PAPER – 19: COST AND MANAGEMENT AUDIT

The following table lists the learning objectives and the verbs that appear in the syllabus learning aims and examination questions:

	Learning objectives	Verbs used	Definition
LEVEL C	KNOWLEDGE What you are expected to know	List	Make a list of
		State	Express, fully or clearly, the details/facts
		Define	Give the exact meaning of
	COMPREHENSION What you are expected to understand	Describe	Communicate the key features of
		Distinguish	Highlight the differences between
		Explain	Make clear or intelligible/ state the meaning or purpose of
		Identity	Recognize, establish or select after consideration
		Illustrate	Use an example to describe or explain something
	APPLICATION How you are expected to apply your knowledge	Apply	Put to practical use
		Calculate	Ascertain or reckon mathematically
		Demonstrate	Prove with certainty or exhibit by practical means
		Prepare	Make or get ready for use
		Reconcile	Make or prove consistent/ compatible
		Solve	Find an answer to
		Tabulate	Arrange in a table
	ANALYSIS How you are expected to analyse the detail of what you have learned	Analyse	Examine in detail the structure of
		Categorise	Place into a defined class or division
		Compare and contrast	Show the similarities and/or differences between
		Construct	Build up or compile
		Prioritise	Place in order of priority or sequence for action
		Produce	Create or bring into existence
	SYNTHESIS How you are expected to utilize the information gathered to reach an optimum conclusion by a process of reasoning	Discuss	Examine in detail by argument
		Interpret	Translate into intelligible or familiar terms
		Decide	To solve or conclude
	EVALUATION How you are expected to use your learning to evaluate, make decisions or recommendations	Advise	Counsel, inform or notify
		Evaluate	Appraise or asses the value of
		Recommend	Propose a course of action

Paper 19 - COST AND MANAGEMENT AUDIT

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

Working Notes should form part of the answer.

—Wherever necessary, suitable assumptions should be made and indicated in answer by the candidates.

1. **Answer the four Questions [15×4=60]**

(a) (i) What types of Educational Services are covered under the Companies (Cost Records and Audit) Rules 2014? [6]

Answer:

The Companies (Cost Records and Audit) Rules 2014 covers "Education services, other than such similar services falling under philanthropy or as part of social spend which do not form part of any business".
Any company imparting training or education by means of any mode is covered under Education Services. However, auxiliary services provided by companies, as a separate independent entity, to educational institutions viz., (i) transportation of students, faculty and staff; (ii) catering service including any mid-day meals scheme; (iii) security or cleaning or house-keeping services in such educational institution; (iv) services relating to admission to such institution or conduct of examination are not included under Education Services.

In case the educational institution covered under the Rules is providing the above auxiliary services as a part of their total operations, then the institution will be required to maintain records for such auxiliary services also.

(ii) What types of Health Services are covered under the Companies (Cost Records and Audit) Rules 2014? [6]

Answer:

The Companies (Cost Records and Audit) Rules 2014 covers "Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories".
Any company engaged in providing Health services through functioning as or running hospitals, diagnostic centres, clinical centres, test laboratories, physiotherapy centres and post-operative/treatment centres are covered within the ambit of the Companies (Cost Records and Audit) Rules 2014. Further, companies running hospitals exclusively for its own employees are excluded from the ambit of these Rules, provided however, if such hospitals are providing health services to outsiders also in addition to its own employees on chargeable basis, then such hospitals are covered within the ambit of these Rules.

It is clarified that companies engaged in running of Beauty parlours / beauty treatment are not covered under these Rules.

(iii) A company is engaged in manufacturing products on its own as well as purchase the same products from other companies. The outsourced products are treated as trading

activity in the financial accounts. Same products are also manufactured by supply of materials to converters. What would be treatment of such products for the purposes of maintenance of cost accounting records and cost audit? [3]

Answer:

Products manufactured by the company as well as conversion activity through third parties will be covered under the Companies (Cost Records and Audit) Rules 2014 and the company would be required to maintain cost accounting records and get cost audit conducted subject to threshold limits. The finished products bought from outside parties (treated as Trading Activity in Financial Accounts) would be reflected as "Cost of Finished Goods Purchased" in Abridged Cost Statement.

(b)(i) A company is engaged in manufacturing of multiple products. Some of the products are covered under the Companies (Cost Records and Audit) Rules, 2014 and some are not. Part-A, Para 4 of the Annexure to the Cost Audit Report (Product/Service Details for the company as a whole) requires Net Operational Revenue to be reported for each CETA Heading for both the current year and the previous year. Can the Net Operational Revenue of all the Products that are not covered under the Rules be reported in this Para as a single line item? [7]

Answer:

Part-A, Para 4 of the Annexure to the Cost Audit Report of Companies (Cost Records and Audit) Rules, 2014 require reporting of Net Operational Revenue of every CETA Heading separately comprised in the Total Operational Revenue as per Financial Accounts. Hence, the company would be required to report Net Revenue of every CETA Heading irrespective of whether the same is covered under maintenance of cost accounting records and cost audit or not. In case some of the Products are under the same CETA Heading but having different units of measurement (UOM), then Net Revenue is to be reported for separate UOMs. It may be noted that the number of quantitative details and abridged cost statements will have to be provided for each unique combination of CETA Heading and UOM of the Products which are covered under cost audit.

