Paper-19 - COST AUDIT & MANAGEMENT AUDIT

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

The figures in the margin on the right side indicate full marks.
The paper is divided in three sections.
From Section A answer any four questions (4x15=60 marks)
From Section B answer any two questions (2x10=20 marks)
From Section C answer any two questions (2x10=20 marks)

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

Section A
Answer any four Questions [4x15=60]

Question 1.

(a) Purchase of Materials ₹ 3,00,000 (inclusive of Trade Discount ₹ 3,000); Fee on Board ₹ 12,000; Import Duty paid ₹ 15,000; Freight inward ₹ 20,000; Insurance paid for import by sea ₹ 10,000; Rebates allowed ₹ 4,000; Cash discount ₹ 3,000; CENVAT Credit refundable ₹ 7,000; Subsidy received from the Government for importation of these materials ₹ 20,000. Compute the landed cost of material (i.e. value of receipt of material). [5]

(b) What are the records to be maintained for wastages or spoilages of materials according to the Cost Accounting Record Rules, 2011? [5]

(c) Which persons cannot be appointed or reappointed as Cost Auditor of a company? [5]

Answer:

(a) Computation of Material Cost Sheet

	Particulars	**Amount (₹)**
	Purchase price of Material	3,00,000
Add:	Fee on Board	12,000
Add:	Import Duties of purchasing the material	15,000
Add:	Freight Inward during the procurement of material	20,000
Add:	Insurance paid	10,000
	Total	**3,57,000**
Less:	Trade Discount	3,000
Less:	Rebates	4,000
Less:	CENVAT Credit refundable	7,000
Less:	Subsidy received from the Government for importation of materials	20,000
	Value of Receipt of Material	**3,23,000**

Note:

(i) Cash discount is not allowed, as it is a financial item.

(ii) Subsidy received, rebates and CENVAT Credit refundable are to be deducted for the purpose of computing the material cost.

(b) The records to be maintained for wastages or spoilages of materials are as follows:

(i) The quantity and value of wastage, spoilage, rejections and losses of raw materials, intermediates, process materials, consumable stores, small tools and machinery spares, whether in transit, storage, manufacture or at any other stage are required to be maintained for each item.

(ii) The method followed for adjusting the above losses as well as the income derived from the disposal of rejected and waste materials including spoilage, if any, in determining the cost of product, is required to be indicated in the cost records.

(iii) Any abnormal wastage or spoilage or rejection or losses are to be indicated distinctly and separately along with reasons thereof.

(iv) Recycling of waste, if any.

(v) Efficiency reports in which the waste is classified as normal or abnormal;

(vi) Storage Capacity and its co-relation with waste;

(vii) Whether waste is as par Industry norms;

(viii) Waste as per machine design and cross–verify with the industry norms;

(ix) Trend analysis of waste and its impact;

(x) Waste Accounting;

(xi) Accounting for spoilage and its analysis.

(c) As per sub-Section (3) of Section 226 of the Companies Act, 1956 implies that the following persons cannot be appointed or reappointed as Cost Auditor of a company –

(i) a body corporate;

(ii) an officer or employee of the company;

(iii) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(iv) a person who is indebted to the company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

(v) a person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. ("security" means an instrument which carries voting rights);

(vi) The sub-Section (4) of Section 226 provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-Section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(vii) A person, who is in full time employment elsewhere [Section 224 (1B)].

If an auditor becomes disqualified after his appointment, under any of the above provisions he shall be deemed to have vacated his office.

Question 2.

(a) Whether the Cost Accounting Record Rules, 2011 are applicable to foreign companies? State with reason. [2]

(b) Capacity utilization depends on various factors like hours, the plant worked, efficiency with which it worked, quality of input materials etc. In the context of this statement, please give your comments on the following data relating to a chemical plant and a sugar mill.

		For the year 2013-14	
(i)	**Chemical Plant:**	**Budgeted**	**Actual**
	Production (KL)	**18,00,000**	**13,50,000**
	Vessel occupancy	**7,200**	**6,000**
(ii)	**Sugar Mill:**	**2013-14**	**2012-13**
	Installed Capacity: Tonnes of cane crushing per day (TCD)	**5,000**	**4,000**
	Duration of the season (days)	**240**	**250**
	Cane crushed (MT)	**10,20,000**	**8,00,000**
	Sugar production (MT)	**1,22,500**	**79,300**

[8]

(c) What is XBRL? Describe the process which is to be followed to file the reports in XBRL Format? [2+3]

Answer:

(a) The Cost Accounting Record Rules, 2011 apply to a foreign company as defined in section 591 of the Companies Act, 1956. According to this section 591, foreign companies are companies incorporated outside India which have a place of business in India. It does not matter whether the place of business in India was established in India before on or after the commencement of the Companies Act, 1956. It would appear that the foreign companies would have to maintain cost records only in respect of businesses and activities transacted in India.

