

FINAL EXAMINATION

GROUP IV

(SYLLABUS 2008)

SUGGESTED ANSWERS TO QUESTIONS

DECEMBER 2014

Paper- 17 : COST AUDIT & OPERATIONAL AUDIT

Time Allowed : 3 Hours

Full Marks : 100

The figures in the margin on the right side indicate full marks.

Please: (1) Answer all bits of a question at one place.

(2) Open a new page for answer to a new question.

(3) Attempt the required number of questions only.

Working notes should form part of the answer.

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

Section A (50 Marks) (Cost Audit)

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

1. (a) State whether the following statements based on the quoted terms are "True" or "False" with justifications for your answer. No credit will be given for any answer without justification: 1x5=5
- (i) Cost accounting standard on Repairs & Maintenance cost is dealt in CAS-12.
 - (ii) Cost statements and other working papers as prescribed under cost accounting record rules duly audited and signed by the auditors remain with the company.
 - (iii) The performance appraisal report is a public document and it cannot be treated as confidential.
 - (iv) Out-put Costing is best used in Chemical Industry.
 - (v) Manager of an investment centre is required to earn a satisfactory return.
- (b) In each of the cases/statements given below, one out of four alternatives is correct. Indicate the correct answer (only indicate A or B or C or D as you think correct.) 1x5=5
- (i) Clarification of cost audit report to be given to Cost Audit Branch by Cost Auditor by
 - (A) 30 days
 - (B) 45 days
 - (C) 60 days
 - (D) 180 days
 - (ii) Excisable clearance means
 - (A) only sale of goods from factory.
 - (B) total clearance from the factory.
 - (C) despatch from bonded warehouse.
 - (D) None of the above

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- (iii) The main purpose of "Efficiency Audit" is to ensure that
 (A) various policies of management are implemented.
 (B) planned expenditure gives optimum returns.
 (C) every rupee invested gives optimum returns.
 (D) activities of business are beneficial to society at large.
- (iv) Cost Audit was introduced in the year
 (A) 1956
 (B) 1959
 (C) 1965
 (d) None of the above
- (v) Cost audit report along with annexure and proforma are signed by
 (A) One Director and one Secretary
 (B) The Chief Finance Officer and Managing Director
 (C) The Chief Finance Officer and Secretary
 (D) All of the above

- (c) Fill in the blanks in the following sentences by using appropriate word(s)/phrase(s)/ number(s): 1x4=4
- (i) CERA (Central Excise Revenue Audit) is conducted by the organisation of _____.
- (ii) Every Cost Auditor shall submit the cost audit report along with observation in form _____ as per Companies (cost records and audit) Rules, 2014.
- (iii) The forex component on purchase of imported material shall be priced at a rate on _____.
- (iv) Where any credit under Central Value Added Tax (CENVAT) is available on any material, the cost of such material shall be after _____.

Answer:

1. (a) (i) True: The cost accounting standard on repair & maintenance is dealt in CAS- 12
 (ii) True: The cost statements & other working papers duly audited and signed by the Auditor remained with the company.
 (iii) False: The performance appraisal report is meant to be used by the company and the report is confidential.
 (iv) False: Output costing is best used in the industry of single product, like Paper industry.
 (v) True: Investment centres may be treated as separate firms where the manager has overall responsibility of managing inputs, put puts and investment.

- (B) (i) A
 (ii) B
 (iii) C
 (iv) C
 (v) A

- (c) (i) Comptroller and Auditor General (CAG)
 (ii) CRA – 3
 (iii) the date of transaction
 (iv) adjusting such credit

2. (a) The following is the Abridged Balance Sheet of UPS Ltd. for the years 2013-14 and 2012-13:

	(₹ in lakhs)	
	31.03.2014	31.03.2013
Liabilities		
Share Capital	480	480
Debenture redemption reserve	25	35

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Capital subsidy	35	35
Revaluation reserve	140	145
General reserve	145	140
Balance in Profit and Loss Account	48	40
Secured Loan	345	310
Unsecured Loan	115	102
	1333	1287
Assets		
Gross block	780	797
Accumulated depreciation	(325)	(290)
Capital WIP	48	38
Investment	170	170
Current Assets		
Inventories	455	380
Sundry Debtors	185	195
Advance for Capital equipment	18	21
Other Loans and advances	160	138
Cash and Bank Balances	19	25
Current Liabilities		
Sundry Creditors		
For capital expenses	(19)	(21)
For others	(188)	(197)
Provision for Taxes	(62)	(71)
Miscellaneous Expenses	92	102
	1333	1287

- Notes: (i) Fixed asset includes Goodwill and Patents ₹ 102 lakhs (Previous year ₹ 118 lakhs).
(ii) Term loans due for the payment within 12 months are ₹ 85 lakhs (Previous year ₹ 81 lakhs).

