FINAL EXAMINATION

(REVISED SYLLABUS - 2008)

GROUP - IV

Paper-17 : COST AUDIT & OPERATIONAL AUDIT

Section I : Cost Audit

Q. 1. (a) How is "Manufacturing Activity" defined under the Companies (Cost Accounting Record Rules), 2011?

(b) Are there any sectors exempted under Companies (Cost Accounting Records) Rules 2011?

(c) Companies covered under any of the 6 Industry/Product Specific Cost Accounting Records Rules 2011 are also subject to cost audit. Will they be required to file Compliance Report also under these Rules?

Answer 1. (a)

" Manufacturing Activity" includes any act, process or method employed in relation to-

(i) transformation of raw materials, components, sub-assembles, or parts into semi-finished or finished products; or

(ii) making, altering, repairing, fabricating, generating, composing, ornamenting, furnishing, finishing, packing, re-packing, oiling, washing, cleaning, breaking-up, demolishing, or otherwise treating or adapting any product with a view to its use, sale, transport, delivery or disposal; or

(iii) constructing, reconstructing, reconditioning, servicing, refitting, repairing, finishing or breaking up of any products.

The above definition of " manufacturing " is couched in the widest possible terms and extends the scope of cost record maintenance obligations under section 209(1)(d) of the Act to all except those companies which qualify as SMEs under the 2011 Record Rules.

Answer 1. (b)

MCA General Circular No. 67/2011 dated 30th November 2011, states that the Companies (Cost Accounting Records) Rules, 2011 are not applicable to wholesale & retail trading, banking, financial, leasing, investment, insurance, education, healthcare, tourism, travel, hospitality, recreation, transport services, business/professional consultancy, IT & IT enabled services, research & development, postal/courier services, etc. unless any of these have been specifically covered under any other Cost Accounting Records Rules.

Answer 1. (c)

(i) If one or more product(s)/activity(s) of a company is covered under cost audit and there are other products that are not covered under Cost Audit as per companywise cost audit orders issued in the past or industry specific cost audit orders dated 2nd May, 2011 and 30th June, 2011, the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

(ii) If one or more product(s)/activity(s) of a company is covered under Cost Audit and the other product(s)/activity(s) belong to the exempted category, then the company will not be required to file a Compliance Report.

Q. 2. (a) As a Cost and Management Auditor, you are asked to look into the proposed decision to temporarily suspend operations due to depressed market conditions:

₹ in '000

Budgeted level (per annum)	**Capacity Utilisation**	
	60%	**80%**
Direct Material	**1800**	**2400**
Direct Labour	**2400**	**3200**
Production overhead	**1260**	**1380**
Administrative Overhead	**620**	**660**
Selling & Distribution overhead	**680**	**740**
Total	**6760**	**8380**

The company is likely to operate at 50% capacity only and turn over is expected to be ₹ 49.5 lacs p.a. Market Research indicates that the depression will be over in a year and after that they can effect a sale of ₹ 90 lacs p.a utilizing 75% of capacity.

If operations are suspended for a year, the following cost will be incurred :

- **Fixed cost ₹ 4,00,000**
- **Settlement with labour force ₹ 3,50,000**
- **Maintenance of Plant will continue and cost ₹ 1,00,000**
- **Cost of reopening will be ₹ 1,00,000**

Draft a report to the Management of the following two options:

(i) To suspend production for one year and restart thereafter when market improves.

(ii) To continue production at 50% capacity level.

(b) A company manufacture various types of product under review. As a Cost Auditor would you accept the absorption of 'Selling and Distribution' expenses as a percentage on Sales Values.

Answer 2. (a)

Draft report is as follows :

To,
The Managing Director,

Dear Sir,

Sub : Report on proposal for temporary suspension of operations due to depressed market conditions :

This has reference to your letter no. ______________ dated ______________ .

As desired, I have examined carefully both the options that are available viz.,

(i) To suspend production for one year and restart thereafter when market improves.

(ii) To continue production at 50% capacity level.

Due to depressed market conditions, the plant has to be operated only at a low cost capacity utilization of 50%. The market research report has predicted that the adverse market conditions are going to be a temporary phenomenon for a period of only one year. Thereafter that they can effect a sale of ₹ 900 lacs p.a utilizing 75% of capacity.

Details pertaining to the feasibility of both the options are as under :

Option I : Suspension of production for one year

	₹ in '000
Fixed cost	400
Settlement with labour force	350
Maintenance of Plant	100
Cost of reopening	100
Total	950

Option II : Continue production at 50% capacity level.

₹ in '000

Particulars	**Current Year**	**Next Year**
	50% capacity	**75 % capacity**
Direct Material	1500	2250
Direct Labour	2000	3000
Production overhead	1200	1350
Administrative Overhead	600	650
Selling & Distribution overhead	650	725
Total cost	5950	7975
Sales	4950	9000
Profit/(Loss)	(-)1000	1025

Analysis of the above comparative data shows that if company continues operation at 50% capacity, there will be loss of ₹ 10 lacs.

On other hand, if operations are suspended, the loss will be ₹ 9.50 lacs. Thus there is additional loss of ₹ 50,000/- only.

If the operations are suspended, the company may have to encounter the following problems :

- Problems of recruiting new personnel,
- Links with old customers will be broken,
- It may have an adverse effect on the image of the company.

Attaining 75% capacity utilization immediately after closer for a year may not be easy to achieve. It may therefore be seen from the above that even though the company may just save ₹ 50,000/-, by doing so it may have to face a lot of difficulties as listed above.

Final recommendation : The company is advised to continue production at 50% capacity utilization and never mind the small loss of ₹ 50,000/- by continuing production in view of factors discussed above.

Hope you find the above report and analysis in order.

Thanking you,

Sd.

(Cost and Management Auditor.)

Working notes :

(I) Direct Material Cost is 100% variable cost.

Direct material cost at 75% Capacity = 18,00,000/60 × 75 = ₹ 22,50,000

Direct material cost at 50% Capacity = 18,00,000/60 × 50 = ₹ 15,00,000

(II) Direct Labour Cost is 100% variable cost.

Direct Labour Cost at 75% capacity = 24,00,000/60 × 75 = ₹ 30,00,000

Direct Labour Cost at 50% capacity =24,00,000/60 × 50 = ₹ 20,00,000

(III) Production Overhead is a semi variable cost.

At 80%, Production Overhead is ₹ 13,80,000

At 60%, Production Overhead is ₹ 12,60,000

For 20% variation, difference is ₹ 1,20,000

Variable production overhead at 60% capacity = 120000/20 × 60 = ₹ 3,60,000

Fixed production overhead = ₹ 12,60,000 – ₹ 3,60,000 = ₹ 9,00,000

Thus at 50% capacity, Fixed production overhead = ₹ 9,00,000 and

Variable production overhead = ₹ 3,60,000/60 × 50 = ₹ 3,00,000.

Similarly, at 75% Capacity,

Variable production overhead = 3,60,000/60 × 75 = ₹ 4,50,000

Total production overhead = ₹ 9,00,000 + ₹ 4,50,000 = ₹ 13,50,000

(IV) Administrative overhead is a semi variable overhead.

