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) Who can be appointed as a "Cost Auditor" of a Company? [3]

Answer:

"Cost Auditor" means an auditor appointed to conduct an audit of cost records, under sub-section (2) of section 148 of the act and shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959. "Cost Accountant" for the purpose of these rules means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under sub-section (1) of section 6 and who is deemed to be in practice under sub-section (2) of section 2 of that Act and includes a firm of cost accountants.

(a)(ii) What are the other services that a Cost Auditor of the company can provide to the company in which he is appointed as Cost Auditor? [5]

Answer:

An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case maybe, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company, namely:—

(a) accounting and book keeping services;

(b) internal audit;

(c) design and implementation of any financial information system;

(d) actuarial services;

(e) investment advisory services;

(f) investment banking services;

(g) rendering of outsourced financial services;

(h) management services; and

(i) any other kind of services as may be prescribed.

Provided that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Explanation.— For the purposes of this sub-section, the term "directly or indirectly" shall include rendering of services by the auditor,—

(i) in case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual;

(ii) in case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners.

(a)(iii) Whether cost auditor of the company has to directly submit his Cost Audit Report to the Central Government? [3]

Answer:

No. The report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company. Then the company shall within 30 days from the date of receipt of a copy of the cost audit report prepared in pursuance of a direction under sub-section (2) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.

(a)(iv) The maximum period prescribed for presenting Cost Audit Report is 180 days from date of close of the financial year. If Financial Accounts of a company is not ready before the stipulated time period, how cost audit report will be completed reconciled with the financial books of the company? [4]

Answer:

Maintenance of cost accounting records is a continuous process. No time limit has been prescribed in the rules for "submission" of records to cost auditor. The time limit of 180 days as prescribed in the rules is for submission of Cost audit Report in case Cost Audit is applicable to the company.

In case financial accounts are not ready or are yet to be adopted in the AGM, the same was clarified by the Cost Audit Branch earlier. In such cases the cost auditor can submit the report based on provisional accounts and submit a supplementary report of reconciliation in case there are materials differences in the final adopted accounts.

(b)(i) A company is engaged in construction of residential housing, offices, industrial units, Roads, Bridges, Marine facilities etc. having sites in India and abroad. The company also has Joint venture projects in India and abroad. Whether Companies (Cost Records and Audit) Rules 2014 would be applicable to the company? [5]

Answer:

All companies engaged in construction business either as contractors or as sub-contractors, who meet with the threshold limits laid down in the Companies (Cost Records and Audit) Rules, 2014 and undertake jobs with the use of own materials [whether self-manufactured/produced or procured from outside] shall be required to maintain cost

records and get cost audit conducted as per the provisions of the Companies (Cost Records and Audit) Rules, 2014.
The provisions of the Companies (Cost Records and Audit) Rules, 2014 would also apply for construction activities undertaken under BOT/BOOT mode, or the projects undertaken as EPC contractor or the projects undertaken abroad by a company incorporated in India.
The Companies (Cost Records and Audit) Rules, 2014, do not make any distinction between the Contractor and Sub-Contractor and accordingly all such companies will be included within the ambit of the Rules.

(b)(ii) A company has units in SEZ and in non-SEZ areas. The Companies (Cost Records and Audit) Rules 2014 has exempted companies operating in special economic zones from cost audit. What would be applicability of the Companies (Cost Records and Audit) Rules 2014 on such a company in respect of maintenance of cost accounting records and cost audit? [5]

Answer:
Rule 3 of the Companies (Cost Records and Audit) Rules 2014 is specific and it has mandated maintenance of cost accounting records on all products/activities listed under Table-A and Table-B subject to threshold limits. No exemption is available to any company from maintenance of cost accounting records once it meets the threshold limits. Hence, the above company would be required to maintain cost accounting records for all its units including the one located in the special economic zone.
In view of the provisions of Rule 4(3)(ii) of the Companies (Cost Records and Audit) Rules 2014 the unit located in the special economic zone would be outside the purview of cost audit and the company would not be required to include particulars of such unit in its cost audit report. The other units of the company located outside the special economic zone would be covered under cost audit subject to the prescribed threshold limits.

