PAPER – 19: Cost and Management Audit

Paper – 19 : Cost and Management Audit

Time Allowed: 3 Hours **Full Marks: 100**

Answer Question No. 1 which is compulsory and Carries 20 Marks and any 5 questions from Question No. 2 to 8.

I. Answer the following

1. (a) Fill in the blanks:

(i) 1965
(ii) Total clearance from factory
(iii) Comptroller and Auditor General (CAG)
(iv) Personalised
(v) CAS – 13

(b) State whether the following statements are true or false:

(i) False.
(ii) False.
(iii) False.
(iv) False.
(v) True.

(c) Answer any five of the following in one or two sentences

(i) Rule 3(A)(2) of the Companies (Cost Records and Audit) Rules, 2014 dealing with generation, transmission, distribution of electricity has excluded captive generation as defined in Electricity Rules, 2005. It may noted that in case of company whose products / service are covered under the rules and it consumes electricity from the captive generating plant, determination of cost of generating, transmission, distribution and supply of electricity as per CRA – 1 would be mandatory since the cost of consumption of electricity has to be at cost. Hence maintenance of cost records for generation, transmission, distribution and supply of electricity would be applicable. However cost audit will not be applicable to such captive plants provided the entire generation is consumed captively and no portion sold outside.

(ii) The Cost Audit shall be conducted by a Cost Accountant in practice who shall be appointed by the Board. A cost Accountant, who is in employment, is not eligible for appointment as a Cost Auditor.

(iii) Every Cost Auditor appointed, shall continue his duty till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the Cost Audit Report for the financial year for which he has been appointed.

(iv) Energy Auditing is an activity that serves the purposes of assessing energy use, pattern of a factory or energy consuming equipment and identifying energy saving opportunities in reducing avoidable losses, improving the effectiveness of energy use and increasing energy use efficiently. The energy Auditor is normally expected to give recommendations on effective improvements leading to monetary benefits and also advise on energy management issue, Generally energy auditor for the industry is an external party

(v) Internal auditing has been defined as an independent objective assurance and consulting activity designed to add value and improve an organization's operations. It helps and organization to accomplish its objectives by bringing systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governing processes. It is essentially management control mechanism that operates through measurement and evaluation of effectiveness of the monitoring process.

(vi) Every Cost Auditor shall forward his report to the Board of Directors of the company. The company shall furnish Central Government such report along with full information and explanation on every reservation or qualification contained therein.

II. Answer any 5 from Question No. 2 to 8. Each question carries 16 marks.

2. (a) Every Company required to get cost audit conducted under section 148 (2) of the Companies Act, 2013 shall:-

(i) Appoint a Cost auditor within one hundred and eighty days of the commencement of every financial year:

(ii) Inform the Cost auditor concerned of his or its appointment:

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

(iv) Within a period of thirty days from the date of receipt of a copy of the Cost Audit Report, furnish the Central Govt. with such report along with full information and explanation on every reservation or qualification contained therein, in form CRA – 4 along with fees specified in Companies (Registration Offices and Fees) Rules, 2014.

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

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

The disqualifications of a Cost Auditor: The following persons are not eligible for appointment as a cost auditor:

(a) A body corporate. However, a Limited Liability partnership registered under the Limited Liability Partnership Act, 2008 can be appointed. *[Section 141(3)(a)* of the Companies Act, 2013].

(b) An officer or employee of the company. *[*Section 141(3)(b) of the Companies Act, 2013*]*.

(c) A person who is a partner, or who is in the employment, of an officer or employee of the company. *[*Section 141(3)(c) of the Companies Act, 2013*]*.

(d) A person who, or his relative or partner is holding any security of or interest in the company or any of its subsidiary or of its holding or associate company or a subsidiary of such holding company. *[*Section 141(3)(d)(i) of the Companies Act, 2013*]*.

(e) Relatives of any partner of the firm holding any security of or interest in the company of face value exceeding ₹1 lakh. *[*Section 141(3)(d)(i) of the Companies Act, 2013 and Rule 10(1) of Companies (Audit and Auditors) Rules, 2014*]*.

(f) A person who is indebted to the company or its subsidiary, or its holding or associate company or a subsidiary or such holding company, for an amount exceeding ₹5 lakhs. [Section 141(3)(d)(ii) of the Companies Act, 2013 and Rule 10(2) of Companies (Audit and Auditors) Rules, 2014*]*.