If the company is engaged in manufacturing of products as well as providing of services and/or trading, such services which are covered under the Companies (Cost Records and Audit) Rules, 2014 will be required to be reported separately according to the definition provided in the Rules classified under different types of services within the same class of service. It may be noted that the number of quantitative details and abridged cost statements will have to be provided for each classification of service covered under cost audit.

Other services that are not covered under the Rules and Revenue from Trading Activity may be reported under suitable heads denoting the service/activity.

The New Taxonomy has introduced a separate line item in this Para to report "Other Operating Incomes" which will form part of the Total Operating Revenue.

(ii) Many Companies have filed Form 23C as well as Form CRA-2 for 2014-15 in respect of different products and/or multiple cost auditors, if applicable. Which SRN Number has to be reported in the cost audit report while filing the same in XBRL Mode? [4]

Answer:

(a) Companies who have filed multiple Form 23C in respect of multiple cost auditors will be required to provide the SRN Numbers against each Form 23C filed.

(b) In case the company after filing individual Form 23C has also filed Form CRA-2, in such case the company will be required to provide the SRN Number of the latest CRA-2 only since the details of multiple cost auditors, if applicable for the company, would be covered under one Form CRA-2.

(iii) What is the status of companies after the notification of Companies (Cost Records and Audit) Rules, 2014, who have not filed cost audit report and/or compliance report pertaining to any year prior to financial year commencing on or after April 1, 2014? [4]

Answer:

Companies that were covered under the Companies (Cost Accounting Records) Rules, 2011 or any of the 6 industry specific Cost Accounting Records Rules and were required to file Compliance Report and/or Cost Audit Report for and upto any financial year commencing prior to April 1, 2014 are required to comply with the erstwhile Rules and file the Compliance Report and/or Cost Audit Report in XBRL Mode for the defaulted years. For this purpose, the Costing Taxonomy 2012 will continue to be available and such reports would be required to be filed in Form A-XBRL and Form I-XBRL, as the case may be.

(c)(i) The pipe company manufactures two products A and B during the first year of its operations. For purposes of product costing, an overhead rate of application of ₹1.70 per direct labour hour was used, based on budgetary factory overhead of ₹ 3,40,000 and budgeted direct labour hours of 2,00,000 as follows:

	Budgeted overhead	Budgeted Hours		Product A	Product B
Department 1	₹ 2,40,000	1,00,000	**Dept I**	4	4
Department 2	₹ 1,00,000	1,00,000	**Dept II**	1	1
	3,40,000	2,00,000		5 hours	5 hours

At the end of the year, there was no work on process. There were, however, 2,000 and 6,000 finished units, respectively of products A and B on hand. Assume that budgeted activity was attained.

(I) What was the effect on the company's income of using a plant wise overhead rate instead of departmental overhead rates?

(II) Assume that material and labour costs per unit of product A were ₹10 and that the selling price was established by adding 40% to cover profit and selling and administrative expenses. What difference in selling price would result from the use of departmental against plant wise overhead rates?

(III) Explain why departmental overhead rates were generally preferable to plant wise rates. [2+2+2=6]

Solution:

(I) Computation of effect on income of company by using Plant wise over head rate instead of Departmental Overhead Rates:

Particulars	A	B
Overheads using plant wise OH rate A = (1.7 x 5); B = (1.7 x 5)	8.5	8.5

(-) Overhead using Dept OH rate A = [(4x2.4) + (1x1)] = 10.60 B = [(1x2.4) + (4x1)] = 6.40	10.6	6.4
Difference	(-)2.1	2.1
No. of units of stock	2,000	6,000
Increase or decrease in value of stock	(-)4,200	12,600

Effect on the company : By using plantwise overhead rate closing stock of A will decrease by ₹4200 and that of B will increase by ₹12,600. As a result of this, company's profit was shown in excess by ₹8,400.

(II) Computation of selling price of Product A by using plant wise Overhead Rate:

Particulars	Amount (₹)
Materials & Labour @ 10 p.u. Overheads	10.00 8.50
Works cost	18.50
(+) 40% towards Selling & Distribution OH's and profit	7.40
Selling Price	25.90

Computation of Selling Price of Product 'A' by using dept. OH rates:

Particulars	Amount
Materials & Labour Overheads	10.00 10.60
	20.60
(+) 40% towards Selling & Distribution OH's and profit	8.24
Selling Price	28.84

Difference in Selling Price = 28.84 – 25.90 = 2.94

(III) When there are departments, departments OH rate should be used for absorbing factory overheads and not by using plant wise/general/blanket/single overhead rate. The reason being in different departments, nature of working differs. In one department, machine play dominant role. In some other department, material play dominant role. Depending upon dominance of each factor, OH rate should be used for absorbing overheads.
Therefore, it is always advisable, preferable and appropriate to use departmental overhead rate instead of blanket overhead rate.