(b)(iii) What is installed capacity and how is this different from total available capacity? How the installed capacity is to be calculated in a multi-product company using the same machine/ facilities? Should installed capacity be the capacity at the beginning of the year or at the end of the year under audit? [5]

Answer:
The Institute of Cost Accountants of India has defined "Installed Capacity is the maximum productive capacity, according to the manufacturer's specifications or determined through an expert study" [CAS-2 of Cost Accounting Standards]. The Installed Capacity to be disclosed in the Quantitative Details of CRA-3 is to be considered as at the beginning of the year. Capacity enhanced during the year should be considered as the increase in Installed Capacity during the year on pro-rata basis. Available capacity is the total installed capacity after adjustment of capacity enhanced during the year and if any capacity is available by means of leasing arrangement or taking on third-party capacity for increasing the total capacity.
If the same available capacity is utilised for production of multiple products, the following different basis may be adopted to determine the available capacity in respect of each of the products:
(i) If the company has a system of allocating the total available capacity for production of multiple products, then such allocated available capacity is to be considered for the products being manufactured by utilising the same production facility.

(ii) If the production allocation is not pre-determined and changes from period to period, then the capacity utilisation is to be determined on the basis of total production of all the products taken together and the total available capacity should be considered for all the products.

(c)(i) How would you treat Self manufactured packing material as per CAS 9 related to Packing Material Cost? [3]

Answer:

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

(c)(ii) How would you compute cost of utilities generated for the purpose of inter unit transfers as per CAS 8? [3]

Answer:

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

(c)(iii) How would you treat repairs and maintenance costs not traceable to a cost object as per CAS 12? [3]

Answer:

Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following two principles:

(a) Cause and effect- Cause is the process or operation or activity and effect is the incurrence of cost.

(b) Benefits received-Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

(c)(iv) How would you treat Separation cost due to voluntary retirement, retrenchment, termination etc. as per CAS 7 related to Employee Cost? [3]

Answer:

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

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

(c)(v) What is 'equalised transportation cost' under CAS 5? [3]

Answer:

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

(d)(i) What are the types of Cost Accounting Process? [5]

Answer:

Cost accounting process is divided into the following functional classifications:

a) Cost book-keeping involving the recording of costs according to some required classification.
b) Cost analysis requiring presentation of cost data to indicate where costs have deviated from plan and to identify the reasons.
c) Cost control involving determination of whether the current costs represent what is regarded as satisfactory performance.
d) Cost comparison of alternative products, activities, methods or areas of production.
e) Cost planning for the cost system or planning the procedure of work.

The following processes are usually involved to arrive at the product unit cost:

a) Cost classification by grouping of costs according to their common characteristics.
b) Grouping of costs identified with cost units or cost centres and which are common.
c) Arriving at unit product cost from costs collected under each cost centre.

(d)(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.

(d)(iii) How would you compute cost of utilities generated for the purpose of inter unit transfers as per CAS 8? [1]

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

(e)(i) What is XBRL? [3]

Answer:
XBRL is a language for the electronic communication of business and financial data which is revolutionizing business reporting around the world. It provides major benefits in the

preparation, analysis and communication of business information. It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using financial data. XBRL stands for eXtensible Business Reporting Language. It is already being put to practical use in a number of countries and implementations of XBRL are growing rapidly around the world.

(e)(ii) Who developed XBRL? [3]

Answer:
XBRL is an open, royalty-free software specification developed through a process of collaboration between accountants and technologists from all over the world. Together, they formed XBRL International which is now made up of over 650 members, which includes global companies, accounting, technology, government and financial services bodies. XBRL is and will remain an open specification based on XML that is being incorporated into many accounting and analytical software tools and applications.

(e)(iii) What are the advantages of XBRL? [3]

Answer:
XBRL offers major benefits at all stages of business reporting and analysis. The benefits are seen in automation, cost saving, faster, more reliable and more accurate handling of data, improved analysis and in better quality of information and decisionmaking. XBRL enables producers and consumers of financial data to switch resources away from costly manual processes, typically involving time-consuming comparison, assembly and re-entry of data. They are able to concentrate effort on analysis, aided by software which can validate and process XBRL information. XBRL is a flexible language, which is intended to support all current aspects of reporting in different countries and industries. Its extensible nature means that it can be adjusted to meet particular business requirements, even at the individual organization level.