(g) A person who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for an amount exceeding ₹1 lakh. [Section 141(3)(d)(iii) of the Companies Act, 2013 and Rule 10(3) of Companies (Audit and Auditors) Rules, 2014].

(h) A person or a firm who, whether directly or indirectly, has business relationship with the company or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company. [Section 141(3)(e) of the Companies Act, 2013 and Rule 10(4) of Companies (Audit and Auditors) Rules, 2014].

(i) A person whose relative is a director or is in the employment of the company as a director or key managerial personnel of the company. [Section 141(3)(f) of the Companies Act, 2013].

(j) A person who is in the full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor if such person or persons is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies. [Section 141(3)(g) of the Companies Act, 2013].

(k) A person who has been convicted by a court for an offence involving fraud and a period of ten years has not elapsed from the date of such conviction. [Section 141(3)(h) of the Companies Act, 2013].

(l) Any person whose subsidiary or associate company or any other form of entity, is engaged as on date of appointment in consulting and providing specialised services to the company and its subsidiary companies: [Section 141(3)(i) and Section 144 of the Companies Act, 2013].
(i) accounting and book keeping services
(ii) internal audit
(iii) design and implementation of any financial information system
(iv) actuarial services
(v) investment advisory services
(vi) investment banking services
(vii) rendering of outsourced financial services
(viii) management services

3. (a) Objectives of Management Audit: Management audit is carried out to-

a. Appraise the management performance at all the levels.
b. Spotlight the decision or activities that are not in conformity with organizational objectives.
c. Ascertain that objectives are properly understood at al l levels;
d. Ascertain that controls provided at different levels are adequate and effective in accomplishing management objectives or plans of operations;
e. Evaluate plans which are projected to meet objectives,
f. Review the company's organizational structure, i.e. assignment of duties and responsibilities and delegation of authority.

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

(i) To ensure optimum utilization on all the resource employed, including money, materials, machines, men and methods;
(ii) To highlight efficiencies in objectives, policies, procedures and planning;
(iii) To suggest improvement in methods of operations;
(iv) To highlight weak links in organizational structure and in internal control systems and suggest necessary improvements.

(v) To help management by providing health indicators and help to prevent sickness or help to cure in case of sickness; and
(vi) To anticipate problems and suggest remedies to solve them in time.

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

- Customers measure it by the product quality, prompt and courteous after sales service, regularity in maintaining supplies etc.
- Shareholders, measure it by the consistency in financial performance and prospects of growth.
- Suppliers measure it by the company's liquidity and ability to honour commitments.
- Banks and Financial Institutions measure it by the financial health, net worth and history of serving debts.
- Government looks at it from the point of view of revenue generation and as an honest tax payer.
- Employees look for steady career growth and smooth industrial relations.

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

- Prepare a list of desirable attributes
- Group them functionally and specify the qualifications
- Assign weights to each attribute based on their relative importance.
- Involve experts in the respective fields in rating the qualifications and attributes-based on facts, judgments and interpretations.
- Summarise the rating under the selected groups and present a composite evaluation to the management.

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

4. (a) Taking into consideration the requirements like showing separately local and export sales, with details like quality, net realization, price per unit, packing charges etc, profitability statements have been prepared as follows:

<u>Statement of Cost of Production</u>

Production:10,000	Total Cost (₹)	Per unit cost (₹)
Direct materials (20,000 kgs.@ ₹ 5 per kg)	1,00,000	10.00
Imported components (10,000 units@ ₹ 3/unit)	30,000	3.00
Direct labour	10,000	1.00
Prime cost	1,40,000	14.00
Factory overhead	15,000	1.50
Opening WIP	10,000	1.00

	1,65,000	16.50
Less: Closing WIP	5,000	0.5
Work Cost	1,60,000	16.00
Administrative overheads	5,000	0.5
Cost of production	1,65,000	16.5

Statement of Cost and Profit on Export sales

Export Sales:1000 units	Total cost (₹)	Per unit cost (₹)
Cost of production	16,500	16.50
Export packing	2,000	2.00
Handling at Port	500	0.5
(A) Cost of Sales	19,000	19.00
Export sales realization	20,000	20.00
Export Incentive @10% of F.O.B	2,000	2.00
Duty draw back on components	2,500	2.50
(B) Total Realisation	24,500	24.50
Profit on export (B) – (A)	5,500	5.50

(b) "Waste multiplier" is the quantity of output from any process, which will be needed to get one unit of final output. To arrive waste multiplier processing cost per kg of output is worked out. These costs are then aggregated to arrive at total yarn cost. This is done by using a factor known as Waste multiplier.