(b)

Chemical Plant:	**Actual**	**Budget**	**Actual as % of Budget**
Production (in thousand KL)	1,350	1,800	75
Occupancy hours	6,000	7,200	83.33
Production per hour (KL)	225	250	90

Comments:

Actual Production is only 75% of the Budget. The lower production is due to —

(i) Lower efficiency (90% of efficiency achieved) and

(ii) Reduction in occupancy hours by 16.67% (i.e., 100 - 83.33).

Sugar Mill :	2013-14	2012-13
Installed Capacity (TCD)	5,000	4,000
Duration of the season (days)	240	250
Cane crushed per day (MT) [10,20,000 / 240, 8,00,000 / 250]	4,250	3,200
As percentage of Installed capacity [4,250 / 5,000 × 100, 3,200 / 4,000 × 100]	85	80
Sugar Recovery Percentage [1,22,500 /10,20,000 × 100, 79,300 / 8,00,000 × 100]	12%	9.9125%

Comments:

(i) There is a drop in duration of season from 250 to 240 days i.e., 4% drop as compared to 2012-13.

(ii) Though there is a drop in duration of season by 4% the Production has gone up due to increase in installed capacity.

(iii) Efficiency has gone up from 80% to 85%.

(iv) Sugar recovery percentage is much better and it may be due to better quality sugar cane.

(c) XBRL (eXtensible Business Reporting Language) is a language based on XML (Extensible Markup Language) family of languages. It is an open standards-based reporting system that is built to accommodate the electronic preparation and exchange of business reports around the world using internet as a medium. It has been defined specifically to meet the requirements of business and financial information.

It enables unique identifying tags to be applied to items of accounting data. The tags provide a range of information about the item, such as whether it is a monetary item, percentage or fraction. XBRL not only allows labels in any language to be applied to items, it also allows the accounting references or other subsidiary information to be added to the tags.

The following steps have to be followed in sequence:

1. Mapping the individual cost elements of the company to the elements of the costing taxonomy.
2. Populating the relevant data in the software/filing tool.
3. Creating instance document.
4. Validating the Instance Document with the Validation Tool of MCA (Ministry of Corporate Affairs).
5. Use available tool to convert the Instance document to a human readable format and check correctness of data.
6. Attaching the Instance Document to the e-Form and filing on MCA Portal.

Question 3.

(a) Give a comparison between Compliance Report and Cost Audit Report. [5]

(b) Bina Ltd. requiring to make and maintain cost accounts and records contends that the auditor need not report on the non-maintenance of cost records because the provisions of cost-audit were not made applicable to it. How would you react to the above situation? [3]

(c) "Finance costs are those costs which are incurred by an enterprise in connection with the borrowing of funds" — State the principles of measurement of finance costs. [5]

(d) Whether the Annexure to the Compliance Report is to be prepared by the company or by the Cost Accountant? [2]

Answer:

(a) Both "Compliance Report" and "Cost Audit Report" cover common ground as both require certificate by Cost Accountant on the following areas:

- Maintenance of proper cost records by company as per Companies (Cost Accounting Records) Rules, 2011 prescribed under clause of sub-section (1) of section 209 of the Companies Act, 1956.
- Maintenance of detailed unit-wise and product/activity-wise cost statements and schedules thereto in respect of the product groups/ activities cost records comply with Generally Accepted Cost Accounting Principles and Cost Accounting Standards issued by the Institute of Cost and Works Accountants of India. Both have to be filed with Central Government within 180 days of the end of the relevant financial year.

However, there are a number of differences between the two which are tabulated below:

SL. No.	Points of comparison	Compliance Report	Cost Audit Report
1.	Applicable Rules	Companies (Cost Accounting Records) Rules, 2011	Companies (Cost Audit Report) Rules, 2011
2.	Observations and Suggestions	Observations and suggestions limited to maintenance of cost records	Observations and suggestions relevant to cost audit to be given.
3.	Nature of examination of cost records involved	Examination of cost records	Audit of cost records
4.	Submission of report to the Central Govt.	Compliance Report to be submitted by the company to Central Govt.	Cost Audit Report to be submitted by the cost auditor to Central Govt. with copy to company
5.	Circulation of Report to shareholders	Company not to circulate compliance report to share-holders	Company to circulate cost audit report to shareholders if directed by the Central Govern-ment.