(e)(iv) Who can benefit from using XBRL? [3]

Answer:
All types of organizations can use XBRL to save costs and improve efficiency in handling business and financial information. Because XBRL is extensible and flexible, it can be adapted to a wide variety of different requirements. All participants in the financial information supply chain can benefit, whether they are preparers, transmitters or users of business data.

(e)(v) What is the future of XBRL? [3]

Answer:
XBRL is set to become the standard way of recording, storing and transmitting business financial information. It is capable of use throughout the world, whatever the language of the country concerned, for a wide variety of business purposes. It will deliver major cost savings and gains in efficiency, improving processes in companies, governments and other organisations.

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

(a)(i) What are the objectives of Management Audit? [5]

Answer:

Management audit is carried out to –

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

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

   (I) to ensure optimum utilization on all the resource employed, including money, materials, machines, men and methods;
   (II) to highlight efficiencies in objectives, policies, procedures and planning;
   (III) to suggest improvement in methods of operations;
   (IV) to highlight weak links in organizational structure and in internal control systems, and suggest necessary improvements;
   (V) to help management by providing health indicators and help prevent sickness or help cure in case of sickness; and
   (VI) to anticipate problems and suggest remedies to solve them in time.

(a)(ii) What are the internal control aspects relating to Investments? [5]

Answer:

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

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

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

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

(b) Distinguish the following –
- **(i) Financial Audit and Management Audit**
- **(ii) Cost Audit and Management Audit**
- **(iii) Management Audit and Internal Audit** **[10]**

Answer:

(i) Distinguish between Financial Audit and Management Audit.

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

(ii) Distinguish between Cost Audit and Management Audit

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

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

(iii) Distinguish between Management Audit and Internal Audit

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

(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) The operating performance of three divisions of a company for the year that ended on 31 March 2006 is given as follows:

	Division I	Division II	Division III
	₹	₹	₹
Sales	2,00,000	2,50,000	3,00,000
Operating Profit	25,000	25,000	27,000
Investment	2,50,000	2,00,000	2,00,000

(i) Identify the most profitable division on the basis of: (a) Operating Profit Margin; and (b) ROI.
(ii) Explain with reasons which of the above two measures provides a better indication of the overall operating performance of all the divisions. [10]

Solution:

	Division I	Division II	Division III
	₹	₹	₹

Sales	2,00,000	2,50,000	3,00,000
Operating Profit	25,000	25,000	27,000
Investment	2,50,000	2,00,000	2,00,000
(a) Operating Profit Margin $\left[\frac{\text{Operating Profit}}{\text{Sales}}\times 100\right]$	$\frac{25,000}{2,00,000}\times 100$ = 12.50%	$\frac{25,000}{2,50,000}\times 100 = 10\%$	$\frac{27,000}{3,00,000}\times 100$ = 9%
(b) ROI $\left[\frac{\text{Operating Profit}}{\text{Sales}}\times 100\right]$	$\frac{25,000}{2,50,000}\times 100$ = 10%	$\frac{25,000}{2,00,000}\times 100 =$ 12.50%	$\frac{27,000}{2,00,000}\times 100 =$ 13.50%

i. a. On the basis of Operating Profit Margin, Division I is the most profitable division as it gives the highest profit margin on sales.
   b. On the basis of ROI, Division III is the most profitable division as it gives the highest return on the total investment.

ii. Success of a concern is measured by the return to its owner from the business at the end of an accounting period. Although the operating success of the concern is reflected through its Operating Profit Margin, but its overall operating performance is evaluated by the return that it has been earning from its total Capital Employed in the business and return to the owner of the business. Accordingly, ROI (i.e., Return on the Total Capital Employed) provides a better indication of the overall operating performance of a concern, as it reflects the return against the total long-term fund invested into the business. In spite of earning a good Operating Profit Margin, a concern cannot sustain in the long run if it does not get a return on its total investment.