Process	% of wastage on input	Net output for 100 units of input		Waste multiplier
Total				1.3161
Blow room	9.18	100-9.18	90.82	1.1953
Carding	7.17	90.82-[7.17/100x90.82]=	84.31	1.1096
Drawing	1.10	84.31-[1.10/100x84.31]=	83.38	1.0974
Roving(Simplex)	0.30	83.38-[0.30/100x83.38]=	83.13	1.0941
Ring Frame(Spinning)	7.21	83.13-[7.21/100x83.13]=	77.14	1.0153
Reeling and winding	1.50	77.14-[1.50/100x77.14]=	75.98	1.0000

Calculation of Waste Multiplier-

Total	wm0=Actual input/Actual out put	100/75.98	1.3161
Blow room	wm1=WM0 X Net output/Actual Input	=1.3161X90.82/100	1.1953
Carding	wm2=Wm1 X Net output/Actual Input	=1.3161X84.31/100	1.1096
Drawing	wm3=WM2 X Net output/Actual Input	=1.3161X83.38/100	1.0974
Roving(Simplex)	wm4=WM3 X Net output /Actual Input	=1.3161X83.13/100	1.0941
Ring Frame(Spinning)	wm5=WM4 X Net output /Actual Input	=1.3161X77.14/100	1.0152
Reeling and winding	wm6=WM5 X Net output /Actual Input	=1.3161X75.98/100	1.0000

5.

	Year Ending (₹ in lakhs)		
	31-3-16	31-3-15	31-3-14
Gross sales inclusive of excise duty	2,040	1,965	1,875
Excise duty	295	280	265
Net sales (A)	1,745	1,685	1,610
Cost of Sales excluding depreciation & Interest:			
Raw Material consumed	1,140	1,060	975
Direct Wages	35	32	27
Power and Fuel	30	27	24
Stores and Spares	6	5	4
Factory overheads (excluding depreciation)	12	10	8
Administrative overheads (excluding depreciation)	174	165	158
Selling and distribution overheads (excluding depreciation)	137	130	118
Bonus and Gratuity	12	10	9
Total (B)	1,546	1,439	1,323
Operating Profit (A) - (B) =	199	246	287

Value addition is defined as "the difference between the net output value (Net Sales) and cost of bought out materials and services for the product under reference".

	Year Ending (₹ in lakhs)		
	31-3-16	31-3-15	31-3-14
(X) Net sales	1,745	1,685	1,610
Less : (i) Cost of Bought Out Materials & Service (Raw Materials and Stores & Spares)	1,146	1,065	979
(ii) Power & Fuel, other bought out services	30	27	24
(iii) Over heads (excluding Salaries & Wages, Rates & Taxes and Depreciation)	298	283	265
(Y) =(i)+(ii)+(iii)	1,474	1,375	1,268
Value Addition : (X) - (Y) =	271	310	342

	Year Ending (₹ in lakhs)		
	31-3-16	31-3-15	31-3-14
Hence, (a) Operating profit as % of Value Added i.e.	199/271= 73.43%	246/310= 79.35%	287/342= 83.92%
(b) Value Addition as % of Net Sales i.e.	271/1745= 15.53%	310/1685= 18.40%	342/1610 21.24%

6. **(a)** Installed capacity for machine:

=365 x No. of hours used / shift x no. of units x units manufactured/ hours
=365 days x 8 hrs x 3 shifts x 600 units = 52.56 lakh units

Practical capacity / Available capacity:
Installed capacity
Less: Time lost for maintenance, repairs, set-ups, power cuts
Less: Normal delays
Less: Holidays, Weekly off days x No. of shifts x units manufactured / hrs
= (365 days – 52 Sundays – 10 holidays) x [8 hrs – 1 (idle time)] x 3 shifts x 600 units
= 38,17,800 Units

Normal capacity is Average of 3 normal years
Normal capacity = (36.12 + 35.64 + 36.24) lakh units / 3 = 36.00 lakh units

Actual capacity utilization:
= output achieved / Installed capacity
$= \frac{36.12}{52.56} \times 100$ (lakh unit) = 68.72%