(b) (i) Legal provisions

- ➢ Section 209(1)(d) of the Companies Act, 1956 empowers the Central Government to make it compulsory in case of specified classes of companies to maintain cost records.
- ➢ The Central Government may order audit of cost records maintained under section 209(1)(d) according to provisions of section 233B of the Companies Act, 1956.
- ➢ Section 227(3) of the Companies Act, 1956 includes cost records in the term of proper books of account on which the auditor has to express opinion on.

(ii) In the given situation, section 209(1)(d) is applicable to the company though section 233B is not applicable. The auditor should not accept the management's contention since he would not be discharging his duty under section 227(3) if he accepts it.

(c) Principles of Measurement of Finance Costs:

1. Finance costs incurred in connection with acquisition of resources such as materials, utilities and the like will not form part of the cost of such resources.
2. Bank charges for negotiation of documents in connection with a purchase material or resources are generally treated as finance costs and should not be included in material cost or other resources. This is based on the premise that sale documents are negotiated through bank to avoid credit risks or to avail bank finance. Hence Bank charges on bills negotiated through bank on collection or acceptance basis are often added to material cost or other resources but are best excluded from material cost or other resources.
3. Interest when charged by the supplier for the whole of part of the credit period extended is treated as a finance charge. This is so even if the interest appears on the face of the invoice.
4. In case of leased assets, if it is an operating lease – the entire rentals will be treated as a part of administrative overheads, while in case of a financial lease – the finance cost portion will be segregated and treated as a part of finance costs.
5. Material is often held for long periods for seasoning, maturing etc. The storage and interest cost for such storage should be treated as part of material cost.

(d) The Company is responsible for maintenance of Cost Accounting Records. Hence the preparation of the Annexures is the responsibility of the Company.

The "Cost Accountant" authenticating the Compliance Report is required to certify and state whether the same has been maintained in accordance with the Rules.

Question 4.

(a) There are various types of cost audits available. Describe those types of cost audit on the basis of persons who directs it and on the basis of persons who conduct it. [7]

(b) The Cost Account of a company has arrived at a profit of ₹ 73,24,150 based on cost accounting records for the Year ended 31.03.2014. As Cost Auditor, you find the following differences between the Financial Accounts and Cost Accounts (figures are in ₹)

Particulars	**₹**
(i) Profit on sale of fixed assets	**63,000**
(ii) Loss on sale of investments	**11,200**
(iii) Voluntary retirement compensation included in salaries & wages in Financial Accounts	**16,75,000**
(iv) Donation paid	**25,000**
(v) Profit from retail trading activity	**7,12,300**

You are required to calculate the profit as per financial books after reconcile between the profit figures as per Cost Accounts and Financial Accounts. [5]

(c) "Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated." — Write about the risks which are associated with Cost Audit. [3]

Answer:

(a) Types of Cost Audit:

1. On the basis of persons who direct the audit to be performed —

(i) **Statutory Cost Audit:** Sec. 233B of the Companies Act, 1956 stipulates Cost Audit for certain types of Companies / Industries. However, it is not a regular or recurring feature on an annual basis. The Government orders the conduct of Cost Audit, from time to time, whenever it feels that such type of audit is necessary for a particular industry.

(ii) **Cost Audit on behalf of the Management:** The objectives of such audit include verifying – (I) accuracy of costing data, (II) accounting for abnormal losses and gains, (III) computation of cost of production, (IV) proper overhead rates, (V) quality of cost accounting system, etc. Thus, this audit seeks to ensure that the cost data placed before the management are reliable and useful for decision-making.

(iii) **Cost Audit on behalf of a Customer:** In case of cost plus contracts, often the buyer or the Contractee insists on a cost audit to satisfy about the correct ascertainment of cost. Sometimes, such audit is contained in the agreement between the parties that the supplier or the contractor will extend all co-operations to the Cost Auditor. The cost of production arrived at for this purpose may differ from the cost of production ascertained for internal control purposes.