(b) From the following information of S Ltd. prepare its trading, profit & Loss A/c and balance Sheet:

Sales	**₹ 7,30,000**	**Quick Ratio**	**1.3**
Working Capital	**₹ 1,20,000**	**Current Ratio**	**2.5**
Bank Overdraft	**₹ 15,000**	**Proprietary Ratio**	**0.6**
Share Capital	**₹ 2,50,000**	**Fixed Assets/Proprietary Fund**	
		GP Ratio	**10%**

Net Profit is 10% of Proprietary fund. There are no long-term liabilities and fictitious assets. Closing stock is 10% more than the opening stock. [10]

Solution:

Books of S Ltd.
Trading and Profit & Loss A/c for the year that ended on

Dr.			**Cr.**
Particulars	**Amount ₹**	**Particulars**	**Amount ₹**
To Opening Stock	1,05,000	By Sales	7,30,000
To Purchases (Bal. fig.)	6,67,500	By Closing Stock	1,15,500
To Gross Profit c/d	73,000		

	8,45,500		8,45,500
To Indirect Expenses	43,000	By Gross Profit b/d	73,000
To Net Profit	30,000		
	73,000		73,000

Balance Sheet as on

Liabilities	Amount ₹	Assets	Amount ₹
Share Capital	2,50,000	Fixed Assets	1,80,000
Reserves & Surplus	50,000	Current Assets:	
Current Liabilities:		Stock	1,15,500
Bank Overdraft	15,000	Quick Assets	84,500
Quick Liabilities	65,000		
	3,80,000		3,80,000

Working Notes:

1. GP Ratio = $\frac{GP}{Sales}$

Here, 10% = $\frac{GP}{7,30,000}$

$\therefore$ GP = ₹73,000

2. Current Ratio = $\frac{\text{Current Assets (CAs)}}{\text{Current Liabilities (CLs)}} = 2.5 = \frac{2.5}{1}$

$\therefore$ Working Capital = CAs – CLs = 2.5 – 1 = 1.5

Again, given Working Capital = ₹ 1,20,000

$\therefore$ Current Assets (CAs) = 2.5/1.5 × 1,20,000 = ₹ 2,00,000

$\therefore$ Current Liabilities (CLs) = 1/1.5 × 1,20,000 = ₹ 80,000

Again, Quick Ratio = $\frac{\text{CAs - Stock}}{\text{CLs - Bank Overdraft)}}$

Or, 1.3 = $\frac{(2,00,000 - \text{Stock})}{(80,000 - 15,000)}$

Or, 84,500 = 2,00,000 – Stock

$\therefore$ Closing Stock = ₹1,15,500

Again, Closing Stock = 10% more than Opening Stock

$\therefore$ Opening Stock = 100/100 × 1,15,500 = ₹1,15,500

3. Total Current Assets = Quick Assets + Stock

Hence, 2,00,000 = Quick Assets + 1,15,500

$\therefore$ Quick Assets = ₹84,500

Again, Total Current Liabilities = Quick Liabilities + Bank Overdraft

Here, 80,000 = Quick Liabilities + 15,000

$\therefore$ Quick Liabilities = ₹ 65,000

4. Proprietary ratio = $\frac{\text{Fixed Assets (FA)}}{\text{Proprietors' Funds (PF)}}$ = 0.6

$\therefore$ FA = 0.6 PF

Again, as per company Balance Sheet, we know that

Proprietors 'Fund (PF) + Long-term Loan (LTL) = Fixed Asset (FA) + Working Capital (WC)
Here, PF = FAs + WC [as here, LT Loans = Nil]
or PF = 0.6 PF +1,20,000
or 0.4 PF= 1,20,000
∴ Proprietors 'Fund (PF) = ₹ 3,00,000
∴ Fixed Asset (FA) = 0.6 × 3,00,000 = ₹ 1,80,000

5. Proprietors' Fund (PF) = Share Capital (SC) + Reserves & Surplus (RS) – Miscellaneous Expenditure (ME)
Here, 3,00,000 = 2,50,000 + RS - Nil [as here, Miscellaneous expenditure = Nil]
∴ Reserves & Surplus (RS) = ₹ 50,000

6. NP = 10% of PF = 10% of 3,00,000 = ₹ 30,000

7. Indirect Expenses Debited to Profit & Loss A/c = GP - NP= 73,000 - 30,000 = ₹ 43,000

(c) Given below are the abridged balance sheets and profit & loss accounts of SP Spinning Mills Ltd. :

