pipes & Tubes	31,20
Outstanding Liabilities :		Work-in-Progress	15,50
Rent for March'14	1,00	Raw Materials - H.R. Skelp	8,20
Salaries for March'14	60	- C.R. Sheets	4,20
Power Charges	10	Deposits (long term)	27,00
Telephone Charges	10	Income Tax paid in advance	1,00
Bonus	1,90	Furniture	30
		Buildings	77,60
		Plant & Machinery	1,33,80
	4,02,10		4,02,10

(i) You are required to calculate —

a. Current Ratio,
b. Acid-test Ratio,
c. Debt-equity Ratio,
d. Turnover-fixed Assets Ration,
e. Net working Capital-Turnover Ratio,
f. Return on Capital Employed Ratio,
g. Net Profit Turnover Ratio,
h. Value of Production to Net Worth Ratio, and

Offer your comments against each.

(ii) Can you draw any conclusions from the study of the ratios ? [12]

Answer:

(i) Ratios and Comments :

Before calculation of the various ratios, we can process the given information as under :

Particulars	**Amount (₹'000)**	**Amount (₹'000)**
Current Assets		
Cash in hand	1,20	
Cash at Bank	10,20	
Bills Receivables	1,90	
Sundry Debtors	90,00	
Finished Goods	31,20	
Work-in-progress	15,50	
Raw Materials - H.R.Skelp 8,20 - C.R. Sheet 4,20	12,40	
Income Tax paid in Advance	1,00	
	1,63,40	
Current Liabilities:		
Sundry Creditors	37,40	
Outstanding Liabilities:		
- Rent	1,00	
- Salaries	60	
- Power	10	
- Telephone	10	
- Bonus	1,90	
	41,10	

Particulars	**Amount (₹'000)**	**Amount (₹'000)**
Liquid Assets		
Cash in hand	1,20	
Cash at Bank	10,20	
Bills Receivables	1,90	
Sundry Debtors	90,00	
	1,03,30	
Liquid Liabilities (in this case same as current liabilities as there is no Bank Overdraft)		
Sundry Creditors	37,40	
Outstanding Liabilities:		
- Rent	1,00	
- Salaries	60	
- Power	10	
- Telephone	10	
- Bonus	1,90	
	41,10	

Particulars	**Amount (₹'000)**	**Amount (₹'000)**
Borrowed Funds		
Secured Loans	1,77,30	
Unsecured Loans	52,00	

Sundry Creditors	37,40	
Outstanding Liabilities	3,70	
	2,70,40	
Own Funds		
Capital	1,14,00	
Reserves & Surplus	17,70	
	1,31,70	
Fixed Assets		
Furniture	30	
Buildings	77,60	
Plant and Machinery	1,33,80	
	2,11,70	
Net Working Capital		
Current Assets	1,63,40	
Less: Current Liabilities	41,10	
	1,22,30	
Capital Employed	**1,14,00**	
Value of production:		
Net Sales	2,70,40	
Less : Gross profit	(-) 59,20	
	2,11,20	
Net Worth		
Capital	1,14,00	
Add: Reserves and Surplus	17,70	
	1,31,70	

(a) Current Ratio :

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{1{,}63{,}40}{41{,}10} = 3.976.$$

This indicates that the company has ₹3.976 of current assets for every rupee of current liability. So, if can meet its current obligations even if it can realise only 1/4th of the current assets. But, it has to be borne in mind that while the current assets can decline in value on account of doubtful debtors and unsaleable finished goods' stock, the liabilities do not fall in value as they have to be paid for. Thus, it is simply a quick measure of the company's liquidity.

(b) Acid – Test Ratio :

$$\frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} = \frac{1{,}03{,}30}{41{,}10} = 2.51$$

This indicates that the company is in a much better position and has the ability to meet its obligations without delay.

(c) Debt – Equity Ratio :

$$\frac{\text{Borrowed Fund}}{\text{Own Fund}} = \frac{2{,}70{,}40}{1{,}31{,}70} = 2.05$$

This indicates that the company is dependent on borrowed funds, i.e., depends on the external sources of finance to a considerable extent.

(d) Turnover – Fixed Assets Ratio :

$$\frac{\text{Total Net Sales}}{\text{Fixed Assets}} = \frac{2{,}70{,}40}{2{,}11{,}70} = 1.28$$

This is a test to know as to how the investment in the company's business is serving the desired purpose of generating sales. Here, the ratio indicates that the company could make sales worth ₹1.28 only against each rupee of investment in fixed assets. So the position is not satisfactory. This indicates that the assets are not fully employed.

(e) Net Working Capital Turnover Ratio :

$$\frac{\text{Total Net Sales}}{\text{Net Working Capital}} = \frac{2{,}70{,}40}{1{,}22{,}30} = 2.21$$

This is a test to measure the efficiency of the firm in the employment of its working capital. This indicates that the company could make 2.21 times sales turnover for every rupee of working capital employed. This may be considered to be satisfactory.