At 80% capacity, Administrative overhead = ₹ 6,60,000

At 60% capacity, Administrative overhead = ₹ 6,20,000

For 20% variation, difference is = ₹ 40,000

At 60% capacity, Variable Administrative overhead = 40000/20 × 60 = ₹ 1,20,000

Thus, Fixed Administrative overhead = ₹ 6,20,000 – ₹ 1,20,000 = ₹ 5,00,000

Similarly, at 50% capacity,

Variable Administrative overhead = ₹ 1,20,000/60 × 50 = ₹ 1,00,000

Total Administrative overhead = ₹ 5,00,000 + 1,00,000 = ₹ 6,00,000

At 75% capacity,

Variable Administrative overhead=120000/60 × 75= ₹ 1,50,000

Thus Total Administrative overhead = ₹ 5,00,000 + 1,50,000 = ₹ 6,50,000.

(V) Selling and Distribution Overhead :

This is semi variable overhead.

At 80% , S&D OH = ₹ 7,40,000

At 60%, S&D OH = ₹ 6,80,000

For 20% variation, difference is = ₹ 60,000

Thus, at 60% capacity, variable S&D o/h = 6000/20 × 60 = ₹ 1,80,000

Fixed OH at 60% capacity = ₹ 6,80,000 – ₹ 1,80,000 = ₹ 5,00,000

Thus at 50% capacity,

Variable S&D O/H = 1,80,000/60 × 50 = ₹ 1,50,000

Total S&D O/H = ₹ (1,50,000 + 5,00,000) = ₹ 6,50,000

Similarly at 75% capacity,

Variable O/H = 180000/60 × 75 = ₹ 2,25,000

Total O/H = ₹ 2,25,000 + ₹ 5,00,000 = ₹ 7,25,000

Answer 2. (b)

The method of absorption of Selling and Distribution Overheads as a percentage of Sales Value is not correct because :

(a) Some quantities of product have been consumed captively.

(b) Different advertisement and selling techniques resulting in separate expenses incurred for various types of products.

(c) Freight cost is different for different types of products.

(d) A product has different demand in different areas and their selling expenses cannot be pooled as common.

Q. 3. (a) The following figures are extracted from the Financial Accounts of SBW Ltd. for the year ended 31-03-2012 :

	₹	₹
Sales (20,000 units)		**50,00,000**
Materials		**20,00,000**
Wages		**10,00,000**
Factory Overheads		**9,00,000**
Administrative Overheads		**5,20,000**
Selling and Distribution Overheads		**3,60,000**
Finished Goods (1,230 units)		**3,00,000**
Work-in-progress :		
Materials	**60,000**	
Labour	**40,000**	
Factory Overheads	**40,000**	**1,40,000**
Goodwill Written off		**4,00,000**
Interest paid on capital		**40,000**

In the costing records, Factory Overhead is charged at 100% of Wages, Administration Overhead 10% factory cost and Selling and Distribution Overhead at the rate of ₹ 20 per unit sold.

Prepare a statement reconciling the profit as per Cost Records with the profit as per Financial Records.

(b) What is meant by True and Fair Cost of Production?

Answer 3. (a)

SBW Ltd.

Profit & Loss Account

(For the year ended 31st March, 2012)

Dr. *Cr.*

Particulars	₹	Particulars	₹
To Opening Stock	Nil	By Sales (20,000 units)	50,00,000
To Materials	20,000	By Closing Stock (1,230 units)	3,00,000
To Wages	10,00,000	By Work-in-progress	1,40,000
To Factory Overheads	9,00,000		
To Administrative Overheads	5,20,000		
To Selling & Distribution Overheads	3,60,000		
To Goodwill written off	4,00,000		
To Interest on Capital	40,000		
To Net Profit	2,20,000		
	54,40,000		54,40,000

Cost Profit & Loss Statement

(For the year ended 31st March, 2012)

Particulars	₹
Materials	20,00,000
Wages	10,00,000
Prime Cost	30,00,000
Add: Factory Overhead @ 100% of wages	10,00,000
	40,00,000
Less : Closing Work-in-progress	1,40,000
Factory Cost (20,000 + 1,230) units	38,60,000
Administrative Overheads @ 10% of Factory Cost	3,86,000
	42,46,000
Less : Closing Stock of Finished Goods 1,230 units *(See Note)*	2,46,000
Cost of Production (20,000 units)	40,00,000
Selling & Distribution Overhead @ ₹ 20 per unit	4,00,000
Cost of Sales (20,000 units)	44,00,000
Sales Revenue (20,000 units)	50,00,000
Profit	6,00,000

Note: Cost of 21,230 units is ₹ 42,46,000. Therefore, the cost of one unit is ₹ 200. Hence the cost of 1,230 units is ₹ 2,46,000.

Alternatively : Administrative overheads could be excluded from the cost of production.

Reconciliation Statement

Particulars	₹	₹
Profit as per Cost Records		6,00,000
Add: Factory Overheads over-absorbed		
(₹ 10,00,000 – ₹ 9,00,000)	1,00,000	
Selling & Distribution Overhead Over-absorbed	–	
(₹ 4,00,000 – ₹ 3,60,000)	40,000	
Difference in the valuation of closing stock of finished goods		
(₹ 3,00,000 – ₹ 2,46,000)	54,000	1,94,000
		7,94,000
Less: Administrative Overhead Underabsorbed		
(₹ 5,20,000 – ₹ 3,86,000)	1,34,000	
Goodwill written off relates to		
Financial Accounts	4,00,000	
Interest on Capital	40,000	5,74,000
Profit as per Financial Accounts		2,20,000

Answer 3. (b)

The concept of "True and Fair Cost of Production" is used in the context of cost audit wherein the cost auditor has to state whether in his opinion the company's cost accounting records have been kept so as to give a true and fair view of the cost of production, processing and marketing of the product. A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The following are the relevant considerations in determining whether the cost of production determined by the cost auditor is true and fair :

- Determination of cost following the generally accepted cost accounting principles
- Application of the costing system appropriate to the product
- Materiality
- Consistency in the application of costing system and cost accounting principles
- Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents
- Elimination of material prior-period adjustments
- Abnormal wastage's and losses and other unusual transactions being ignored in determination of cost.

If as a result of the examination of the books of account, the cost auditor desires to give a qualified report he shall indicate the extent to which he has to qualify the report and the reasons there for.

Q. 4. (a) Who is competent authority in companies to appoint cost auditor?

(b) What procedure is required to be followed by a company in respect of appointment of cost auditor?

(c) A company, manufacturing Cotton Textile, wrote off in the same year, the expenditure in replacement of Copper Rollers used for printing fabrics and Stainless Steel frames used for Dying Yarn whose life are more than one year. State whether the Cost Auditor can qualify the report for these?

(d) What as a Cost Auditor, will you verify in the area of work-in-progress?