(ii) Discuss the treatment of idle time and overtime wages in cost records. [3+3=6]

Solution :

Treatment of Idle Time

As per CAS-7, Idle Time Cost shall be assigned direct to the cost object or treated as overheads depending on the economic feasibility and specific circumstances causing such idle time.

Treatment of different categories of Idle Time are as below:-

(i) Unavoidable idle time above would be for insignificant periods. In Cost Accounts, this is allowed to remain merged in the Production Order or Standing Order Number on which the worker was otherwise employed.

(ii) Normal Idle Time is booked to factory or works overhead. For the purpose of effective control, each type of idle time, i.e., idle time classified according to the causes is allocated to a separate Standing Order Number.

(iii) Abnormal Idle Time would usually be heavy in amount involves longer periods and would mostly be beyond the control of the management. Payment for such idle time is not included in cost and is adjusted through the Costing Profit and Loss Account or included in Profit and Loss Account, when the accounts are integrated.

(iv) Tendency to conceal Idle Time should be discouraged. It is a non-effective time and the resultant loss of profit due to reduced production activity but also increases the cost per unit of production as the fixed costs continue to be incurred, irrespective of the reduced quantum of production due to loss of labour time. Idle Time should, therefore, be highlighted prominently so that action can be taken to remove the causes thereof. Although for obvious reasons, it is not possible to record minor details, vigilance is necessary for finding out long-term idleness among the workers.

Treatment of Overtime in Cost Records

As per CAS-7, 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.

When overtime is worked due to exigencies or urgencies of the work, the basic / normal payment is treated as Direct Labour Cost and charged to Production or cost unit on which the worker is employed. Whereas the amount of premium (extra amount) is treated as overhead.

If overtime is spent at the request of the customer, then the entire amount (including overtime premium) is treated as direct wages and should be charged to the job.

When the overtime is worked due to lack of capacity as general policy of the company, then the total amount paid is treated as direct wages which is computed at the estimated rate based on the figures of the previous years.

Overtime worked on account of the abnormal conditions such as flood, earth-quake, etc., should not be charged to cost, but to costing Profit and Loss Account if integrated accounts are maintained.

(iii) Mr. X purchased an asset costing ₹50,000, and a spare part costing ₹4,000. This spare part is specific to the asset purchased. Also given that the life of the equipment is 4 years, whereas the life of the spare part is 5 years. State the treatment of this spare part as per CAS-6. **[3]**

Solution :

Spares which are specific to an item of equipment shall not be taken to inventory, but shall be capitalized with the cost of the specific equipment. Cost of capital spares and/or insurance spares, whether procured with the equipment or subsequently, shall be amortised over a period, not exceeding the useful life of the equipment.

In the given case, the spare parts should be amortised over the useful life of the equipment i.e. 4 years.

(d) (i) While doing Cost Audit, the Cost Auditor should hold professional skepticism. Explain **[6]**

Answer:

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

(a) A cost auditor conducting an audit in accordance with Cost Auditing Standards obtains reasonable assurance that the Cost Statements taken as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the Cost Statements taken as a whole. Reasonable assurance relates to the whole audit process.

A cost auditor cannot obtain absolute assurance because there are inherent limitations in an audit that affect the cost auditor's ability to detect material misstatements. These limitations result from factors such as the following:

(1) The use of sample testing.
(2) The inherent limitations of internal control (for example, the possibility of management override or collusion).
(3) The fact that most audit evidence is persuasive rather than conclusive.

Also, the work undertaken by the cost auditor to form an audit opinion is permeated by judgment, in particular regarding:

(1) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and
(2) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the Cost Statements.

(b) Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions. (For example, transactions between related parties). In these cases certain Cost Auditing Standard identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:

(1) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or
(2) Any indication that a material misstatement has occurred.

Accordingly, because of the factors described above, an audit is not a guarantee that the Cost Statements are free from material misstatement, because absolute assurance is not attainable. Further, an audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

(ii) Explain the following as per Cost Auditing Standard 103 –

(I) Inherent Risk;
(II) Control risk &
(III) Detection risk. **[3 x 3 = 9]**

Answer:

(I) "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no

related controls. The risk of such misstatement is greater for some assertions and related cost heads, items of cost and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations.
Cost heads consisting of amounts derived from cost estimates that are subject to significant measurement uncertainty pose greater risks than do cost heads consisting of relatively routine, factual data.
External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a cause changes to a manufacturing process rendering the existing classification of variable and fixed costs inappropriate and cause product contribution to be misstated. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of cost heads, items of cost, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, external market constraints may cause normal capacity as an unreliable basis for determining unit costs.