(f) Return on Capital Employed Ratio :

$$\frac{\text{Net Profit}}{\text{Capital Employed}} \times 100 = \frac{17{,}70}{1{,}14{,}00} \times 100 = 15.53\%$$

This indicates that the profitability in relation to the capital employed is reasonably satisfactory. The company earns a fair return on investment in its own industry.

(g) Net Profit Turnover Ratio :

$$\frac{\text{Net Profit}}{\text{Sales turnover}} \times 100 = \frac{17{,}70}{2{,}70{,}40} \times 100 = 6.54\%$$

This indicates that net profit is much lower than what is reasonably expected. This test, of course is not indicative of profitability. It is test which signifies a profit on sales. Ratio at (f) above is a good indicator for the company.

(h) Value of Production To Net Worth :

$$\frac{\text{Value of Production}}{\text{Net Worth}} = \frac{2{,}11{,}20}{1{,}31{,}70} = 1.60 \; = \qquad \underline{\text{Value of production}}$$

This ratio measures the efficiency in the use of funds for value of production. The result is not satisfactory as the value of production is not even double the value of net worth.

Conclusions :

The following conclusions can be drawn from the study of the ratios :

(i) The liquidity position of the company is good as the current ratio and acid-test ratio are 3.976 and 2.51 respectively.

(ii) The solvency position is not satisfactory as the debt-equity ratio is 2 : 1 — which means that the company is dependent upon external finance. The company may run into difficulties in case these external funds are withdrawn and the creditors put pressure for repayment.

(iii) The Gross Profit to Net Sales comes to : $\frac{59,20}{2,70,40} \times 100 = 121.90\%$, whereas net profit to sales is 6.54%. The profitability in relation to capital employed is 15.53% — which is an indicator of fair return for the company in the industry in which it is operating under the present circumstances.

(iv) The operating efficiency of the company is not upto the expectations as : Turnover-fixed assets ratio and Net working capital Turnover ratio are 1.28 and 2.21 respectively. The Net worth utilisation by the value of production is only 1.6 times.

6. (b) In recent times there is so much discussion about effective material procurement system in organisations. Enumerate 10 points for carrying out a Management Audit of material procurement function in a company. [6]

Answer:

Management Audit of the procurement function must cover the following inter alia.

(i) Organisation of the purchase department.

(ii) Preparation of Material Requirement Plan integrated with the production Plan.

(iii) Continuous vendor development and sourcing

(iv) Differentialed inventory policies for imported, indigenous, own production, Critical, insurance etc. items.

(v) Long-term ordering and short-phasing of deliveries

(vi) Good system of vendor rating

(vii) Clearly defined procedures and authority for placement of purchase orders

(viii) Procedures for floating tenders, negotiation etc.

(ix) Authority for price approvals and modifications

(x) Good system of flow up of deliveries

(xi) Follow-up on rejected materials

(xii) Ensuring quality in supplies by providing determents.

7. (a) Why Management audit is resorted to even through we have Financial Audit, Internal Audit and Cost Audit? State the salient features of Management audit. [6+2]

Answer:

Financial Audit involves verification and attestation of financial data shown in books of accounts as supported by vouchers and supporting documents. It deals with the checking and verification of past records. It is compulsory according to the statute. This is performed by a chartered accountant in practice to depict a true and fair view of the financial aspect of company. The financial audit may be taken as a sort of protective tool available to the shareholders for safeguarding their interest.

Cost Audit is concerned with review, examination, and appraisal of accounting records so as to ensure interalia true and correct cost of production.

Therefore, Cost Audit is product oriented. Cost Audit is not applicable to all but covers only limited industries for which an order is required to be issued by the Govt. of India. Company Law Board. Cost Auditor needs professional qualifications as prescribed under the Act and Regulations. A perusal of the Cost Audit (Report) Rules could show that cost auditor is required not only to certify about the correctness of cost of product processing, manufacturing or mining activities as the case may be, and marketing of the product under reference as exhibited in the record maintained for the purchase, but he is expected also to make observation as regards improvement of the efficiency of the concern under audit and as regards the drawbacks that may come to his notice in the course of his audit. It would thus, be seen that the constructive feature is a distinct specialty of cost audit. The prominence of constructive aspect in cost audit has made it quite distinct from financial audit.

Management Audit is entirely different from the above two types of audits. It is concerned with appraisal of total performance of management of the company. Management Audit is the neither compulsory under any statute or law but is purely voluntary and terms of reference and scope are determined by the management. This can be undertaken internally by Management themselves or externally by Management Consultants. No qualification is prescribed for a Management Auditor. The area and scope of Management Audit is very wide and comprehensive. It is a tool in the hands of Top Management.

Salient Features

Cost audit does not normally cover the operational areas and management functions. Management audit covers up the deficiency and aims at better efficiency in business operations and management functions. The Managements auditor reviews the existing plans, procedures, practices, etc. and offer constructive suggestions for improvements. It is mainly constructive in approach.

Internal Control and Internal Audit are the techniques used for successful management control and management Audit. They have limited area and scope as compared to overall review of the total Management function.