Answer 4. (a)

As per provisions of section 233B(2), the Board of Directors of a Company can appoint a cost auditor after obtaining prior approval of the Central Government. Under the revised procedure, the first point of reference will be the Audit Committee to ensure that the cost auditor is free from any disqualification as specified under section 233B (5) read with section 224 and sub-section (3) or sub-section (4) of section 226 of the Companies Act, 1956. The Audit Committee should also ensure that the cost auditor is independent and is at arm's length relationship with the company. After ascertaining the eligibility, the Audit Committee will recommend to the Board of Directors for appointment.

In those companies where constitution of an Audit Committee is not required by law, the functions of the "Audit Committee" as per the procedure will be discharged by the "Board of Directors".

Answer 4. (b)

The Company is required to e-file its application with the Central Government on www.mca.gov.in portal, in the prescribed Form 23C within ninety (90) days from the date of commencement of each financial year, along with the prescribed fee as per the Companies (Fees on Application) Rules, 1999 as amended from time to time and other documents as per existing practice i.e.

(i) certified copy of the Board Resolution proposing appointment of cost auditor; and

(ii) copy of the certificate obtained from the cost auditor regarding compliance of section 224(1-B) of the Companies Act, 1956.

Answer 4. (c)

The Cost Auditor is justified in qualifying his report since as per the Cost Accounting Records (Textiles) Rules, cost of items like Copper Rollers used for printing fabrics and the stainless steel frames used for dying yarn put into use in the relevant year shall be treated as deferred revenue expenditure and spread over the effective life of such items. Thus writing off such items in same year is not correct.

Answer 4. (d)

The Cost Auditor should verify the following area of work-in-progress :

(i) That the work-in-progress has been physically verified and it agrees with the quantity shown in job-cards of uncompleted work.

(ii) That the valuation of the work-in-progress is correct with reference to the stage of completion of each job or process and the value job cost cards or process cost sheet.

(iii) That there is no over-valuation or under valuation of opening work-in-progress or closing work-in-progress, thereby artificially, pushing up and down net profits or net assets as the case may be.

(iv) That the volume and value of work-in-progress is not disproportionate as compared with finished production.

Q. 5. (a) The following figures are extracted from the statement prepared by the Cost Accountant and the Trial Balance of XYZ Ltd., which is a single product company :

	31.3.12	Year ending 31.3.11 (₹ in lakhs)	31.3.10
Gross sales inclusive of Excise Duty	2,040	1,985	1,875
Excise Duty	295	280	265
Raw Materials consumed	1,140	1,060	975
Direct Wages	35	32	27
Power and Fuel	30	27	24
Stores and Spares	6	5	4
Depreciation charged to production cost centres	16	15	13
Factory overheads :			
Salaries and Wages	5	4	3
Depreciation	2	2	2
Rates and Taxes	1	1	1
Other overheads	6	5	4
Administrative overheads :			
Salaries and Wages	10	9	8
Rates and Taxes	2	2	2
Other overheads	162	154	148
Selling and distribution overheads :			
Salaries and Wages	7	6	5
Packing and Forwarding	6	6	5
Depreciation	1	1	1
Other overheads	124	118	108
Interest	85	74	68
Bonus and Gratuity	12	10	9
Gross Current Assets	840	724	640
Current Liabilities and Provisions	324	305	246

You are required to compute the following ratios as per requirement of Para 9 the Cost Audit Report Rules 2011 :

(i) Operating Profit as percentage of Value Addition.

(ii) Value Addition as percentage of Net Sales.

***Note* : The computation should be based on EBDIT as Operating Profit.**

(b) How does the Cost auditor allocate and apportion the cost of caustic soda in a Chemical Industry where various products are produced?

Answer 5. (a)

	31.3.12	(₹ in lakhs) Year ending 31.3.11	31.3.10
Gross sales inclusive of Excise Duty	2,040	1,985	1,875
Excise Duty	295	280	265
Net sales (A)	1,745	1,705	1,610
Cost of Sales excluding depreciation & Interest			
Raw Material consumed	1,140	1,060	975
Direct Wages	35	32	27
Power and Fuel	30	27	24
Stores and Spares	6	5	4
Factory overheads (excluding depreciation)	12	10	8
Administrative overheads (excluding depreciation)	174	165	158
Selling and distribution overheads (excluding depreciation)	137	130	118
Bonus and Gratuity	12	10	9
Total (B)	1546	1439	1323
∴ Operating Profit (A) – (B) =	199	266	287

Value addition is defined in Para 8 of the Cost Audit (Report) Rules, 2011 as "the difference between the net output value (Net Sales) and cost of bought out materials and services for the product under reference".

The working will be :

	31.3.12	Year ending 31.3.11	31.3.10
(X) Net sales	1745	1705	1610
Less : (i) Cost of Bought Out Materials & Service (Raw Materials and Stores & Spares)	1146	1065	979
(ii) Power & Fuel, other bought out services	30	27	24
(iii) Over heads (excluding Salaries & Wages, Rates & Taxes and depreciation)	298	283	265
(Y)	1474	1375	1268
Value Addition : (X) – (Y) =	271	330	342

	31.3.12	Year ending 31.3.11	31.3.10
Hence,			
(a) Operating profit as % of Value Added	199/271	266/330	287/342
i.e.	73.43%	80.6%	83.92%
			= 84%
(b) Value addition as % of Net Sales	271/1745	330/1705	342/1610
i.e.	15.53%	19.35%	21.24%

Answer 5. (b)

Cost auditor may allocate and apportion the cost of Caustic Soda in a chemical industry before split –off point in any of the following basis:

(i) Sales Value at split off point.

(ii) Sales value minus post expenditure after split off point.

(iii) Technical estimate i.e. percentage.

(iv) Raw material cost can be identified and cost may be allocated and apportioned on basis of Raw Material cost.

(v) Percentage of salaries and wages for the final product.

(vi) On basis of Asset Value of various products.

(vii) Machine Hours utilized for production of Caustic Soda and different products.

(viii) Area occupied for production of Caustic Soda and different products.

Q. 6. (a) A sugar mill has a boiler which uses its own by product, bagasse as fuel. The steam generated is first used for generation of power and the exhaust steam is used in the process of sugar manufacture. The following details areextracted from the financial accounts and costaccounting records of the sugar mill:

Sugar produced	**24,50,000**	**quintals**
Steam generated and consumed	**12,45,000**	**tonnes**
Fuel (Bagasse) consumed for production of stream	**6,23,450**	**tonnes**
Cost of generation of steam including cost of water (other than fuel cost)	**₹ 5,75,40,000**	
Steam used for generation of power	**5,75,000**	**tonnes**
Power purchased from Electricity Board @₹ 5.75 per KWH	**48,50,000**	**KWH**
Power generated from steam turbine	**4,82,15,000**	**KWH**
Variable conversion cost for generation of power (excluding cost of steam)	**₹ 3,87,14,000**	

Notes : **(1) The sales value of bagasse, if sold in the open market is₹ 1,750 per tonne.**

(2) The exhaust steam (after generation of power) transferred to sugar manufacturing process is valued at 85% of the cost of production of steam.

Prepare two separate cost sheet for steam an power as per Cost Accounting Record Rules and compute the average cost of power as per Para 5 of the Annexure to the Cost Audit Report, 2011.