Calculate the following for the company:

- (i) Capital employed for both the years
(ii) Net worth as on 31.03.2013 and 31.03.2014
(iii) Debt equity ratio as on 31.03.2014 12

- (b) What disclosures are required to be made by a Company in respect of cost audit in its annual report? 2
(c) What are the objectives for codification of cost accounts? 4

Answer:

2. (a) (i) Capital Employed

(₹ in lakhs) (₹ in lakhs)

	31.03.2014	31.03.2013
Gross block	780	797
Less: Depreciation	325	290
Net Block	455	507
Less: Goodwill and patents	102	118
Less: Revaluation Reserve	140	145
Net Fixed Assets	213	244
Current Assets:	31.03.2014	31.03.2013
Inventories	455	380
Sundry debtors	185	195
Other Loans and advances	160	138
Cash and Bank Balances	19	25
Total current assets (A)	819	738

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Current Liabilities:				
Term Loan due for payment within 12 months	85		81	
Creditors-others	188		197	
Provision for taxes	62		71	
Total current liabilities (B)	335		349	
Working Capital (A-B)	484	484	389	389
Capital Employed		697		633

Average Capital Employed:

$$(697+633)/2 = 665$$

(ii) Net worth:

	(₹ In lakhs)	(₹ In lakhs)
Share Capital	480	480
Debenture redemption reserve	25	35
Capital Subsidy	35	35
General Reserve	145	140
Balance in Profit and Loss Account	48	40
	733	730
Less: Intangible Assets	102	118
Less: Capital Work in progress	48	38
Less: Miscellaneous Expenses	92	102
Net Worth	491	472

(iii) Debt equity ratio:

Debt:

	(₹ In lakhs)	(₹ In lakhs)
Debt (secured and unsecured Loan)	460	412
Less: Term Loan due for payment within 12 months	85	81
	375	331

Equity:

	(₹ In lakhs)	(₹ In lakhs)
Share Capital	480	480
Debenture redemption reserve	25	35
Capital Subsidy	35	35
General Reserve	145	140
Balance in Profit and Loss Account	48	40
	733	730
Less: Miscellaneous Expenses	92	102
	641	628
Debt equity ratio	375/641= 0.59	331/628= 0.53

Note-

(i) AS per accounting standard 12 "Accounting for Government grant" under Capital approach - Grant is treated part of for capital employed and for calculation of Net worth.

(ii) There is no existing liability towards debenture holder of the Company, so balance in debenture redemption Reserve is taken as part of Reserve and Surplus.

Alternative Answer: If debenture redemption reserve is not taken as part of Reserve and Surplus, then Debt Equity ratio will be:

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(iii) Debt equity ratio:

Debt:

	(₹ In lakhs)	(₹ In lakhs)
Debt (secured and unsecured Loan)	460	412
Less: Term Loan due for payment within 12 months	85	81
	375	331

Equity:

	(₹ In lakhs)	(₹ In lakhs)
Share Capital	480	480
Capital Subsidy	35	35
General Reserve	145	140
Balance in Profit and Loss Account	48	40
	708	695
Less: Miscellaneous Expenses	92	102
	616	593
Debt equity ratio	375/616= 0.61	331/593= 0.56

(b) The company is required to disclose full particulars of the cost auditor along with the due date and actual date of filing of Cost auditor's report by the Cost auditor, in its Annual report from the financial year 2010-11.

Since the cost audit report of a particular financial year may not have been submitted before publication of the Annual report, relevant details of due and actual date of filing for last financial year and the due date of filing of the current year may be published in the Annual Report.

(c) Important objectives of codification of Cost accounts may be stated as

1. For apportionment of similar items of expenses on one suitable basis of apportionment.
2. Which is operating from a special economic zone.
3. Computerisation of Cost accounting is made easier with codification of accounts.
4. It will reduce the clerical work in the organization.
5. It facilitates allocation, apportionment and absorption of cost to different cost units or cost centers.