	1998-99	*1997-98*	*1996-97*
	(₹ In lakhs)		
Balance Sheet :			
Share capital	**245**	**245**	**245**
Reserves and Surplus	**726**	**1,077**	**1,313**
Long term borrowings	**287**	**180**	**160**
Working capital loans	**1,639**	**451**	**672**
Sundry creditors	**1,616**	**1,255**	**1,015**
Other Provisions	**389**	**315**	**305**
Total	**4,902**	**3,523**	**3,710**
Net block	**1,009**	**541**	**612**
Investments	**19**	**19**	**19**
Current assets :			
Inventory	**1,160**	**1,521**	**1,641**
Book Debts	**11**	**114**	**172**
Loans and advances	**2,641**	**1,286**	**1,231**
	62	**42**	**35**
Total	**4,902**	**3,523**	**3,710**

Profit & Loss Account:			
Sales	**5,091**	**3,938**	**4,215**
Other income	**446**	**365**	**342**
Total	**5,537**	**4,303**	**4,557**
Raw materials, stores and spares consumed	**3,728**	**2,775**	**2,964**
Factory wages	**162**	**215**	**206**
Salaries	**377**	**322**	**295**
Power and fuel	**826**	**673**	**710**
Repairs and maintenance:			
Buildings	**7**	**18**	**15**
Plant and Machinery	**38**	**54**	**48**
Vehicles	**43**	**33**	**24**
Depreciation:			
Buildings	**11**	**14**	**16**
Plant and machinery	**57**	**43**	**48**
Vehicles	**66**	**26**	**30**
Interest	**277**	**130**	**152**
Other overheads (excluding salaries and depreciation:)			
Factory overheads	**138**	**94**	**82**
Administrative overheads	**71**	**59**	**41**
Selling and distributing overheads	**87**	**83**	**80**
Loss for the year	**(-) 351**	**(-) 236**	**(-) 154**
Total	**5,537**	**303**	**4,557**
Sales for the year (Kgs.)	**4350890**	**3436921**	**3725405**

The bankers to the company appointed you as a Consultant for identifying the factors which have contributed to the continuing losses. Prepare a short note highlighting the factors which have prima facie led the company to sickness. [10]

Solution:

Working notes	**1998-99**	**1997-98**	**1996-97**
Sales – quantity kgs.	43,50,890	34,36,921	37,25,405
Sales (Value in ₹ Lakhs)	5,091	3,938	4,215
Average sales realization per Kg.- (₹)	117	115	113
Raw Materials, stores & spares consumed (₹- Lakhs)	3,728	2,775	2,964
Material cost as % of sales value (%)	73.2	70.5	70.3
Direct wage cost % of sales value (%)	3.2	5.4	4.9
Observations:			

From the above figures, it is apparent that the Company's declining profitability is NOT due to market conditions as revealed by the following factors:

(a) The sales price has been marginally increasing year to year.

(b) The very small increase in material cost is also in step with the increase in sales realization.

(c) The company has been able to control direct labour cost effective.

(d) The level of production has been maintained and has in fact improved in the latest year.

(e) Inventory and book debt levels have been brought down considerably.

On the other hand, the following factors present a disturbing picture and lead to the inference that the financial management is either incompetent, or the management was diverted the borrowed working funds to some other activity or invested in unproductive assets like vehicles:

	1998-99	1997-98	1996-97
Long term borrowings	287	180	160
Working capital loans	1639	451	672
Net block	1009	541	612
Loans & advances	2641	1286	1231
Depreciation, repairs & maintenance of vehicles	109	59	54
Interest	277	130	152

The increase in working capital borrowings and the consequent interest thereon were not warranted, especially when the funds blocked in inventory and book debts have come down. The additional interest burden and additional expenses on vehicles amount to ₹ 197 lakhs whereas the increase in loss as compared to the previous year is only ₹ 115 lakhs.

Preliminary conclusion:

(i) Prima facie, it appears that the unit has become sick due to diversion of funds by the management to other activities or for personal expenditure.

(ii) The fixed assets have doubled. But there is no profit accruing by the increased assets.