7. (b) "To-day's customer is the more demanding than the customer of yesterday"- In view of this how would you evaluate, as a Management Auditor, the performance of " Customer Services Department". [10]

Answer:

A customer is the most important person for business because it is he who provides the profit. Therefore, the starting point in any marketing strategy is identifying the customers, their needs and organizing the efforts of the company towards satisfying such needs.
In order to create and retains customers, certain services are to be provided by properly attending to their needs and supplying right quality goods at the right price. Such services would not only stimulate the demand for the products of the company but also will help to establish product acceptability and widen the scope of potential customers.
Customers services may be evaluated on the following lines:
• Do the products manufactured by the company meet the needs of the customers of different purchasing power and different tastes?
• Are the prices of the products reasonable, considering the product quality?
• Are the prices competitive to similar other products available in the market?
• Are the customers given prompt and personal attention?
• Does the company guarantee the quality of its products?
• Does the company provide after-sales services?
• Are the customers complaints carefully and promptly attended to?
• Are spare parts of the products easily available in the company offices and in the open market?
• Are the product properly packed to avoid any damage to its products?
• Is there any provision for home-delivery services?
• Does the company undertake marketing research in regard to customer behaviour and customer services?
• Does the company make use of marketing research data to improve customer services?
• Does the company's product bear ISI Mark / AGMARK?
• Are the company's products easily available at various retail outlets?
• How effective are the various channels of distribution used by the company?
• Does the company educate the customers about the use of the products through printed material and other means?
• Are the sales man retailers continuously motivated to provide the best attention and services while selling company's products?

8. Write a short note on any three of the following: [6×3=18]
(a) Professional Behaviour
(b) The major characteristics of ERP systems necessitating change in Audit Approach.

(c) Concurrent Audit

(d) Management Audit Programme (MAP)

Answer:

(a) Professional Behaviour:

The principle of Professional Behaviour imposes an obligation on Professional Accountants to company with relevant laws and regulations and avoid any action that may bring discredit to

the profession. This includes actions which are reasonable and informed third party, having knowledge of all relevant information, would conclude negatively affects the good reputation of the profession. In marketing and promoting themselves and their work, professional Accountants should not being the profession into disrepute Professional Accountant should be honest and truthful and should not
(i) Make exaggerated claim for the services they are able to offer the qualifications they possess or experience they have gained or
(ii) Make disparaging references or unsubstantiated comparisons to the work of others.
The conceptual framework requires a Professional Accountant to identify, evaluate and address threats to comply with the fundamental principles, rather than merely complying with a set of specific rules which may be arbitrary. If threats to ethics are not clearly insignificant, a Professional Accountant should apply safeguards to eliminate the threats or reduce them to an acceptable level.

(b) The major characteristics of ERP systems necessitating change in the Audit approach:

The major characteristics of ERP systems necessitating change in the Audit approach are as follows:

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

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

(c) Concurrent Audit :

Concurrent audit is a systematic examination of financial transactions on a regular basis to ensure accuracy, authenticity and compliance with procedures and guidelines. It is an examination, which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. The main focus of this audit is to ensure that transactions adhere to the system and laid down procedures. It serves the purpose of effective internal control as it reduces the time gap between occurrence of a transaction and its overview or checking. The concurrent audit is similar in nature to internal audit as both are generally initiated by the management itself. However, there is basic difference between the two i.e. concurrent audit is regular audit of financial transactions whereas internal audit is a periodic audit.
Sound internal controls are essential to the prudent operation of banks and to promote stability in the financial system as a whole. Concurrent Audit ensures that adequate internal controls within banking organizations are supplemented by an effective internal audit function, which independently evaluates the control systems within the organization. Concurrent Audit of Bank Branches involves checking of all aspects of banking and other operations on an ongoing daily basis to ensure that the Branch is adhering to the Bank's laid down systems and procedures. The

Concurrent Auditors are responsible to examine and comment on all the areas specified by the Bank/RBI from time to time in regard to concurrent audit of branches. A copy of guidelines on the manner of conduct of audit is also provided at the time of allotment of concurrent audit and from time to time thereafter. Therefore, it ensures that all errors and frauds, if any are generally detected immediately after their occurrence to control the damage, if any.

(d) Management Audit Programme (MAP):

Management Audit Programme is an essential pre-requisite to conduct the audit. It is a plan of action drawn in advance of taking up the audit, and to help the auditor to cover the entire area of his function thoroughly.
He should lay down for himself a proper procedure to be followed to complete the work in time, giving thorough coverage to all aspects.

An efficient management Audit Programme comprises the following:
(i) Review of the organizational objectives and plans.
(ii) Study of the policy and practices of the management.
(iii) Critical review of organizational structure.
(iv) Study the systems and procedures.
(v) Evaluation of operations and utilization
(vi) Study of the efficiency of the use of physical resource available.
(vii) Exercise proper management control.
(viii) Maintain suitable monitoring system through MIS.
(ix) Check adherence to the statutory obligation.
(x) Review the efficiency of manpower handling, which is the key factor for organization's success.