(iv) **Cost Audit on behalf of Government:** The Government may order that a Cost Audit may be conducted in the following situations -

- When it is approached with requests for subsidies, protection, etc.- to satisfy itself whether the need is genuine or made up , whether the industry seeking assistance is efficiently run, etc.
- In public interest - to establish the fair price of any product.

(v) **Cost Audit by Trade Association:** The Trade Association may seek full information on the costing system, level of efficiency, utilisation of capacity, etc. It may also require a cost audit when -

- Its activities include maintenance of price of the products manufactured by its member units, or
- Where there is a pooling or contribution arrangement by all members of the association.

2. On the basis of persons who conduct the audit —

(i) **Internal Cost Audit —**

- It is conducted by persons who are in the regular employment of the Company.
- It is oriented towards the objectives of the Management, primarily for system compliance and decision making purposes.
- It may be conducted as part of the system of Internal Control and Internal Check.

(ii) **External Cost Audit —**

- It is conducted by parties outside the Firm i.e. those who are not Company's employees.
- It is oriented towards the objectives of the persons who direct the audit to be performed, e.g. Government, Trade Association etc.
- It is not part of the regular organisational procedure.

(b)

Reconciliation of profit between Cost Accounts & Financial Accounts for year ended 31.03.2014.

	₹	₹
Profit as per Cost Accounts		73,24,150
Add: Profit on sales of assets not included in Cost Accounts	63,000	
Profit from trading activity	7,12,300	7,75,300
		80,99,450
Less: Loss on sale on investments	11,200	
Voluntary retirement compensation not included in cost	16,75,000	
Donation paid	25,000	17,11,200
Profit as per Financial Accounts		**63,88,250**

(c) Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Generally, audit risk is a function of the risk of material misstatement and detection risk. The risk of material misstatement again has two components viz. Inherent Risk and Control risk. So there is three types of audit risks as follows—

(i) Inherent risk – the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(ii) Control risk – the risk that a misstatement that could occur in an assertion about the measurement, assignment or disclosure of cost 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, operational and management control.

(iii) Detection risk – the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Question 5.

(a) "The Council of the Institute of Cost Accountants of India has constituted Cost Accounting Standards Board (CASB)." — State the Objectives and Functions of the Cost Accounting Standards Board in this regard. [5]

(b) You are the Cost Auditor of PP Jute Mills Ltd. for the year ended March 31, 2013. The company had a strike from 15.9.2012. Although the company resumed working from 18.11.2012, normal production was achieved only from 12.12.2012. The expenses incurred during the year ended March 31, 2013 were:

	(Amount in ₹ lakh)
Salaries and wages (Direct)	**450**
Salaries and wages (Indirect)	**220**
Power (Variable)	**160**

Depreciation	**140**
Other fixed expenses	**260**

Detailed examination of the records revealed that of the above, the following relate to the period 15.9.2012 to 17.11.2012:

	(Amount in ₹ lakh)
Salaries & wages (Indirect)	**80**
Depreciation (Non- productive)	**60**
Other fixed expenses	**110**

As a Cost Auditor you are requested to calculate abnormal cost which will be excluded from the product cost. **[8]**

(c) Define Service Cost Centre according to CAS-13. **[2]**

Answer:

(a) Objectives and Functions of the Cost Accounting Standards Board (CASB):

Objectives — the objectives of the CASB are to develop high quality Cost Accounting Standards to enable the management to take informed decisions and to enable regulators to function more effectively by integrating, harmonizing and standardizing cost accounting principles and practices.

Functions — the following will be the functions of the CASB:-

a. To issue the framework for the cost accounting standards;

b. To equip the cost & management accounting professionals with better guide lines on cost accounting principles;

c. To assists the members in preparation of uniform cost statements under various statutes;

d. To provide from time to time interpretations on Cost Accounting standards;

e. To issue application guidance relating to particular standard;

f. To propagate the cost accounting standards and to persuade the users to adopt them in the preparation and presentation of general purpose cost statement;

g. To persuade the government and appropriate authorities to enforce cost accounting standards, to facilitate the adoption thereof, by industry and corporate entities in order to achieve the desired objectives of standardization of cost accounting practices;

h. To educate the users about the utility and the need for compliance of cost accounting standards.