Idle capacity:
Installed capacity ─ Actual capacity
= (52.56 ─ 36.12) lakh units
= 16.44 lakh units

Abnormal Idle capacity:
Practical capacity
Less: Higher of [normal / actual]
= 38,17,800 ─ 36,12,000
= 2,05,800 units

(b) Computation of Material Cost Sheet

	Particulars	Amount (₹)
	Purchase price of Material	2,00,000
Add:	Fee on Board	10,000
Add:	Import Duties of purchasing the material	15,000
Add:	Freight Inward during the procurement of material	20,000
Add:	Insurance paid	12,000
	Total	2,57,000
Less:	Trade Discount	3,000
Less:	Rebates	4,000
Less:	CENVAT Credit refundable	7,000
Less:	Subsidy received from the Government for importation of materials	18,000
	Value of Receipt of Material	2,25,000

7. (a) Computation in difference in Valuation of Stock

	Financial Accounts (₹)	Cost Accounts (₹)
Opening (WIP & FG) Closing (WIP & FG	2,91,09,835 4,15,35,070	3,14,84,660 4,72,61,495
	1,24,25,235	1,57,76,835

Reconciliation of Financial Profit and Costing Profit:

	₹	₹
Profit as per Financial Accounts		1,54,28,642
Add: Difference in Stock Valuation	33,51,600	
Loss on Sale of Fixed Assets	1,22,546	
Donation not considered in Cost Records	4,85,560	
Voluntary retirement compensation not included in cost	16,76,540	56,36,246
		2,10,64,888
Less: Non - operating income	45,36,770	
Less: Interest income from intercorporate deposit	6,15,340	51,52,110
Profit as per Financial Accounts		1,59,12,778

(b) Internal audit involves the following area of operations:

1. Reliability and integrity of financial and operating information: Internal auditor should review the reliability and integrity of operating and financial information and means used to identify, measure, classify and report such information.

2. Compliance with law, plans, procedures and regulations: Internal auditor should review the systems established to ensure compliance with those policies, plan and procedure, law, regulations which have a significant impact on operations and reports and should determine whether the organization is in compliance thereof.

3. Safeguarding of Assets: The internal auditor should verify the existence of assets and should review the means of safeguarding assets.

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

5. Accomplishing of established objectives and goals and operation: Internal auditor should review operation of programmes to ascertain whether the results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned. The scope of internal audit at first phase is related to past business and not planning decision such as, whether to make or buy, whether to undertake a new project or export etc. These are managerial decisions and the scope of internal audit is not practical in initial stage unless it is management audit. The 2nd phase is the execution stage having its base in the subsequent recording in books of accounts. In this stage the scope of internal audit is necessary which need the correction of accounts and proper classification of heads. The final phase is the review of transactions where it is mainly the scope of internal audit.

8. (a) As per the newly enacted Companies (Cost Records and Audit) Rules, 2014, Cost Audit is applicable to the non-regulated sectors if overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under Rule 3 is ₹ 35 crore or more.

In this case, the company is not satisfied the first criteria of Rule 4 i.e. overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more. Hence, the company is not required to get its cost records audited.

The company is in the process of listing on a stock exchange in India which will nowhere affect the applicability of the Companies (Cost Records and Audit) Rules, 2014. Hence, the company is not required to get its cost records audited.

(b) The following disclosures are required to be made in the cost statement as per CAS - 19 as regard to Joint Costs:

(1) The cost statement shall disclose the basis of allocation of Joint costs to individual products and the value assigned to the by-products.
(2) The cost statement shall also disclose
(3) The disclosure should be made only where material, significant and quantifiable.
(4) Disclosures shall be made in the body of cost statements or as a foot note or as a separate schedule.
(5) Any change in the cost accounting principles and methods applied for the measurement and assignment of the Joint costs and the value assigned to by - product during the period covered by the cost statement which has a material effect on the joint/by -products shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

(c) Propriety Audit: The term 'propriety' has been defined by Kohler 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. Propriety audit is concerned with executive actions and plans bearing on the finances & expenditure of the company. The cost auditor has to judge:

(i) Whether the planned expenditure is designed to give optimum results.
(ii) Whether the size and channels of expenditure were designed to produce the best results, and
(iii) Whether the return from expenditure on capital as well as current operations could be bettered by some other alternative plan of action.