3. (a) Chandragupta & Sons Ltd. has received an enquiry for supply of 3,00,000 numbers of Special Type of Machine Parts. Capacity exists for manufacturing of the machine parts, but a fixed investment of ₹ 90,000 and working capital to the extent of 25% of Sales Value will be required to undertake the job.

The costs estimated as follows:

Raw Materials—30,000 kgs @ ₹ 3.50 per kg.

Labour Hours—10,000 of which 1,500 would be overtime hours payable at double the labour rate.

Labour Rate ₹ 3 per hour.

Factory Overhead—₹ 3 per direct labour hours.

Selling and Distribution Expenses—₹ 32,000.

Material recovered at the end of the operation will be ₹ 8,000 (estimated)

The Company expects a Net Return of 25% on Capital Employed.

You are Management Accountant of the Company. The Managing Director requests you to prepare a Cost and Price Statement indicating the price which should be quoted to the Customer.

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- (b) General Cements Ltd. has a captive generation plant for its cement factory. The following information is available with regard to the power generation for the month of June, 2014.

Coal consumption	155 tons @ ₹ 500 per ton
Oil	220 litres @ ₹ 39.50 per litre
Water	1500 gallons at 60 per gallon
Stores and other consumables	₹ 4,000

Salaries of generating plant:

2 supervisors each at ₹ 6,500 p.m., 5 skilled workers at ₹ 3,500 p.m., 3 helpers at ₹ 2,200 p.m.

Salaries to boiler house attendant, 8 workers, each at ₹ 2,200 p.m.

Cost of generating plant—₹ 12,00,000 having life of plant 15 years with ₹75,000 residual value.

Cost of Boiler Plant—₹ 5,00,000 having life of plant 10 years with no residual value.

Miscellaneous income received by sale of ash— ₹ 4,000.

Repair and maintenance—Generating plant ₹ 8,500, Boiler house ₹ 5,500.

Share of Administrative Overhead— ₹ 6,250.

No. of units generated during the month— 4,00,000 units.

You are required to prepare the operating cost sheet to calculate the cost per unit of electricity generated considering no power generated is used by generating plant itself.

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Answer:

3. (a) Statement of Estimated Cost and Price Quotation

Product : Specialised Type Machine Parts	Capacity : 3,00,000 Units	
Material (30,000 Kgs @ ₹ 3.50)	105000	
Less: Estimated Scrap Value	<u>8000</u>	
		97000
Labour -		
8500 Hrs @ ₹ 3	25500	
8500 Hrs @ ₹ 3	<u>9000</u>	
		34500
Prime Costs		131500
Add: Factory Overhead (10,000 @ ₹ 3)		30000
Factory Cost		161500
Add: Selling & Distribution Expenses		32000
Total Cost		193500
Add: Profit		36900
Sales		230400

Working:

Calculation of Sales

Let Sales be S

$S = \text{Total Cost} + 25\% \text{ of Capital Employed}$

$$= 193500 + 25/100 \times (90000 + S/4)$$

$$= 193500 + 22500 + S/16$$

Or, $S - S/16 = 216000$

Or, $15 S/16 = 216000$

$S = 230400$

Profit = Sales – Cost

$$= 230400 - 193500$$

$$= 36900$$

Working Capital = 1/4th of Sales

$$= 230400 \times 1/4$$

$$= ₹ 57600.$$

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(b)

Operating Cost Sheet of Power Generation for the month of June, 2014 (No. of units generated 4,00,000 units)

		(₹)	
Coal consumption (155 Tons at ₹ 500)	77,500		
Less: Sale of Ash	<u>4,000</u>		73,500
Oil (220 liters at ₹ 39.50 per ltr)			8,690
Water (1500 gallon at ₹ 60/- per gallon)			90,000
Stores and other consumables			4,000
<u>Salaries of generating plant</u>			
Supervisor (2 × ₹ 6,500)	13,000		
Skilled worker (5 × ₹ 3,500)	17,500		
Helpers (3 × ₹ 2,200)	<u>6,600</u>		37,100
Salaries to boiler house attendant (8 workers × ₹ 2,200)			17,600
<u>Repairs and maintenance</u>			
Generating plant	8,500		
Boiler House	<u>5,500</u>		14,000
<u>Depreciation</u>			
Generating plant (12,00,000 – 75,000)/180 months	6,250		
Boiler House 5,00,000/120 months	<u>4,167</u>		10,417
Share of Administrative Overhead			6,250
Total cost of power generated			2,61,557
Power generated during the month		4,00,000 unit	
Cost per unit (₹ 261,557/4,00,000 unit)		₹ 0.65 per unit	