(b) **PP Jute Mills Ltd.**

Calculation of fixed expenses incurred during the period: 18.11.2012 to 11.12.2012:

	(Amount in ₹ Lakh)
Total Expenses for 2012-2013	1,230
Less: Variable Expenses (Power)	160
Fixed Expenses for 2012-13	1,070
Less: Fixed expenses during strike period	250
Fixed Expenses during non strike period	820

Since strike period was for 64 days (15.9.2012 to 17.11.2012)

The non-strike period is 301 days.

Hence fixed expenses attributed to 24 days i.e.

18.11.2012 to 11.12.2012 is 7.97% (24÷301×100) of ₹ 820 lakh = ₹ 65.35 lakh

	(Amount in ₹ Lakh)
Expenses incurred during the period of 15.9.2012 to 17.11.2012	240.00
Expenses incurred during the period of 18.11.2012 to 11.12.2012	65.35
Total	305.35

Hence ₹ 305.35 lakh is to be treated as Abnormal Cost and should be excluded from Product Cost.

(c) The cost centre which provides services to Production, Operation or other Service Cost Centre but not directly engaged in manufacturing process or operation is a service cost centre. A service cost centre renders services to other cost centres / other units and in some cases to outside parties.

Examples of service cost centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, welfare services, safety, transport, component, tool stores, pollution control, computer cell, dispensary, school, township, Security etc.

Administrative Overheads include cost of administrative Service Cost Centre.

Section B

Answer any two Questions [2x10=20]

Question 6.

(a) You are the Internal Auditor of Arena Manufacturing Ltd. The Managing Director has asked you to enquire into the cause of abnormal wastage of raw materials during the month of April. The wastage percentages for the last few months are: Jan. — 1.3%, Feb. — 1.1%, Mar. — 1.3% and Apr. — 3.9%. How will you proceed to carry out the assignment? [7]

(b) Describe Internal Audit Evidence as per Standards on Internal Audit (SIA) 10. [3]

Answer:

(a) Abnormal Wastage: The rate of wastage in the month of April is about 3 times than that of the previous months. Hence, it may be considered as abnormal. In respect of audit of abnormal wastage, the Auditor should proceed on the following lines —

1. **General:**
   - (i) Procure a list of Raw Materials, showing the names and detailed characteristics of each Raw Material.
   - (ii) Enquire whether there is any change which will affect material wastage, e.g. changes in - (I) source of supply of raw materials, (II) methods or process, (III) operating condition of machines, (IV) labour force i.e. replacement of experienced employees by raw hands etc.
   - (iii) Enquire whether any new production line was taken up during the month in respect of which standard Input-Output Ratio is yet to be set up.

2. **Wastage Figures:**
   - (i) Obtain the standard consumption figures, and ascertain the basis of computation of normal wastage figures.
   - (ii) Examine whether the basis adopted for wastage calculation for the month of April is the same as that adopted for the other three months.
   - (iii) See the breakup of normal wastage - (I) transit, (II) storage, (III) handling, and (IV) processing.
   - (iv) Obtain a statement showing break up of wastage figures, (as above) for the four months under review and compare the results of the analysis for each of the four months.

3. **Consumption Records:** Examine the following to find out material variances / deviations if any -
   - (i) Purchase of various lots,
   - (ii) Identification of each lot with actual material consumption, and
   - (iii) Ascertaining actual wastage figures.

4. **Abnormal Process Loss:**
   - (i) Material Quality: Examine inspection and testing reports to find out if raw material purchased are of poor quality or sub-standard. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.
   - (ii) Machine Utilisation: Machine breakdown, power failure, etc. may also result in loss of materials in process. Check Machine Utilisation Statements.
   - (iii) Inspection: A high rate of rejection in the finished lots may also be responsible for abnormal wastage. Examine the Inspection Reports for the inspection carried out on the completion of each stage of work or process.
   - (iv) Old Lot Consumption: It is possible that the wastage may have occurred because, the particular lot out of which issues were made in April was lying in the store for a long time, leading to deterioration in quality, or because of a change in weather, which may have led to the deterioration.
   - (v) Previous period comparison: Compare the wastage figures of April this year with that of April last year and see whether there is any correlation.

5. **Abnormal Storage and Handling Loss:** This can happen due to -
   - (i) Write-offs on account of reconciliation of physical and book-stocks. In case of periodical physical stock-taking, such write offs will be reflected only in the month in which reconciliation takes place.
   - (ii) Accidental, theft or fire losses in storage. The Auditor should examine such possibilities

also.

(b) SIA (Standards on Internal Audit) 10: Internal Audit Evidence —

(i) To obtain sufficient appropriate evidence to enable the auditor to draw reasonable conclusions therefrom on which to base his opinion or findings.