(II) "Control risk" is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's Cost Statements. Some control risk will always exist because of the inherent limitations of internal control.
Inherent risk and control risk are the entity's risks; they exist independently of the audit of the Cost Statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. When the auditor's assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. The Cost Auditing Standard do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risk of material misstatement." Although the Cost Auditing Standard ordinarily describe a combined assessment of the risk of material misstatement, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

(III) "Detection risk" is the risk that the cost auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of cost heads, items of cost, or disclosure and because of other factors. Such other factors include the possibility that a cost auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the audit team, the application of professional skepticism, and supervision and review of the audit work performed.
Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level.

For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.

(e)(i) What are the duties of the Companies in relation to provisions of Section 148 of the Companies Act, 2013 and the Rules framed thereunder? [5]

Answer:

Every company required to get cost audit conducted under Section 148(2) of the Companies Act, 2013 shall:-

(a) Appoint a cost auditor within one hundred and eighty days of the commencement of every financial year;

(b) Inform the cost auditor concerned of his or its appointment;

(c) 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 or 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;

(d) Within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in form CRA-4 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

(ii) The following figures were extracted from the Trial Balance of a company as on 31st December 2014.

Particulars	Debit (₹)	Credit (₹)
Inventories		
Raw Material	**1,40,00**	
WIP	**2,00,00**	
FG	**80,00**	
Office Appliances	**17,40**	
Plant and Machinery	**4,60,50**	
Buildings	**2,00,00**	
Sales		**7,68,000**
Sales Returns	**14,00**	
Material purchased	**3,20,00**	
Freight on materials	**16,00**	
Purchase returns		**4,800**
Direct labour	**1,60,00**	
Indirect labour	**18,00**	
Factory supervision	**10,00**	
Factory repairs & upkeep	**14,00**	

Heat, light & power	65,00	
Rates & taxes	6,30	
Misc factory expenses	18,70	
Sales commission	33,60	
Sales travelling	11,00	
Sales Promotion	22,500	
Distribution department salaries & wages	18,00	
Office salaries	8,60	
Interest on borrowed funds	2,00	

Further details are given as follows:
Closing inventories are Material ₹ 1,80,000, WIP ₹ 1,92,000 & FG ₹1,15,000.
Accrued expenses are Direct Labour ₹ 8,000, Indirect Labour ₹ 1,200 & interest ₹ 2,000.
Depreciation should be provided as 5% on Office Appliances, 10% on Machinery and 4% on Buildings.
Heat, light and power are to be distributed in the ratio of 8:1:1 among factory, office and distribution respectively.
Rates & taxes apply as 2/3rd to the factory and 1/3rd to office.
Depreciation on building to be distributed in the ratio of 8:1:1 among factory, office and distribution respectively
Prepare a Cost Sheet statement as per CAS 22 showing all important components. [6]

Solution:

Cost Sheet

Particulars	Amount (₹)	Amount (₹)
Direct Materials		
Opening stock	1,40,000	
Add: Purchases	3,20,000	
Add: Freight	16,000	
Less: Returns	(4,800)	
Less: Closing Stock	(1,80,000)	2,91,200
Direct Labour	1,60,000	
Add: Accrued	8,000	1,68,000
Prime Cost		**4,59,200**
Factory Overheads:		
Indirect labour	18,000	
Accrued indirect labour	1,200	
Factory supervision	10,000	
Repairs & upkeep	14,000	
Heat, Light & Power	52,000	
Rates & taxes	4,200	
Misc. Factory expenses	18,700	
Depreciation on plant & machinery	46,050	
Depreciation on buildings	6,400	
	1,70,550	
Add: Opening WIP	2,00,000	
Less: Closing WIP	(1,92,000)	1,78,550
Factory Cost		**6,37,750**

Administration Overheads		
Heat, Light & power	6,500	
Rates & taxes	2,100	
Depreciation on buildings	800	
Depreciation on office appliances	870	
Office salaries	8,600	
	18,870	
Add: Opening FG stock	80,000	
Less: Closing FG Stock	(1,15,000)	(16,130)
Cost of Production of saleable units		**6,21,620**
Selling & Distribution overheads		
Heat & light	6,500	
Depreciation on buildings	800	
Sales commission	33,600	
Sales travelling	11,000	
Sales promotion	22,500	
Distribution department expenses	18,000	92,400
Cost of Sales		**7,14,020**

(iii) What is the procedure for appointment of cost auditor under the Companies Act, 2013? **[4]**

Answer:

The cost auditor is to be appointed by the Board of Directors on the recommendation of the Audit Committee, where the company is required to have an Audit Committee. The cost auditor proposed to be appointed is required to give a letter of consent to the Board of Directors. The company shall inform the cost auditor concerned of his or its appointment as such and 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 or 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.
Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.