(b) In dealing with the financial position of a company as per para 9 of the Annexure to the Cost Audit Report, state your opinion regarding:

(i) Is the Capital Employed to be computed as at the beginning of the accounting period or at the end of the accounting period or average of both?

(ii) Should investments like National Savings Certificates deposited with Government authorities for Sales Tax, Excise etc. as security be treated as investments outside the business?

(iii) How is 'net worth' defined in this para? The para also states "if there is any change in the composition of the net worth during the year, special mention may be made along with the reasons there for." How would you take care of this provision?

(iv) Should the net sales figure include other service charges and jobbing income?

(v) In case the financial accounts of the company are yet to be finalized and audited, should the cost auditor provide the data under para9?

Answer 6. (a)

Cost of Steam

Cost of Fuel- Bagasse 623,450 tonnes @ ₹ 1750 per tonne	₹	109,10,37,500
Conversion Cost including Cost of water	₹	5,75,40,000
Total Cost	₹	114,85,77,500
Steam generated (Tonnes)		12,45,000
Gross Cost of steam per tonne	₹	922.55
Steam directly used for sugar production=		
(12,45,000 – 5,75,000) tones × 922.55 =	₹	61,81,08,500
Value of exhaust steam from steam turbine		
At 85% of cost = 5,75,000 × 922.55 × 85% =	₹	45,08,96,313 (A)
Total cost of steam used for Sugar Production =	₹	106,90,04,813
Average cost of steam per tonne =	₹	858.64

For disclosure in Para 5 of the Annexure to the Cost Audit Report :

Steam Consumption per quintal of sugar = $\frac{12{,}45{,}000 \text{ tonnes}}{24{,}50{,}000 \text{ quintal}}$ = 0.51 tonnes

Steam cost per quintal of sugar = $\frac{₹106{,}90{,}04{,}813}{24{,}50{,}000}$ = 436.32

Cost of Power

Cost of high pressure steam sent to steam turbine = 5,75,000 tonnes × ₹ 922.55	₹	53,04,66,250
Conversion cost for generation of Power	₹	3,87,14,000
Total	₹	56,91,80,250
Less : Credit for exhaust steam transferred to sugar manufacture (A) in Steam Cost	₹	45,08,96,313
Net cost of Power generated	₹	11,82,83,937
Power generated		4,82,15,000 KWH
Cost of Power generated	₹	2.45 per KWH

For disclosures in Para 5 of the Annexure to the Cost Audit Report

Quantity & Cost of Power	KWH	₹	₹ /KWH
(a) Own generation	4,82,15,000	11,82,83,937	2.45
(b) Purchased	48,50,000	2,78,87,500	5.75
	5,30,65,000	14,61,71,437	2.755

Power consumed per quintal of sugar

$= \frac{5{,}30{,}65{,}000 \text{ KWH}}{24{,}50{,}000 \text{ Quintals}}$ = 21.66 KWH

Power cost per quintals of sugar
= 21.66 KWH × 2.755 = ₹ 59.67

Note : Similar data (consumption and cost per unit of output of product under audit) is to be furnished for the current year and two previous years.

Answer 6. (b)

(i) Capital employed should be stated as at the close of the accounting period.

(ii) Such investments are in normal course of business and for the business, therefore these cannot be treated as investments outside the business.

(iii) The term 'net worth' has been defined as share capital plus reserves and surplus (excluding revaluation reserve) less accumulated losses and intangible assets. In other words it can be calculated as under :

Share	Capital (paid up capital- equity and preference)	**
Add:	Reserves and Surplus	**
Less:	Revaluation Reserve	**
Less:	Intangible Assets	**
Less:	Profit and Loss A/c(Debit balance)	**
Less:	Misc/ deferred expenditure	**

A reconciliation of net worth in following form may be provided :

Net worth at the beginning of the year		**
Add :	increase in capital	
Add :	increase in reserve	
Less:	Decrease in reserves	
Less:	Any loss	
Less:	Any acquisition of intangible asset or incurrence of expenses treating as deferred	
Net worth at the end of the year		**

(iv) If other service charges and jobbing income are a regular part of the activity and are of material value these can be treated as sales , otherwise not to be so considered.

(v) Where the financial accounts have not been finalized at the time of submission of the Cost Audit Report, Cost Auditor may indicate in his report all financial data under para 9 are on the basis of the unaudited or provisional accounts . This is necessary as all cost statements contain a lot of data which have a linkage to the financial accounts. After the accounts have been finalized, a supplementary cost audit report should be submitted as soon as the audited accounts are made available.

Q. 7. (a) Draft an " Audit Programme" as a Cost Auditor after being appointed for Cenvat Credit Audit.

(b) For what purposes the Cost Auditor refers to financial records while conducting Cost Audit of an entity?

Answer 7. (a)

The " Audit Programme" of Cenvat Credit Audit should include the following :

(1) (i) Name of the Auditee.

(ii) Address/ Location of the Auditee.

(iii) Period to be covered.

(iv) Estimated time(days) required.

(v) Audit team members consisting of Partners/Qualified/Semi-qualified staff required.

(vi) Queries of the Auditor to be settled by the representative of the concern.

(vii) Report to be submitted to the representative of the company.

(2) Review of Manufacturing Process.

(3) Review of Bill of Materials.

(4) Review of Statutory details:
   - (i) Classification of Input to Output.
   - (ii) MSN Nomenclature etc.

(5) Input checking
   - (i) Raw Materials
   - (ii) Packing Materials.

(6) Batch record checking.

(7) Yield Analysis-Input consumption and Output Yield.

(8) Cenvat Records-
   - (i) PLA Register
   - (ii) Amount Claimed and Claimable against Raw Material and Capital Goods.
   - (iii) Summary Statement of Cenvat Credit.
   - (iv) Vendor Invoices etc.

Review and checking of the documents of Notices/Show Cause/Litigation matter in respect of Cenvat Audit.

Answer 7. (b)

A cost auditor is ultimately required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production, etc. In arriving at this opinion, the cost auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power, cost of stock, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, scrap, fuel etc. Annexure to the cost audit reports require detailed information in respect of financial position including capital employed, net worth, profit, net rates, operating profit, unit cost of power and fuel, total wages and salaries, etc. It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit report. Further the cost statements also contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; Overhead expenditure also needs allocation between activities covered by rules and activities not so covered. Naturally this can be done only with reference to financial ledger. Under Part II of Schedule VI to the Companies Act, 1956, quite a few matters which are to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. A correlation between consumption of raw materials as per cost records and financial records may throw up the need for inquiry into errors, mistakes and manipulation. Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would require that the cost auditor may examine deviation before reporting on the same. Thus it is imperative for the cost auditor to refer to financial records for conducting the cost audit.

Q. 8. (a) Comment on the following :

(i) Name of Internal Auditor of one division Company who is a member of the Institute of Cost Accountants of India is proposed as Cost Auditor of another division in the same Company.

(ii) A Cost Accountant is in full time employment in a company. He is also holding part time certificate of practice. Whether he can certify the Compliance Report of group companies and/or any other company.

(iii) Whether separate Form 23C is required to be filed by a company having two or more different types of products covered under cost audit?