(ii) Scope of an internal audit is much broader in comparison to that of statutory audit. The depth of coverage of internal audit, being a management function, would also be much wider. An internal audit function normally is spread beyond checking of financial transactions and is expected to cover comments on internal control systems, risk management, propriety aspect of transactions.

(iii) To evaluate sufficiency of appropriate audit evidence before conclusions therefrom. The internal audit evidence should enable internal auditor to form an opinion on the scope of the terms of engagement.

(iv) The reliability of internal audit evidence depends on its source – internal or external and on its type.

(v) When internal audit evidence obtained from one source is inconsistent with that obtained from another, or the internal auditor has doubts over the reliability of information to be used as internal audit evidence, the internal auditor shall determine what modifications to or additional audit procedures are necessary to resolve the matter.

(vi) Various methods for obtaining audit evidence include inspection, observation, inquiry and confirmation, computation and analytical review.

Question 7.

(a) Distinguish between Management Audit and Internal Audit. **[6]**

(b) State the roles of stakeholders in Corporate Governance. **[4]**

Answer:

(a) Distinction between Management Audit and Internal Audit

Particulars	Management Audit	Internal Audit
1. Definition	Management Audit is the systematic independent appraisal activity within an organisation for a review of the Management's efficiency in its decision-making function.	Function of internal control with the objective of determining whether other internal controls are well designed and properly operated.
2.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.
3. 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.

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 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.
6. Aspect	Qualitative aspects of decision-making are analysed.	Internal Audit Function focuses more on quantitative aspects when compared to Management Audit.

(b) The role of stakeholders in Corporate Governance —

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

(i) The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

(ii) Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

(iii) The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.

(iv) Where stakeholders participate in the corporate governance process, they should have access to relevant information.

Question 8.

(a) How can an internal control system with regard to sales return and purchase return be designed? [7]

(b) "Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management." — List out the uses of management Audit in this context. [3]

Answer:

(a) Internal control systems with regard to sales return and purchase return are as follows:

- **Sales return —** An internal control/internal check system should provide for authorization of goods returned by customers and the processing of claims. The system should operate at the following points :
  - **(i) Authorising returns** - The authority to grant returns is a matter of management policy. For example, a company may fix limits on authority of officials to accept returns in terms of value of goods returned.
  - **(ii) Receiving and accepting goods**- Receipt of goods returned is handled by the receiving department. It should inspect the goods for their quality and quantity and prepare an inspection report. It also prepares pre-numbered inward return note and sends a copy of it to the clerk maintaining inventory records and another to the person responsible for making and issuing credit notes.
  - **(iii) Authorising credits** - A responsible official of the company may be authorised to issue a pre-numbered credit note to the customer. He should give authorisation on the basis of copy of inward return note and on the basis of inspection report of the

receiving department. One copy of credit note should be sent to the clerk maintaining accounts receivable ledger and other to the clerk handling sales return book to enable them to update their records.

- **Purchase returns —** An internal control/check system with regards to purchase returns should operate at following points :
  - **(i) Authorising returns** - The power to authorise purchase returns is, generally, vested with an official of receiving department or purchase department and is a matter of management policy.
  - **(ii) Preparing advice note for returns** - The receiving department which inspects such goods, should prepare an advice note to be sent to the finance department mentioning the details of goods to be returned. Notification copies are also sent to stores and despatch department.
  - **(iii) Preparing outward return notes** - The stores department issues goods to be returned to the despatch department on authorisation of advice note. It should prepare a statement for all such returns. The despatch department prepares prenumbered goods outward return notes for such returns and arranges for their transportation and follow control procedures similar to those in case of sales transactions. It also sends a copy of outward return note to the finance department.
  - **(iv) Preparing debit note and authorising debits** - The accounts department examines the advice note with original invoice and outward return notes. A numerically controlled debit note is prepared and sent to the supplier. One copy of debit note is sent to the clerk maintaining purchase return book and other to the clerk handling accounts payable ledger. After obtaining a credit note to that effect from the supplier, payment to him is adjusted accordingly.

(b) Uses of Management Audit:

1. Management audit is useful in synthesizing, accounting, economic and other data required by management in constructing basic policy framework.
2. Management audit assists in establishing, reviewing and improving the planning system.
3. Management audit ensures that the management is getting the adequate information for correct decisions.
4. Management audit aids in the design and maintenance of adequate authority structure.
5. It helps in the improvement information system to expedite flow of information among responsibility centres.
6. It substantially contributes for improvement of entire communication system.