(2) Answer any two questions [10×2=20]

(a)(i) What are the needs for Operational Audit? **[5]**

Answer:

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

1. **Need for Current Control:** Surveys and special investigations are occasional in character. They are costly, time consuming and keep the departmental key personnel busy during

that period. They are undertaken mostly to find causes of certain affairs or to fix responsibility for certain undesirable happenings. These basically attempt to carry out a post-mortem rather to give a signal for dangers and forthcoming disasters. Operational Audit is required to ensure day-to-day control of activities.

2. **Unbiased Reports:** Performance Reports contained in the annual accounts and routine reports prepared by the operating departments have their own limitations, may be subjective, manipulated or biased. Hence, Operational Audit is required.
3. **Information Needs:** Managers require full, objective and current information about conditions prevalent in their operational areas, and also in areas beyond their direct observation. Operational Audit provides the required information to them.
4. **Shortcomings of Internal Audit:** Conventional Internal Audit reports are often routine and mechanical in character and have definite leaning towards accounting and financial information. They are historical in nature. Operational Audit overcomes this limitation of Internal Audit.
5. **Analytical Evaluation:** Departmental Managers and their aides generally routine transmit information. But an Independent Operational Audit Team will be able to evaluate the operations analytically.
6. **Non-detected Cracks:** Even when a department is working well and smoothly, there may be some crack or gap in operations or in controls. Operational Audit is a management information source since it will find out the possibilities of such undetected gaps / lapses in control.
7. **Communication Gaps - to fill up:** Conventional sources of Management information are –
   (a) Departmental Manager's routine performance report,
   (b) Internal Audit Reports,
   (c) Periodic Special Investigation, and
   (d) Survey.
   These sources create communication gaps on activities, which do not come under the direct observation of managers. Hence, Operational Audit is required.
8. **Environment Changes:** Operational Audit is required to analyse whether the activities, operations, procedures, methods and objectives of the enterprise are in tune with its present environmental conditions. There is a need for an instrument, which should signal change in advance.
9. **Supplementing Managers:** Executives and Managers are too pre-occupied with implementation of plans and achieving targets. They are left with very little time to collect information and locate problems. Hence, an independent Operational Audit team should provide them data inputs on the effectiveness of operations.

(ii) What are the features of a good Internal Control System? [5]

Answer:

A good Internal Control System should possess the following features -

i. Proper Organisation Structure:
   (a) A good Internal Control System should involve segregation of duties in such a manner that error or fraud cannot take place.
   (b) Proper division of duties, with respect to access to assets, authorisation of transactions, execution of transactions and record keeping should be based on the organisation structure.

ii. Scheme of authorisation and procedures: A good Internal Control System should define proper authorizations and procedures. *The* scheme of authorisation should ensure that -

(a) Every transaction is duly authorised by the competent official,
(b) Every transaction is properly accounted in the books, and
(c) Supervisory procedures are laid down based on the responsibilities of each official.

iii. Internal Check:

(a) Accounting Procedures should be designed in such a manner that no single person is authorised to carry out all the operations involved in a transaction.
(b) The system should institute a prompt and independent verification of an individual's work by prescribing cross-checks and cross-reconciliations as a part of the operating procedure itself and also provide for complimentary allocation of duties.

iv. Suitable Personnel:

(a) Competent and honest persons alone should be employed in the organisation so that the system operates effectively.
(b) The qualification, experience and personal characteristics of the personnel involved arc important in establishing and maintaining a system of Internal Control.

v. Internal Audit System:

(a) The Management may establish an Internal Audit Department and delegate some of its supervisory functions like review of Internal Control.
(b) Internal Audit constitutes a separate component of Internal Control System undertaken by specially assigned staff with the objective of determining whether Internal Controls are well designed and operating properly.

(b) Distinguish the following –

(i) Operational audit vs. Internal Audit;
(ii) Operational Audit vs. Financial Audit;
(iii) Operational Audit vs. Management Audit. **[4+3+3 = 10]**

Answer:

(i) Operational Audit Vs Internal Audit

Particulars	Operational Audit	Internal Audit
1. Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	Function of internal control with the objective of determining whether other internal controls are well designed and in place.
2. Link with Internal Control	This is not a part of Internal Control. This is over and above the regular internal control system.	This operates as a part of Internal Control System.
3. Objectives	1. Appraisal of controls. 2. Evaluation of performance. 3. Appraisal of objectives and plans. 4. Appraisal of organizational structure.	1. To deterrhine whether internal controls are well designed and properly operated, and 2. To assist all members of Management in the objective discharge of their responsibilities by reviewing activities and procedures.