4. (a) Comment on the following:

3x5 =15

- (i) During plant stoppages the direct machine operator of the production floor is being utilised by the company for cleaning, oiling and other routine jobs of the same plant. Their wages for the period also are treated as direct wages in cost of production.
- (ii) A company started commercial production in June, 2012. The product is covered under Cost Audit. In the end of the first Financial Year the Turnover of the company is below the norms of Turnover as per Cost Audit Order. In the Second Year the company exceeds the Turnover as per Cost Audit Order. State the year when the Cost Audit is applicable.
- (iii) Sugar mills use bagasse as fuel in the boilers. Sugar Mill has not valued bagasse as according to the management it has incurred no cost. State how it can be valued.
- (iv) A company has 2 Wind Mills. Turnover from the two Wind Mills is ₹ 15 crores. The Company's total turnover is ₹ 100 crores. Other activities other than Wind Mill is not covered under Cost Audit Order. Whether, the company will need to get Cost Audit done of Electricity generation activities under Cost Audit Order.
- (v) A Kavari Company Limited been formed by Joint Venture by two companies. Ganga Company Limited share is 52% and Padma Company Limited share is 48%. Kavari Company Limited generate Electricity and selling electricity entirely to Padma Company Limited. No sale of electricity is made to outside customer. Whether Cost Audit is applicable to Kavari Company Limited.

(b) How would you treat the Leased Assets as per CAS 11 related to Administrative Overheads?

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Answer:

4. (a) (i) Here operating workers are required to perform certain type of work which falls in the category of indirect labour like oiling, cleaning maintenance etc. their wages should be treated as indirect wages and accordingly be included in overhead.
- (ii) As per Cost Audit Order the applicability of Cost Audit depends on fulfilling the Turnover. Assuming the Company is not listed. The Company has achieved the target in the second year. So, in the third year the Cost Audit will be applicable.
- (iii) Bagasse is a byproduct in sugar industry, which has a realisable value. As the company is using bagasse as a fuel to produce steam, the bagasse should be valued at its realisable value. In absence of a market price, bagasse may be valued on the basis of average pithhead price of coal after converting the weight of bagasse into equivalent coal adopting a thermal equivalency.
- (iv) If the power generated by the Wind Mills is sold outside and the total turnover from the sale exceeds 2 % of the total turnover of the Company or ₹20 crores, whichever is lower, then Cost Audit will be applicable. Here the Turnover exceeds 2 % i.e. 15 %, and the Cost Audit will apply under Electricity.
- (v) As per Cost Audit Orders dated May 2, 2011 or June 30, 2011 or January 24, 2012 cost audit are not applicable to Generation of electricity for captive consumption. For this purpose, the term "Captive Generating Plant" shall have the same meaning as assigned in Rule 3 of the Electricity Rules, 2005.
- As per Rule 3(1), no power plant shall qualify as a 'captive generating plant' under section 9 read with clause (8) of section 2 of the Act unless-
- In case of a power plant-
 - (i) not less than twenty six percent of the ownership is held by the captive user(s), and
 - (ii) not less than fifty one percent of the aggregate electricity generated in such plant, determined on an annual basis, is consumed for the captive use.
- Here Kavari Company Limited has been formed for only generating Electricity for Padma Company Limited. This is termed as captive consumption as the equity is more than 26% of the proportionate of the equity of the company related to the generating unit or unit identified as the captive generating plant.
- Hence, Cost audit is not applicable to Kavari Company Limited.
- (b) In case of Leased Assets, if the Lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.

Section B (50 Marks) (Operational Audit)

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

5. (a) Fill in the blanks in the following sentences by using appropriate word(s)/phrases(s)/ number(s): 1x5=5
- (i) Reports of cost accountant in special audit is an _____.
- (ii) The term _____ means, for insurance purpose, the present cost of construction of similar building, after deducting from the cost, depreciation based on age, usage, maintenance etc.
- (iii) _____ audit is a step towards the pursuits of environment quality management.
- (iv) Usually the manufacturer of machinery mentioned the specification of machinery as _____ capacity.
- (v) In a _____, the manager is held responsible for level of revenue or output

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generated as the centre.