Section C

Answer any two Questions [2x10=20]

Question 9.

(a) From the following figures extracted from the accounting records, you are required to compute:
(i) Value added;
(ii) Ratio of operating profit to Net sales; and

(iii) Ratio of operating profit to value added.

	₹ lakhs
Net sales excluding excise duty	**20,980**
Increase in stock of finished goods	**241**
Expenses :	
Raw materials consumed	**2,686**
Packing materials consumed	**1,196**
Stores and spares consumed	**560**
Power and fuel	**4,640**
Repairs and maintenance	**199**
Insurance	**117**
Direct salaries and wages	**480**
Depreciation	**880**
Interest paid	**1,390**
Factory overheads :	
Salaries and wages	**240**
Others	**220**
Selling and distribution overheads :	
Salaries and wages	**120**
Additional sales tax	**457**
Others	**1,673**
Administration overheads:	
Salaries & Wages	**120**
Others	**82**

[3+2+2]

(b) Which are the criteria may help the Cost Auditor to select and include the various performance measurement criteria in the Performance Appraisal Report? [3]

Answer:

(a)

		₹ lakhs
Computation of value added:		
Net sales + increase in stock of finished goods		21,221
Less: Cost of bought out goods & services:	2,686	
Raw materials	1,196	
Packing materials	560	
Stores and spares	4,640	
Power and fuel	199	
Repair and maintenance	117	
Insurance	220	
Other factory overheads	1,673	
Other selling and distribution overheads	82	
Other administration overheads		11,373
		9,848
Composition of value added:		
Depreciation		880
Interest		1,390
Additional sales tax		457
Salaries & wages		960

Profit before tax		6,161
Total		9,848
Operating Profit:		
Profit before tax		6,161
Depreciation		880
Interest		1,390
Operating profit		8,431

Ratio of Operating profit to Net Sales: 8,431/20,980 x 100 = 40.19%
Ratio of operating profit to value Added: 8,431/9848 x 100 = 85.61%

(b) The following criteria may help the cost auditor to select and include the various performance measurement criteria in the Performance Appraisal Report:

1. Effect on profitability
2. Effect on resource utilisation
3. Effect on liquidity
4. Effect on risks
5. Effect on quality
6. Effect on competitiveness
7. Effect on responsiveness to the market etc.

Question 10.

(a) Following are date available from a company which has both domestic and export sales. The company is subject to cost audit. Prepare a statement of export profitability.

Production	**10,000 units**	
Sales Domestic	**9,000 units at**	**₹22/unit**
Sales Export	**1,000 units at**	**₹17/ unit**
Raw materials consumed		**₹90,000**
Imported component used only for exported quality		**₹3,000**
Direct Labour		**₹10,000**
Factory overhead		**₹15,000**
Administration overhead		**₹5,000**
Export Packing		**₹3,000**
Freight and Packing for Domestic Sales		**₹4,500**
Handling at Port		**₹500**
Opening WIP		**₹10,000**
Closing WIP		**₹5,000**

For export an imported component is to be used at a cost of ₹3 per unit. The indigenously produced component that is used for domestic sales and included in raw material consumption is ₹4 per unit. Duty drawback on the 1000 units export is ₹1,500. [6]

(b) State the importance of the following areas that could be covered in the Performance Appraisal Report:
(ii) R & D Performance
(iii) Human Resource Accounting. [4]

Answer:

(a) Cost of production common to domestic sales and exports

Total production	10,000 units
Raw materials consumed	₹90,000
Less : Component used only for domestic sales 9000 x ₹4	₹36,000
Net raw material consumption	₹54,000
Direct labour	₹10,000
Factory overhead	₹15,000
Administration overhead	₹5,000
Opening WIP	₹10,000
Closing WIP	₹ (5,000)
	₹89,000
Common cost per unit	₹8.9
Production for export sales	1,000 units
Common cost as above 1000 x ₹8.90	8,900
Cost of imported component used exclusively for exports 1000 x ₹3	₹3,000
Exporting packing	₹3,000
Handling at port	₹500
Cost of exports	₹15,400
Export sales realisation 1000 x ₹ 17	₹17,000
Export profit (Sales less cost)	₹1,600
Export benefit duty drawback	₹1,500
Adjusted export profitability	₹3,100

(b) The areas that could be covered in the Performance Appraisal Report:

(i) R & D Performance: The future performance of companies would depend upon their success of the R & D initiatives. The cost auditor could provide a useful lead in this respect by including analysis of the R & D costs. The analysis may include, inter alia, the percentage of successful research initiatives, the turnaround time taken for development, the response time taken for changes in designs due to customer requirement etc. Total expenditure on R & D initiatives as a percentage of sales turnovers may be a good indicator of the technology leadership status of the company.