(b) Para 9 of the Companies (Cost Audit Report) Rules 2011 requires disclosure of "Cost of Production" and "Cost of Sales" at a company level. How the same would be available when all the products/ activities are not covered under cost audit?

Answer 8. (a)

(i) MCA General Circular No. 68/2011 dated 30th November 2011 may be referred in the present case. A cost auditor cannot render any services to the company whether acting individually, or through the same firm or through other group firms where he or any partner has any common interest, relating to :

(I) design and implementation of cost accounting system; or

(II) the maintenance of cost accounting records, or

(III) act as internal auditor,

However, a cost auditor can certify the compliance report or provide any other services as may be assigned by the company, excluding the services mentioned above.

(ii) A Cost Accountant and a member of the Institute can certify the Compliance Report of the company where he is a permanent employee.

In his capacity as a part-time COP holder, he is neither authorized to certify the Compliance Report of other group companies nor any other company.

(iii) The company would be required to file individual Form 23C for each product under reference even if the same auditor is appointed for all the products.

Answer 8. (b)

The Companies (Cost Accounting Records) Rules 2011 [CARR] is now applicable to all companies engaged in production, processing, manufacturing & mining. Hence, product-wise/activity-wise cost of production and cost of sales would be available from the Cost Accounting Records of all the products/activities, irrespective of whether these are covered under cost audit or not.

It may further be noted that in such a situation, the company would also be required to file a compliance report and for this purpose, product-wise/activity-wise cost of production and cost of sales would be determined to prepare the reconciliation statement as required in the compliance report.

Q. 9. (a) The following data have been collected by you, as a Cost Auditor of a Company :

Particulars	**09-10**	**10-11**	**11-12**
Installed Capacity (lac MT)	**2.5**	**2.5**	**2.5**
Production (lac MT)	**2.4**	**2.3**	**1.25**
Cost/MT of the product (`)	**1000**	**1077**	**1660**

The poor capacity utilization in 2011-12 was due to abnormal power cut. The escalation in costs were 5% in 10-11 and 2% over 10-11 in 2011-12.

(i) Calculate the abnormal cost due to power cut.

(ii) How would you treat these abnormal cost?

(b) As a Cost Auditor of a manufacturing company, furnish your suggestions and observations based on following information: (You may make necessary assumptions) :

Particulars	2011	2010
Profit (₹ In lacs)	**250**	**340**
Capacity Utilisation	**90%**	**95%**
Consumption of Electricity/Tonne of output (KWH)	**4.07**	**3.98**
Capital Employed (₹ In lacs)	**1200**	**1100**
Salaries and Wages ₹ In lacs)	**117**	**98**
Production (MT)	**180000**	**190000**

Answer 9. (a)

Particulars	09-10	10-11	11-12
Installed Capacity (lac MT)	2.5	2.5	2.5
Production (lac MT)	2.4	2.3	1.25
% of Capacity Utilisation	96	92	50
Cost per unit (₹/MT)	1000	1077	1660
Escalation factor	100	105	107
Cost at Base Year price	1000	1025	1551
Total cost of production (₹ in lacs)	2400	2359.8	1938.75
Variable cost /MT	402	402	402
Fixed cost /MT	598	623	1149
Fixed cost@100% utilisation	574		

Hence, increase in Fixed Cost /MT due to poor capacity utilization in 2011-12 is = 1149-574 = ₹ 575.

(i) Abnormal cost due to power cut = 575 × 1.25 = ₹ 718.75

(ii) The abnormal cost must be excluded from computation of Cost.

Working Notes :

As compared to 09-10	10-11	11-12
(A) Difference in total cost (₹ in lacs)	2400-2359.8 = 40.2	2400-1938.75 = 461.25
(B) Difference in Production (lac MT)	2.4-2.3 = 0.1	2.4-1.25 = 1.15
Variable Cost/MT (₹) (A)/(B)	402	402 approx

Answer 9. (b)

Cost Auditor's Observations and Conclusions :

The profit of the company has declined by ₹ 90 lacs during the year 2011, as compared to the year 2010.

This may be due to the following reasons:

(i) Production during the year 2011 has decreased by 10,000 MT. This is perhaps due to underutilization of capacity from 95% to 90%. It may also be due to scarce power supply.

(ii) Based on further analysis and scrutiny, it is noted that the cost of production/Tonne has increased (Assumption.)

(iii) It has also come to light that the price of the product in the market has declined. This may be due to stiff competition. (Assumption)

(iv) Profit as a % of Capital Employed has declined from the figure of 30.9% in 2010 to 20.8% in the year 2011. This is partly due to decline in the amount of profit and partly due to increase in capital employed.

(v) The consumption of electricity in terms of KWH/Tonne of output has increased from 3.98 in 2010 to 4.07 in 2011. This is a serious matter which need investigation and necessary action is to be initiated.

(vi) There is an increase in the Salaries and Wages by ₹ 19 lacs. This is due to the following reasons:

(A) Increase in ₹ 7 lacs due to increments and promotions. (Assumptions)

(B) Increase in ₹ 3 lacs due to additional DA paid to the workers. (Assumptions)

(C) Remaining ₹ 9 lacs is due to employment of new workers. (Assumptions)

Engagement of these new workers is not justified on economic considerations and this has resulted in excessive idle time. Additional work needs to be created for these workers.

Q. 10. How do you define the following under Generally Accepted Cost Accounting Principles?

(a) Value of self manufactured materials.

(b) Cost of cane supplied from own farm to sugar mill.

(c) Depot.

(d) Packing Material Development Cost.

Answer 10. (a)

Self manufactured materials (and self manufactured components and sub assemblies) are valued at cost including Direct Material Cost, Direct Employee Cost, Direct Expenses, Factory Overheads and share of Administrative Overheads relating to production. Share of other Administrative Overheads, Finance Cost and Marketing Overheads are excluded.

Answer 10. (b)

The cane supplied from own farm to a Sugar Mill is charged at State Advisory Price/Control Rate and profit/loss on farm taken to Profit & Loss Account directly. This is permitted by the Cost Accounting Record Rules for Sugar Industry. Such a treatment is advised where the correct determination of cost of the production of items procured from own farm is fraught with difficulty.

Answer 10. (c)

Depot is the bounded premises / place managed internally or by an agent, including consignment agent and C & F agent, franchisee for storing of materials / goods for further dispatch including the premises of Consignment Agent and C&F Agent for the purpose.

Depot includes warehouses, go-downs, storage yards, stock yards etc.

Answer 10. (d)

Packing Material Development Cost is the cost of evaluation of packing material such as pilot test, field test, consumer research, feedback, and final evaluation cost.

Q. 11. (a) How would you treat Self manufactured packing material as per CAS9 related to Packing Material Cost?

(b) How would you compute cost of utilities generated for the purpose of inter unit transfers as per CAS 8?

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

(d) How will you treat an item of Direct Expenses that doesnot meet the test of materiality as per CAS 10?

Answer 11. (a)

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.

Answer 11. (b)

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.

Answer 11. (c)

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 :

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

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

Answer 11. (d)

If an item of Direct Expenses does not meet the test of materiality, it can be treated as part of overheads.