4. Function	Constructive Function, i.e. to provide suggestions for improvement.	Protective Function, i.e. to safeguard the assets of the enterprise.
5. Areas	All aspects of operations are analysed to see whether they are in tune with Management Policies, Objectives and Goals.	The traditional field of internal Auditors is restricted to financial accounting and internal control.
6. Aspect	Qualitative Aspects are analysed. For example in Cash Management, the Operational Auditor would analyse - 1. Whether quantum of cash in hand is related to requirement of cash? 2. Whether surplus cash is promptly invested in short-term securities for maximizing return? 3. Whether maximum possible protection has been given to cash?	1. The Internal Audit Function is said to focus more on quantitative aspects when compared to Operational Audit. 2. Internal Auditors view and examine internal controls in financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not found. 3. They check the accounting books and records to see whether the internal checks work properly and the resulting accounting data are reliable.

(ii) Operational Audit vs Financial Audit

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

(iii) Operational Audit vs Management Audit

Particulars	Operational Audit	Management Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person. It is an audit "for the Management".	The Audit of the Management focuses on evaluating Managers' ability to manage. It is an audit "of the Management".

Areas Covered	Operational Areas where standards and actual performance defined and expressed in quantitative terms are considered.	It is concerned with appraising - 1. Management's accomplishment of organizational objectives, 2. Management functions of planning, organizing, directing, and controlling, and 3. Adequacy of Management's decisions and action in moving towards its objectives.
Focus	Focus is on efficiency and economy in operations.	Focus is on effectiveness of Management decisions and actions.
Standards	Expectations or standards are expressed in quantitative terms, for comparison of actuals therewith.	Standards are not defined in quantitative or monetary terms.
Evaluation	It is objective in nature, since standards are quantifiable.	Evaluation is comparatively subjective, since standards are not defined in monetary terms.
Technical Background	Operational Auditor should have a strong technical and operational background.	Management Auditor should have conceptual background. Technical Background is desirable, but not compulsory.

(c) SP & Co., a cost audit firm, appointed as an internal auditor of the company XYZ LTD. for the audit of revenue for the financial year 2014-15. How would you verify the same if you, as a cost accountant, are responsible for conduct the audit of the same? [10]

Answer:

AUDIT OF REVENUE

1. **Assertions:** In the context of Revenue (as defined under AS - 9), the Auditor should confirm the management's assertions regarding the following -
   (a) **Occurrence:** That recorded revenue arose from transactions which took place during the relevant period and pertain to the entity.
   (b) **Completeness:** That there is no unrecorded revenue.
   (c) **Measurement:** That revenue is recorded at the proper amounts & is allocated to the proper period.
   (d) **Presentation** & **Disclosure:** That the revenue is disclosed, classified and described as per recognised accounting practices / policies and relevant statutory requirements, if any.
2. **Evaluation of Internal Controls:** The Auditor should examine whether the Internal Control provides for the following -
   (a) Systems and procedures relating to generation of revenue including authority to fix prices, offer discounts and other terms of sales.
   (b) Accounting procedures relating to recognition of revenue.
   (c) Existence of periodic reports on actual performance vis-a-vis budgets.
3. **Examination of Records:**
   (a) Examine whether revenue is recognised as per AS-9 requirements.
   (b) Review / analyse the adequacy & efficacy of cut-off procedures relating to Sales

and Sale Returns.

(c) Examine selected entries in the Sales Journal with reference to the related sale invoices, despatch documents, other supporting documents such as the customer's orders and credit approval notes, and entries in the customer's accounts. Compare the actual prices charged with authorized price lists or with the authorization by the appropriate official of the entity, as appropriate.

(d) Verify selected despatch documents with reference to related sale invoices and the Sales Journal.

(e) Scrutinise sample entries in the Sales Return Journal, with reference to the receiving reports in respect of goods returned, Credit Notes and entries in the Customers' Accounts.

(f) See whether revenue recognition principles have been properly applied in case of - (i) goods sent on approval, and (ii) sales to intermediate parties.

(g) Where consideration is receivable in instalments and includes an element of interest, examine whether interest element has been excluded from the amount recorded as Sales.

(h) In respect of Export Sales, see whether AS - 11 requirements are complied with. Also, obtain written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.

(i) Examine related agreements / documents / certificates in respect of revenue arising from services rendered (fees, commission, brokerage etc.) and from Interest, Dividends and Royalties.

(j) Verify realizations subsequent to the Balance Sheet date, to identify cases of unrecorded revenue.

4. **Analytical Procedures:** The following Analytical Procedures may be relevant -

(a) Comparison, product-wise & location-wise, of current year - (i) revenue, and (ii) quantity sold, with previous years' figures.

(b) Comparison of the ratio of - (i) Gross Margin to Sales, (ii) Sales Returns to Sales, (iii) Trade Discount to Sales, (iv) Excise Duty/Sales Tax/ Export Incentives to Sales, for the current year with the corresponding ratios for previous year.

(C) Product-wise Reconciliation of quantity sold during the year with Opening Stock, Purchases/ Production and Closing Stock.