(ii) Human Resource Accounting: This is an extended analysis of total human resource costs, both explicit and implicit, which are capitalised at an appropriate discount rate. This value of human capital is reflection of the enhanced value that an organisation could create by owning the human asset. The cost auditor could observe the value of human asset and link it to the returns. This is an upcoming performance measurement criterion.

Question 11.

(a) The PQR Company has a system of a quarterly-meeting of two days, to discuss the performance as against budgets. In the meeting which is chaired by the Managing Director all senior managers of the operating, costing and finance departments participate. To ensure that there is reasonable interaction among the participants, there is always a final session for two hours duration known as "Open House". In that session the participants are encouraged

to bring out all their criticisms against their colleagues so that each function becomes aware of the extent to which try do not measure up to expectation of their peers.

The Managing Director feels that during the last one or two open sessions, the Cost Department is increasingly being accused of collecting data mostly for statutory and external purpose and less for information of operating managers. He is not sure whether such a criticism is fair. He therefore invites as a representative of the company's cost auditors to attend to the open session. His request to you is that you should sit through the session without participating in it, but later give him your personal view of the role of cost department.

Prepare a note making out that the criticism is partly valid and suggesting how such criticism can be got over. [7]

(b) How Value Chain activity can have an impact in performance analysis? [3]

Answer:

(a) The major complaint of the operating personnel is their feeling that the accounting information about operations is generated mostly for statutory purposes and not necessarily for helping the operating management. In our opinion, such criticism is partly valid, as the accounting structure has to keep in mind the changing demands of fiscal and other statutory requirements.

But, it would be incorrect to conclude that the accounting system generates such data ignoring the demands or requirements of the operating management. At least as far as Cost Audit requirements are concerned, such a criticism is invalid. It may be of interest to operating management to note that the cost accounting records rules require maintenance of records. we quote, "shall be such as to enable the company to exercise as far as possible control over the various operations and costs with a view to achieve optimum economy in costs" as also to enable the Cost Auditor to comply with Cost Audit Report Rules.

The above will indicate that there is no conflict between the statutory requirements of cost records and the demands of the operating management.

It is however necessary, in our opinion, to explain to the operating management, the key areas in which costs are analysed in the cost audit and that such key areas fall within the responsibility of the different operating managers.

The mangers, being involved in the day to day affairs, would naturally seek more details which are merely summarised in the overall analysis as presented by the Cost Audit Report. This point is now briefly illustrated. Some of the key areas of efficiency highlighted in the cost audit reports are:

Material price fluctuations,
Material usage fluctuations
Capacity utilisation —
    Machine efficiencies
    Machine availability

Energy rate variation —
    Usage variations.

The variations in material cost due to price fluctuations would be the combined result of the change in prices in the market place, the efficiency of the procurement function, advanced planning of the material requirements to name only a few factors. Each department concerned with any of the factors specified above would need much more detailed information to improve their performance and such improvement is bound to be reflected ultimately in the cost. Hence, the needs for statutory cost audit analysis are in no way in conflict with the demands of the operating management.

This would be true in each of the other key areas, listed above.

We feel an interaction between the operating management and the cost department, after adequately explaining to the former the rationale of analysis undertaken for statutory cost audit would help better appreciation of the roles of each function by the other.

(b) Value Chain — many company attempts to gain competitive advantage by appropriately linking its own activities with those of the suppliers, channels or customers. Vertical-integration, quality controls on inputs from suppliers, total quality management strategies, controlling distributors' performance through training/financing etc., collaborative arrangements etc. are some of the ways in which company's own activities are beneficially linked to other organizations. This provides an avenue for reporting under performance analysis report. What has been the cost of such coordinating strategies and how much of competitive advantage of the company has improved or strengthened at present level? If such linkages with other companies are established as a matter policy, every year, then performance as to the cost efficiency in such coordinating/ cooperating linkages can be an area for appraisal for the Cost Auditor.