Q. 12. (a) How would you treat Separation cost due to voluntary retirement, retrenchment, termination etc. as per CAS 7 related to Employee Cost?

(b) What is 'equalised transportation cost' under CAS 5?

(c) How would you determine the cost of material consumed in production for captive consumption as per CAS 4?

(d) What are the principles of measuring 'overheads' as per CAS 3?

Answer 12. (a)

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.

Answer 12. (b)

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.

Answer 12. (c)

Material Consumed shall include materials directly identified for production of goods such as :

(i) indigenous materials

(ii) imported materials

(iii) bought out items

(iv) self manufactured items

(v) process materials and other items

Cost of material consumed shall consist of cost of material, duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement. Trade discount, rebates and other similar items will be deducted for determining the cost of materials. Cenvat credit, credit for countervailing customs duty, Sales Tax set off, VAT, duty draw back and other similar duties subsequently recovered/ recoverable by the enterprise shall also be deducted.

Answer 12. (d)

Principles of measuring 'overheads' are as follows :

(i) Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited.

(ii) Overheads other than those referred to in (i) shall be determined on the basis of cost incurred in connection therewith.

For example, machinery spare fabricated internally or a repair job carried out internally will include cost incurred on material, employees and expenses.

(iii) Any abnormal cost where it is material and quantifiable shall not form part of the overheads.

(iv) Finance costs incurred in connection with procured or self generated resources shall not form part of overheads.

(v) Overheads shall not include imputed cost.

(vi) Overhead variances attributable to normal reasons shall be treated as part of overheads.

Overhead variances attributable to abnormal reasons shall be excluded from overheads.

(vii) Any subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(viii) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the overheads.

ix) Credits / recoveries relating to the overheads, material and quantifiable, shall be deducted from the total overhead to arrive at the net overheads. Where the recovery exceeds the total overheads, the balance recovery shall be treated as other income.

(x) Any change in the cost accounting principles applied for the measurement of the overheads shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an entity.

Q. 13. Answer the following in respect of Companies (Cost Audit Report Rules) 2011.

(a) What is the difference between Cost Accounting policy and Cost Accounting system?

(b) Whether Value Addition is to be computed based on Cost record data or audited financial data?

(c) How export benefits are to be treated and shown in the Abridged Cost Statement?

(d) What is the Time limit for submission of Report?

Answer 13. (a)

Cost Accounting Policy of a company should state the policy adopted by the company for treatment of individual cost components in cost determination.

The Cost Accounting system of a company, on the other hand, would provide a flow of the cost accounting data/information across the activity flow culminating in arriving at the cost of final product/activity.

Answer 13. (b)

Value Addition statement is to be computed based on audited financial data.

Answer 13. (c)

Export Benefit is to be considered as a part of Sales.

Answer 13. (d)

The cost auditor shall forward his report referred to in sub rule (1) of the rule 4 to the Central Government and to the concerned company within one hundred and eighty days from the close of the company's financial year to which the report relates.

Q. 14. (a) What constitutes the cost records under Rule 2(e)? Whether the format of "Abridged Cost statement" prescribed in the Companies (Cost Audit Report) Rules, 2011 can be considered as a sample cost statement?

(b) The Companies (Cost Accounting Records) Rules 2011 have not prescribed any specific formats for the cost statements. In what manner and format would the cost statements be kept under these Rules?

(c) Whether product manufactured for 100% captive / self consumption shall be covered under the Companies (Cost Accounting Records) Rules 2011?

Answer 14. (a)

Books of account and other records relating to utilization of materials, labour and other items of cost that provides data/information to compute the cost of production, cost of sales and margin of each of the products/activities of the company on monthly/quarterly/half-yearly/annual basis are considered part of the cost records. It includes statistical, quantitative and other records which enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources. Cost records are required to be maintained on continuous basis from the basic stage of inputs to the final output. There cannot be any exhaustive list of cost records. This would depend on the materiality of cost components in the cost of the product/activity.

The abridged cost statement can be used as a sample cost statement. This may be modified according to the need of the company.

Answer 14. (b)

As per sub rule (2) of Rule 4, the companies are required to maintain cost records on regular basis in such manner so as to make it possible to calculate per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly/quarterly/half-yearly/annual basis. The cost statements are to be prepared for every unit and every product produced, processed, manufactured or mined.

As per sub rule (3), the cost records are to be maintained in accordance with the generally accepted cost accounting principles and cost accounting standards issued by the Institute; to the extent these are found to be relevant and applicable.

Answer 14. (c)

The test of inclusion under the Rules is whether it is a production, processing, manufacturing or mining activity resulting in a product [for definition of "product" refer to Rule 2(m)] intended for use, consumption, sale, transport, store, delivery or disposal and whether the company carrying out the activity falls within the criteria mentioned under Rule 3(1). If the company meets requirement of Rule 3(1), the activity – whether or not for captive/self consumption – will come under the ambit of these Rules.

Q. 15. (a) Certain requirements of audit based on principles of propriety are stipulated in Cost Audit report. Explain the meaning of propriety audit and how this aspect is covered by Cost Audit.

(b) Under what conditions can a firm of Cost Accountants be appointed as Cost Auditors?

Answer 15. (a)

The term 'propriety' has been defined by Kholer as " that which meets the tests of public interest , commonly accepted customs and standards of conduct and particularly as applied to professional performance, requirements of Government regulations, and professional codes." Thus propriety audit is verification of transactions in best interest of public, commonly accepted customs and standards of conduct. Thus propriety audit seeks to ensure that expenditure is not only appropriate to the circumstances, the objectives for which it was incurred are also achieved. The principal standards adopted are as follows :

(i) The expenditure should not be the prima facie more than what is required for the purpose and the person authorizing the expenditure should exercise the same degree of vigilance as he would when dealing with his own money.

(ii) No person having power to authorize expenditure should exercise the power to his own advantage directly or indirectly.

(iii) The funds should not be utilized for benefit of a particular person or group.

(iv) Apart from agreed remuneration /computerization, these should not be left open to any other avenue to indirectly benefit the executives or other employees, and allowances should not be a source of profit for them.

In this context, Cost Audit may be termed as propriety audit as it also seeks to ensure that actual expenditure incurred at each stage of production is appropriate and optimum returns are achieved. The cost auditor has to report on matters which appear to him to be clearly wrong in principle, cases where company's fund have been used in negligent manner etc. These are the areas where the propriety aspect is involved and therefore the aspect is covered by cost audit.

Answer 15. (b)

The Ministry of Corporate Affairs has decided to approve the appointment of cost auditors in firm's name under sub-Section (2) of Section 233-B of Companies Act, 1956 if such proposal is received from Board of Directors of any company subject to the following conditions :

(i) 'All the partners are practicing Cost Accountants within the meaning of Sections 6 and 7 of the Cost & Works Accountants Act, 1959' and

(ii) 'The firm itself has been constituted with the previous approval of the Central Government /Institute as required under Regulation 113 of the Cost and Works Accountants Act, 1959 as amended from time to time.'