(b) State whether the following statements based on the quoted terms are "True" or "False" with justification: 1x4=4

- (i) Production cost efficiency alone is one guarantee of Profit.
- (ii) Loss on sale of fixed assets is an item of both cost accounts and financial accounts.
- (iii) Management audit is carried out to appraise the management performance at top level of management.
- (iv) ERP bridges the information gap across the organization.

(c) What the following abbreviations stand for? 1x5=5

- (i) OECD
- (ii) ISAE
- (iii) QRB
- (iv) CAASB
- (v) IFAC

Answer:

5. (a) (i) Expert Opinion
(ii) Market Value
(iii) Environment Audit
(iv) Rated
(v) Revenue centre

- (b) (i) True: The production cost is one of the component total cost of a product. The company earns profit when the other cost like marketing, administrative finance cost etc. are also efficiently managed.
(ii) False: Loss on sale of fixed assets is an item of only financial accounts and excluded in cost accounts.
(iii) False: at all level of management
(iv) True: The ERP system provides platform for integrating all database into meaningful information system for decision making.

- (c) (i) Organisation for economic cooperation and development.
(ii) International Standards on Assurance Engagement
(iii) Quality review board
(iv) Cost audit and assurance standard board
(v) International Federation of Accountants.

6. (a) What are the areas in which due diligence exercise can take place? 5
(b) What do you understand by environmental audit? Enumerate the major areas in which environmental pollution is caused by the Industries. 9
(c) State briefly the mandatory review areas of the Audit Committee. 4

Answer:

6. (a) Areas in which Due Diligence can take place
1. Commercial/operational due diligence: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
 2. Financial Due Diligence: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed

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after completion of commercial due diligence.

3. Tax Due diligence: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. The accountant has to look at the tax affect of the merger or acquisition.
4. Information systems due diligence: It pertains to all computer systems and related matter of the entity.
5. Legal due diligence: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
6. Environmental due diligence: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
7. Personnel due diligence: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

- (b) Environment Audit is concerned with the verification of performance of the environment systems to control pollution, and their efficacy to conserve environment. Conservation of environment extends not only to control pollution of air and water, but also control of noise level, prevention of denunciation of forests, maintenance of ecology balance, etc.

An illustrative list of different pollution is given below:

Air pollution:

Air pollution is the human introduction into the atmosphere of chemicals, particulates or biological materials that cause harm or discomfort to humans or other living organisms or damage the environment. Air pollution is caused by burning coal or crude oil like naphtha in power stations, smoke from factories, exhaust fumes from automobiles, solvent losses and agricultural chemicals, etc. Air pollution leads to deaths and respiratory diseases.

Water pollution :

Water pollution is the contamination of water bodies such as lakes, rivers and/or oceans caused by effluents from breweries and tanneries, coal washeries, chemical plants, discharge of coolants from nuclear power plants, pesticides and agricultural chemicals. Water pollution affects public health and safety, causes damage to property and leads to many economic losses.

Noise Pollution:

Noise pollution is a type of energy pollution in which distracting, irritating or damaging sounds are freely audible and is caused by noise due to running of heavy machines, big aircrafts, drilling machines, etc. Noise pollution may lead to loss of efficiency at work, loss of hearing and causes psychological disorders, even insanity.

Soil/land Pollution:

Indiscriminate use of fertilizers and pesticides, pollution of soil with man-made chemicals, indiscriminate disposal of solid use etc. Due to pollution the quality of soil deteriorates to the extent that they fail to support vegetation. It affects the global climate also.

- (c) Mandatory Review Areas of the Audit Committee:

The Audit Committee shall mandatorily review the following information as per Clause 49 of the Listing Agreement:

1. Management discussion and analysis of financial condition and results of operations
2. Statement of significant related party transactions (as defined by the audit committee), submitted by management
3. Management letters/letters of internal control weaknesses issued by the statutory auditors

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4. Internal audit reports relating to internal control weaknesses; and
 5. The appointment, removal and terms of remuneration of the Chief Internal Auditor shall be subject to review by the Audit Committee.
7. (a) What are the items required to be covered before verifying the valuation of inventories? 9
- (b) State why it is essential to implement proper internal control system in an organization. 5
- (c) How is the audit in an organization under ERP (Enterprise Resource Planning) environment different from other audit? 4

Answer:

7. (a) Before verifying the accuracy of the valuation of the inventories, the following items are required to be covered :
- (i) Study of existing internal control system in order to identify the weakness in the existing system
 - (ii) Periodicity of physical inventory verification - whether representatives of the statutory auditors or internal auditors or cost auditors are present during physical verification.
 - (iii) Existence of records/reports of verification.
 - (iv) Perusal of accounting policy of the organisation in regard to inventory valuation i.e. whether as per accounting standards.
 - (v) Profit and Loss and Balance Sheet for the period under review and last audited records.
 - (vi) Collection of duly valued and authenticated Stock Sheets and verification with departmental records.
 - (vii) Quantity reconciliation for "Raw materials including Process materials like dice, chemicals and packing material " category items of physical inventory.
 - (viii) Study of system booking purchases and sales.
 - (ix) Verification of confirmations from the parties for company's stock lying with them.
 - (x) Verification of stocks lying at outside godowns, bonded warehouse, depots and retail shops.
 - (xi) Verification of stocks of others lying at company's premises to see that these are not included in the inventory valuation.
 - (xii) Verification of stage of completion of process in regard to various work-in-process.
- (b) Each organisation essentially must have proper internal control system for achieving preset goal. Therefore it plays a very important role in any organisation. The main purpose of implimenting proper internal control system in any organisation may be as follows.
- (i) Compliance- To have compliance with law and accounting practices generally accepted and followed in the country.
 - (ii) Reliance-To increase the reliance on internal system, people and accounting system followed by the organisation, so that the chances of frauds are reduced.
 - (iii) Safeguarding-To safeguard the organisation's accounts, employees and assets by formation of fool-proof policies,rules and regulation.
 - (iv) Security- To provide security to customers, employees and property of the Oranisation, Physical security system like security guards, locks and anti theft devices are used for providing protection.
 - (v) Increased efficiency-To assist human resources and performance management and to keep proper control over the business.
 - (vi) Evaluation-To evaluate the accounting system for proper authorisation of transactions.
 - (vii) Review and correction-To review the working of business, locate weak points in

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operation and take corrective measures.

- (viii) Authorisation- To provide proper authority to purchase, sale, valuation, verification etc.
 - (ix) Delegation - To provide proper division of duty among the employees.
 - (x) Accurate planning - To ensure that auditors and accountants make all financial report timely and correctly for proper planning.
 - (xi) Resource utilisation—To ensure that all resources i.e man .material, money and machines properly and optimally used.
 - (xii) Safeguarding resource-To safeguard the resources of the organisation against mismanagement and fraud and ensure companies activities are in accordance with law and regulation.
 - (xiii) Setting future goals.-It helps in setting future goal and to achieve preset goal.
- (c) Enterprise Resource Planning (ERP) is the activities supported by multi-module application. ERP is the software solution to address the enterprise needs taking the process view of an organisation by tightly integrating all functions like inventory control, order taking, customer service etc into unified system. It facilitates the enterprise wide integrated information system covering all functional areas. A key ingredient of most ERP systems is the use of a unified database to store data for the various system modules. The common database allows every department to store and retrieve information in real time. It allows information to be more reliable, accessible and easily shared.

The major Characteristics of ERP systems necessitating change in audit approach are:

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

8. Write short notes on any three out of the following:

6x3=18

- (a) Control and prevention of Management frauds**
- (b) International Auditing and Assurance Standard Board**
- (c) Difference between Special Audit by Custom and Special Audit by Excise Departments.**
- (d) Disclosure and transparency of Corporate Governance.**

Answer:

8. (a) Control and prevention of Management Frauds:

Control and prevention of Management Frauds is the responsibility of the management. But when the top management itself is perpetuating frauds, it becomes very difficult for the auditors or for that matter anyone else to detect it.

The following measures may be adopted for the control and prevention of management frauds:

- Adequate internal control system may be introduced.
- System audit should be conducted to-suggest improvement in systems and procedures.
- Organization structure of the company should be reviewed and reconstituted, if necessary.

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- Personnel policies of the company should be reviewed and revised, if necessary.
- Supervision at all levels should be tightened.
- Information revealed by inter-firm comparison of performance should be thoroughly analyzed.
- Proper office procedures should be introduced.
- All significant variations from the Budgets or Standards should be checked in detail.

The top management should be basically interested to control and prevent occurrence of management frauds.