(d) Comparison the amount of Dividend/Interest/Royalty for the current year with the corresponding figures for previous years.

(e) Comparison the ratio of Income on Investments to Average Investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

5. **Other Aspects:**

(a) Disclosure: The Auditor should examine whether various items of revenue have been disclosed properly in the Financial Statements and that any disclosure requirements of the relevant statute in this regard have been complied with.

(b) Companies: In case of Companies, the Auditor should carry out additional procedures in view of CARO Requirements, transactions with Related Parties etc.

(c) Documentation: The Auditor should maintain adequate working papers regarding audit of revenue.

(3) Answer any two questions [10×2=20]

(a) From the following information, ascertain the- amount of Capital Employed In the business:

	₹
Goodwill	**2,20,000**
Land & Building	**3,00,000**
Plant & Machinery	**1,80,000**
Furniture & Fixtures	**90,000**
10% Investment [Long Term]	**80,000**
Stock in Trade	**72,000**
Sundry Debtors	**57,000**
Cash at Bank	**43,000**
Cash in Hand	**14,000**
Bills Receivable	**18,000**
Prepaid Expenses	**6,000**
Sundry Creditors	**47,000**
Bills Payable	**12,000**
Outstanding Expenses	**11,000**
Bank Overdraft	**30,000**

[10]

Solution:

Books of S Ltd
Statement showing ascertainment of Capital Employed

	₹	₹	₹
Fixed Assets:			
Goodwill			2,20,000
Land & Building			3,00,000
Plant & Machinery			1,80,000
Furniture & Fixture			90,000
10% Investment [Long Term]			80,000
			8,70,000
Add: Working Capital:			
Current Assets:			
Stock in Trade		72,000	
Sundry Debtors		57,000	
Cash at Bank		43,000	
Cash in Hand		14,000	
Bills Receivable		18,000	
Prepaid Expenses		6,000	
		2,10,000	
Less: Current Liabilities:			
Sundry Creditors	47,000		
Bank Overdraft	30,000		
Bills payable	12,000		
Outstanding Expenses	11,000	1,00,000	1,10,000
Capital Employed			9,80,000

(b) Following is the Balance Sheet of Hum Ltd. as on 31 March 2015:

Liabilities	₹	Assets	₹
Equity Share Capital	2,00,000	Goodwill	50,000
Preference Share Capital	1,00,000	Land & Building	2,00,000
Reserves & Surplus	1,50,000	Plant& Machinery	1,50,000
12% Mortgage Loan	80,000	Furniture & Fittings	30,000
10% Debentures	1,20,000	Investment [Long-term]	70,000
Sundry Creditors	85,000	Stock in Trade	80,000
Bills Payable	10,000	Short-term Investment	40,000
Bank Overdraft	75,000	Sundry Debtors	90,000
Pre received Incomes	5,000	Cash at Bank	40,000
Outstanding Expenses	25,000	Cash in Hand	25,000
		Bills Receivable	15,000
		Accrued Incomes	4,000
		Prepaid Expenses	6,000
		Discount on issue of Shares	20,000
		Preliminary Expenses	30,000
	8,50,000		8,50,000

Compute:

(a) Working Capital; (b) Proprietors' Fund; (c) Capital Employed; (d) Current Ratio; (e) Acid Test Ratio; (f) Proprietary Ratio; (g) Fixed Asset Proprietorship Ratio; (h) Debt-Equity Ratio; (i) Capital Gearing Ratio and (i) Fixed Asset Ratio. **[10]**

Solution:

i. Statement showing computation of Working Capital

	₹	₹
Total Current Assets:		
Stock in Trade		80,000
Short-term Investment		40,000
Sundry Debtors		90,000
Cash at Bank		40,000
Cash in Hand		25,000
Bills Receivable		15,000
Accrued Incomes		4,000
Prepaid Expenses		6,000
		3,00,000
Less: Total Current Liabilities:		
Sundry Creditors	85,000	
Bills Payable	10,000	
Bank overdraft	75,000	
Perceived Incomes	5,000	
Outstanding Expenses	25,000	2,00,000
Working capital		1,00,000

ii. Statement showing computation of Proprietors' Fund

	₹	₹
Equity Share Capital Preference Share Capital Add: Reserves & Surplus		2,00,000 1,00,000 1,50,000

		4,50,000
Less: Miscellaneous Expenditure:		
Discount on Issue of Shares	20,000	
Preliminary Expenses	30,000	50,000
Proprietors' Fund		4,00,000

iii. Statement showing computation of Capital Employed

	₹	₹
Proprietors' Fund as computed in (b) above		4,00,000
Add: Long-term Loans:		
12% Mortgage Loan	80,000	
10% Debentures	1,20,000	2,00,000
Capital Employed		6,00,000

Note: Alternatively, Capital Employed may also be computed following a different approach as computed in the following:

Statement showing computation of Capital Employed

	₹
Fixed Assets:	
Goodwill	50,000
Land & Building	2,00,000
Plant& Machinery	1,50,000
Furniture's Fitting	30,000
Investment [Long Term]	70,000
	5,00,000
Add: Working Capital [as computed in (a) above]	1,00,000
Capital Employed	6,00,000

iv. Computation of Current Ratio

Current Ration $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

Here, Current Assets = ₹ 3,00,000 [as ascertained in (a) above]

Current Liabilities = ₹ 2,00,000 [as ascertained in (a) above]

$\therefore$ Current Ratio = $\dfrac{₹3,00,000}{₹2,00,000} = \dfrac{3}{2} = 1.5$

v. Acid Test ratio = $\dfrac{\text{Current Assets - Stock}}{\text{Current Liabilities - Bank overdraft}}$

$= \dfrac{₹3,00,000 - ₹80,000}{₹2,00,000 - ₹75,000} = \dfrac{₹2,20,000}{₹1,25,000} = 1.76$

vi. Proprietary Ratio = $\dfrac{\text{Proprietors'Fund}}{\text{Total Assets}}$

Here, Proprietors' Fund = ₹ 4,00,000 [as ascertained in (b) above]

Total Assets = FAs + CAs

= ₹ 5,00,000 [as ascertained in (c) above] + ₹ 3,00,000

= ₹ 8,00,000

$\therefore$ Proprietary Ratio = $\dfrac{₹4,00,000}{₹8,00,000} = \dfrac{1}{2} = 0.5$

vii. **Fixed asset Proprietorship Ratio =** $\frac{\text{Fixed Assets}}{\text{Proprietors' Fund}}$

Here, FAs = ₹ 5,00,000 [as ascertained in (c) above]

Proprietors' Fund = ₹ 4,00,000 [as ascertained in (b) above]

$\therefore$ Fixed Asset Proprietorship Ratio = $\frac{₹5,00,000}{₹4,00,000}=\frac{5}{4}=1.25$

viii. Debt – Equity Ratio = $\frac{\text{Debt}}{\text{Equity}}=\frac{\text{Long term Loan}}{\text{Proprietors' Fund}}$

Here, Long-term Loan = ₹ 2,00,000 [as ascertained in (h) above]

Proprietors' Fund = ₹ 4,00,000 [as ascertained in (b) above]

Debt – Equity Ratio = $\frac{₹2,00,000}{₹4,00,000}=\frac{1}{2}=0.5$

ix. Capital Gearing ratio = $\frac{\text{Fixed Interest Bearing Securities}}{\text{Ordinary Secutrities}}$

$$= \frac{\text{Preference share Capital + Long-term Loan}}{\text{Equity Shareholders' Fund}}$$

Here, Fixed Interest Bearing securities = Preference Share Capital + 10% Debentures + 12% Mortgage loan
= ₹ 1,00,000 + ₹ 1,20,000 + ₹ 80,000 = ₹ 3,00,000

Ordinary securities = Equity Shareholders' Fund = Proprietors' Fund – Preference Share Capital
= ₹ 4,00,000 [as computed in (b) above] - ₹ 1,00,000
= 3,00,000

$\therefore$ **Capital Gearing Ratio =** $\frac{₹3,00,000}{₹3,00,000}=1$

x. **Fixed Asset ratio =** $\frac{\text{Fixed Assets}}{\text{Capital Employed}}$

Here, FAs = ₹ 5,00,000 [as computed in (c) above]

Capital Employed = ₹ 6,00,000 [as computed in (c) above]

$\therefore$ Fixed Asset Ratio = $\frac{5,00,000}{6,00,000}$ = 5: 6

(c) Explain the Impact of IFRS on the Cost Structure, Cash Flows and Profitability. [10]

Answer:

The new era of accounting standards has started in India after India committed to converge to the IFRS. The Ministry of Corporate Affairs had notified new Ind AS in 2015. The timeline for the adoption of these new standards is also mentioned in the notification .

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

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

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

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

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

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

- Revenue recognition – companies may have to defer part or whole of their revenues.
- Inventory valuation – explicit rejection of LIFO method could change the inventory costs and thus profitability.
- Property, plant and equipment – recognition of assets and depreciation may change, provisions on revaluation of assets are noteworthy.
- Financial instruments-accounting for hedges and FOREX may result in profits or losses to be recognized or derecognized.
- Construction contracts – there could be changes in contract revenues and profit measurement thereon
- Impairment of assets-recognition of provisions may impact profitability
- Intangible assets-certain existing assets may have to be derecognized
- Business combinations – some costs of M & A cannot be capitalized

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

(a) Recognize all assets and liabilities whose recognition is required by Ind AS
(b) Not to recognize items as assets or liabilities if Ind AS do not permit such recognition;

(c) Reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under Ind AS and
(d) Apply Ind ASs in measuring all recognized assets and liabilities.

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