When a firm is appointed as Cost Auditors, authentication of Cost Audit Report is to be done by the signature of any one of the partners of the firm in his own hand for and on behalf of the firm. The report should not be signed by merely affixing firm name.

Section II : Operational Audit

Q. 16. (a) Discuss the desirable qualities and functions of a Management Auditor.

(b) Discuss the concept of 'evidence' in relation to Management Audit.

Answer 16. (a)

Management audit is the systematic and dispassionate examination, analysis and appraisal of management's overall performance. In this context the essential qualities of a Management Auditor are :

(i) Ability to grasp the business problems.

(ii) General understanding of the motive, purpose ,and objects of the organization.

(iii) Ability to assist the program of the organization.

(iv) Knowledge about the principles of delegation of authority.

(v) Power of understanding different internal control devices, flow charts, flow of work etc.

(vi) Sufficient knowledge about engineering, statistical techniques, cost and management etc.

(vii) General understanding of all economic legislations like Company Law, Customs, Central Excise, IT etc.

(viii) Ability to prepare reports to various levels of management.

(ix) Capacity to adjust with personnel of different types with tact. Management Auditor should be able to elicit information and capable of discovering intelligently in a meeting and should not disclose own ignorance on any issue.

The functions of Management Auditor are as follows :

(i) He should ensure that all pertinent information needed for planning reaches the higher management.

(ii) He should ensure that decisions are based on the objectives of the management.

(iii) He should ensure that key functions or operations which are profit making are given maximum attention.

(iv) The implication of changes in the budgetary proposals should be projected by him adequately both in respect of direct and indirect taxation, to the top levels of management. Similarly changes in the laws should also be studied by him and implications ascertained.

(v) He should keep himself abreast with developments in information technology and introduce latest methods of information and communication system, consistent with cost benefit studies needed to improve the systems.

Answer 16. (b)

In management audit, there are no fixed items of evidence that has to be checked by the management auditor on routine basis. A management auditor has to rely more on his experience to identify the areas of review, particularly the areas of weakness to overcome, strengths to be exploited, and risks to be properly covered.

The auditor's evidence comes through his discussions with concerned persons in the organizations, survey and review of various reports like internal audit reports, inspection reports, physical verification, monthly performance review statements, minutes and notes and above all personal observations.

Evidence may be gathered through sampling techniques and on basis of results drawn, going into details where required. It should be understood that a management auditor does not depend on voucher as an evidence, but shall fall back on various records including vouchers as evidence for his audit if sample demand so. The evidence should be such that an auditor can draw valid conclusions duly verifying the same with people concerned. There are no area of restrictions for obtaining evidence for a management auditor.

Q. 17. (a) You have been appointed as Management Auditor of a Public Ltd company. State whether the use of quantitative ratios is more effective than the use of financial ratios to gain real insight into the financial statements.

(b) As an internal auditor of DEF Ltd. the Managing Director has asked you to enquire into the causes of abnormal wastage of raw materials during the month of September, 2011.

The wastage percentages are as follows:

June, 2011	**1.3%**
July, 2011	**1.1%**
August, 2011	**1.4%**
September, 2011	**3.8%**

How will you proceed to carry out the Assignment?

Answer 17. (a)

The auditor employs a number of techniques to assess the reliability and validity of financial statements. Ratio analysis is one of such techniques and is a valuable tool for overall assessment. Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such an assessment is necessary in organisations having large volume of transactions and in those organisations following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fail to reveal. In fact, the underlying problems and distortions are brought to light by this procedure.

Quantitative ratios and reconciliations can be used more effectively than the financial ratios by an auditor. More particularly, the objective of management-cum-operational audit is not only to verify compliance with the control but to suggest measures to improve operational environment and thus increase overall productivity. Financial ratios keep changing with the variations in the price level. In a dynamic economy, price levels seldom remain constant and hence comparison of financial ratios over the years becomes vitiated. Quantitative ratios and reconciliations remain unaffected by changes in price. They reflect certain basic relationships and change only if there is a change in the method of operation, technology, degree of automation, product mix, etc. A comparison of quantitative ratios over the years can reveal pertinent and leading indications of the real state of affairs. An auditor can gain a real insight into financial statements through the underlying quantitative data. The various quantitative ratios which may be calculated are input-output ratio for a manufacturing concern, occupancy ratio for hotels, etc. The overall reconciliation statement in case of stocks, membership fees of club, payroll with number of employees etc. will be very useful and effective. To illustrate, in a manufacturing industry, normally, standard input-output ratios available enable the auditor to compare quantity of input with reference to quantity of output and normal production losses involved therein. In fact, input-output ratios shall be of great significance in measuring efficient use of resources not only within the organisation but also to measure the performance of the entity against industry standards.

The nature of quantitative ratios and reconciliations that an auditor can work out in a particular audit would depend upon the actual circumstances of the case. However, the auditor must keep a few general considerations in mind while using quantitative data. Firstly, he should analyse and use such data mainly as an evidence to support the figures in the statements under audit. The quantitative wastages and losses may be so high or so low that the genuineness of the production, sales or stock figures may become doubtful. Secondly, the auditor should try to correlate vital relationships between physical quantities. In this regard the auditor should establish the cause and effect relationship between activities. In many cases the sequence of activities and their predecessor-successor relationships may be used to work out activity ratios. Thirdly, the auditor may attempt to link a physical quantity with its corresponding monetary figure through an estimated average rate. Thus, the number of members of different categories in a club may be multiplied by the average rate of membership fee for each category of membership. This would be a good check on the figure of the total membership fees. Though working out quantitative ratios involve greater strain on the auditor, it is more rewarding.

Answer 17. (b)

The rate of wastage in September, 2011 has risen sharply as compared to previous months. Under the circumstances, before setting for detailed investigation, the internal auditor need to understand the manufacturing environment right from the stage of purchase of materials, the movement of stock flow through the production process while its becomes finished goods. To locate the reasons for the abnormal wastage, the internal auditor should first of all assess the general requirements as under :

(i) Procure a list of raw materials, showing the names and detailed characteristics of each raw material.

(ii) Obtain the standard consumption figures, and ascertain the basis according to which normal wastage figures have been worked out. Examine the break up of a normal wastage into that in process, storage and handling stages. Also obtain control reports, if any, in respect of manufacturing costs with reference to predetermined standards.

(iii) Examine the various records maintained for recording separately the various lots purchased and identification of each lot with actual material consumption and for ascertaining actual wastage figures therein.

(iv) Obtain reports of Preventive Maintenance Programme of machinery to ensure that the quality of goods manufacture is not of sub-standard nature or leads to high scrap work.

(v) Assess whether personnel employed are properly trained and working efficiently.

(vi) See whether quality control techniques have been consistent or have undergone any change.

(vii) Examine inventory plans and procedures in report of transportation storage efficiency, deterioration, pilferage and whether the same are audited regularly.

(viii) Examine whether the basis adopted for calculating wastage for September is the same as was adopted for the other three months.

(ix) Obtain a statement showing break up of wastage figures in storage, handling and process for the four months under reference and compare the results of the analysis for each of the four months.

Some specific reasons for abnormal wastage in process specific may be considered by the auditor are as under :

(A) Examine laboratory reports and inspection reports to find out if raw materials purchased were of a poor quality or were of sub-standard quality. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.