- (b) IAASB i.e. International Auditing and Assurance Standards Board develops auditing and assurance standards, pronouncements, and guidance for use by professional accountants. The IAASB's objective is to serve the public interest by setting high-quality auditing and assurance standards. This facilitates the international and national auditing and assurance standards, which enhances the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing the assurance profession.

The IASSB also publishes other pronouncements on auditing and assurance matters, thereby making public understanding of the roles of professional auditors and assurance service providers. The IASSB develops auditing and assurance standards, other pronouncements, and guidance under a shared standard-setting process involving the Public Interest Oversight Board (PIOB). The PIOB oversees the work of the IAASB to ensure that the activities of the IAASB are in the best interest of public.

- (c) **Difference between Special Audit by Excise and Special Audit by Customs**

In addition to departmental audit and audit by CERA, excise and customs authorities are empowered to order special audit by Cost Accountant. The audit can be in respect of Valuation in Central Excise or Cenvat credit. Customs department can order audit by cost accountant in respect of records of custom bonded warehouse.

SPECIAL AUDIT OF VALUATION AND CENVAT CREDIT

Special audit of excise can be ordered in respect of Excise valuation or Cenvat credit.

1. **Valuation Audit - Special Audit:** Valuation is one of the most vital and important aspect of assessment of excise duty payable. In order to ensure that duty is being paid correct 'Assessable Value', a provision has been made to order a 'Special Audit' in some specified cases, vide section 14A of CEA. The audit can be ordered only with prior approval of Chief Commissioner of Central Excise.

2. **Cenvat credit audit - Special Audit:** As per section 14AA of CEA, special audit of Cenvat credit availed or utilized can be ordered by Commissioner of Central Excise. Such audit can be ordered if the Commissioner of CE has reason to believe that (a) Cenvat credit availed or utilized is not within the normal limits, having regard to nature of final products and type of inputs, (b) Cenvat credit has been availed or utilized by reason of fraud, collusion or any willful misstatement or suppression of facts. Such audit can be done by practicing 'Cost Accountant', to be appointed by Commissioner of CE. Expenses of and incidental to such audit, including the remuneration payable to the cost accountant shall be paid by Central Government (i.e. excise department)

Audit when goods are manufactured in customs bonded warehouse

- With the sanction of Assistant Commissioner, manufacturing or other operations can be carried out in the warehouse (section 65 of Customs Act). The facility is useful if final products are to be exported after manufacture (though final products can be cleared for home consumption too). After manufacture, the

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produced goods may either be exported without payment of customs duty or cleared for home consumption on payment of duty.

- These provisions are applicable to EOU, FTZ, STP or EHTP units who have to manufacture goods under customs bond.
- Facility for manufacture in warehouse under bond is also available for goods imported for repairs, reconditioning, re-engineering etc. The goods can be imported without payment of customs duty and can be re-exported after repairs, reconditioning etc. Such re-export must be within three years from date of import. [Notification No. 134/94 - Cus dated 22-6-94]
- Owner has to make application giving full details regarding process to be carried out, imported and other goods used, plan and description of warehouse and volume of manufacture anticipated.
- On obtaining permission, necessary bond has to be executed undertaking to observe all regulations and maintaining accounts etc. Manufacture will not be under supervision of Customs Officers.
- Customs officers can visit warehouse and control and supervise manufacturing process or imported and other goods. Detailed accounts are required to be maintained of raw materials, stock, WIP and production. Input-output norms should be fixed wherever considered necessary.
- Till 1998, manufacture in warehouse was required to be under physical supervision of customs authorities.
- The requirement of physical supervision has now been removed. However, to ensure proper control, provision of special audit has been made.
- Special audit of accounts of the warehouse can be ordered by Chief Commissioner of Customs.
- He can appoint a cost accountant to conduct audit of accounts of warehouse, office, stores, godowns, factory and depot of the manufacturer.

(d) Disclosure and transparency of Corporate Governance include the followings.

- (1) Disclosure should include all information not limited only to material information.
 - (i) The financial and operating results of the company
 - (ii) Company objectives
 - (iii) Membership of the board and key persons and their remuneration
 - (iv) Material foreseeable factors
 - (v) Material issue regarding employees and other stake holders
 - (vi) Government structure and policies
- (2) Information should be prepared, audited and disclosed in accordance with high quality standards of accounting, financial and non financial disclosure and audit.
- (3) An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.
- (4) Channels for disseminating information should provide for fair, timely and cost efficient access to relevant information by users.