(B) Machine breakdown, power failure, etc. may also result into loss of materials in process. Check the machine utilisation statements.

(C) A high rate of rejections in the finished lots may also be responsible for abnormal wastage; therefore, examine the inspectors' reports in respect of inspection carried out on the completion of each stage of work or process.

(D) It is possible that the wastage may have occurred because the particular lot out of which issues were made in September, 2011 was lying in the store for a long time, leading to deterioration in quality or because of a change in the weather which may have led to the deterioration. Compare the wastage figures of September, 2010 with those of September, 2011.

(E) Abnormal wastage in storage and handling may arise due to the following reasons :

(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 such reconciliation takes place.

(ii) *Accidental, theft or fire losses in storage* The auditor should examine the possibility of these for the purpose.

(F) Examine 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.

Q. 18. (a) Enumerate some of the areas of concern in an audit of indirect taxes.

(b) How will you evaluate the internal control system in the area of credit card operations in a bank?

Answer 18. (a)

Some areas of concern in an audit of indirect taxes would be :

(i) Non availment or short / excess availment of control or expert incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with customs rules.

(iv) Applicability of the relevant control excise exemptions.

(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

Answer 18. (b)

The evaluation of internal control system in the area of credit operations in the bank would have to be done in respect of following aspects:

(i) **Segregation of Responsibilities :** The activities relating to credit card operations can be divided in specific areas, namely, beginning from the receipt of application form, evaluating the credit assessment, sanctioning the issuance of card, making and despatch of card would form part one of operations. Later on, particularly, from the accounting view, the significant operations would include receipt of statement from vendors/merchants, raising bills to customers, realization either by directly debiting the customers' accounts or payment received through cheques, periodic reconciliation, etc. While evaluating internal controls, it would have to be seen that adequate division of responsibilities have been carried out to avoid any collusion and independent checks have been built in the system. While evaluating the internal control, it may also be considered whether some part of the operations have been outsourced or performed in-house.

(ii) **Credit Assessment System :** Each application is scrutinised with reference to different parameters for assessing the credit limits to be awarded. The system must be able to generate exception reports at this stage itself. In fact, at the application stage itself, the system must ensure that the applicant was holding one card earlier or has defaulted in respect of any other agency.

(iii) **Control Over Issuance of Cards :** The internal control system must ensure that the cards are under the control of responsible official. A detailed record along with relevant pin codes, etc. have been kept. See that the system has built-in features that it is almost impossible to make counterfeit cards as also photographs are affixed to prohibit any unauthorized use of the same.

(iv) **Reconciling Merchant Records :** It is to be checked whether the system has built-in flexibility of reporting of the payments to be made to merchants and making prompt payment to them. Simultaneously, it should be seen that customer statements are also generated automatically and dispatched to them.

(v) **Periodic Reconciliation and follow-up :** It may be seen whether periodic reconciliation of customers' accounts is done and regular follow-up of overdue accounts takes place. The person who are responsible for maintaining customers' records are not entrusted with the responsibility of reconciliation and follow-up.

Q. 19. (a) Draft a management audit questionnaire for audit of inventory.

(b) Briefly explain the objectives of Operational Audit.

Answer 19. (a)

A management audit questionnaire for audit of inventory is given below:

Long Range Plans :

- Is inventory management sufficiently qualified to meet long-range company objectives?
- Are long-range inventory management plans coordinated with: production, purchasing and finance?
- Is inventory properly and efficiently stored to reduce obsolescence, pilferage, etc.
- Is there an adequate system to plan inventory in the long run at optimum levels?
- Are inventory plans and procedures audited periodically?

Short or Medium Range Plans:

- Is inventory management sufficiently qualified to meet short or medium range objectives?
- Are inventories under control as to type and amount?
- Are short-range inventory management plans an integral part of production and purchasing?
- Is there an adequate inventory system to plan current inventory at optimum levels detect theft and compare physical to perpetual inventories?
- Are lead times figured into inventory levels for purchasing and manufacturing?
- Are reorder levels set?
- Do the plans include 'make' or 'buy' decisions to lower costs?

Organisation Structure :

- Is the inventory department under directions of a suitable person?
- Are the inventories and their in-plant movements organised and reported by their basic types, i.e., raw materials, work in progress and finished goods?
- Is there an effective system of physical inventory to disclose any irregularities or losses?
- Is the ABC analysis followed for the inventory control?

Communication :

- Is there an information system utilised that employs efficient management, methods and techniques to control inventories and to prepare periodic inventory reports that are of great value to management?

- Is there an effective communication system designed to assist in, keeping the inventory turnover rate high?
- Is there good managerial control over movement of work-in-process materials so that this inventory is kept at a minimum?

Control :

- Are inventory management control reports, methods and techniques integrated with production and purchasing?
- Are inventories properly stored to provide a minimum of:
  - (i) obsolescence?
  - (ii) deterioration?
  - (iii) pilferage?
- Is inventory control integrated with :
  - (i) economic order quantities?
  - (ii) re-order points?
- Have steps been taken to balance the cost generated by too small an inventory against the cost of carrying excessive inventories to determine an optimum inventory turnover?
- Are inventory items physically counted to make sure that perpetual inventory records are accurate?
- Is inventory controlled through the use of the ABC concept (A = high-value items, B = medium-value items, C = low-value items)?
- Is there an effective management control system for receiving materials that are not on a purchase order, i.e., products returned by customers?

Answer 19. (b)

Objectives of Operational Audit:

The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different considerations. Generally, operational audit objectives include :

(i) **Appraisal of controls :** The most significant gain an organisation can derive from operational auditing is probably in the area of appraisal of controls. Internal controls, because of their unobtrusive omnipresence in the organisation, provide the essential hinges to ensure proper performance in each functional or organisational area for accomplishing the desired organisational objective.

(ii) **Evaluation of performance :** In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on. The principal basis of performance evaluation can be productivity, personnel, workload, cost and quality. In the area of productivity, the operational auditor can undertake such tests as input-output ratios for materials and labour in quantitative terms.

(iii) **Appraisal of objectives and plans :** Everything in an organisation is the product of basic plans and objectives set by the management. If the management policy favours installation of controls or specifies the extent of controls whether satisfactory or not, controls would have to stay within the policy frame. Therefore, the basic thing that should be evaluated is management policies, plans and objectives. Operational auditor may look into the aspects like whether objectives are clearly spelt out and properly communicated to the personnel responsible for implementation and whether the personnel have understood the objectives in the sense meant by the management. Also, he can take note of any apparent conflict in the objectives for its effect on operations.

(iv) **Appraisal of organisational structure :** Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. Therefore, this is also another important area for appraisal by the operational auditor. In evaluating organisational structure, the aspects that may be considered by the operational auditor whether the organisational structure in conformity with management objectives and is drawn up on the basis of matching of responsibility and authority.

Q. 20. Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets. State (in brief) the major areas you would examine for the above.

Answer 20.

Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas :

- Any show cause notice, which have not matured into demands but may be material and important.
- Contingent liabilities not shown in books.
- Letters of comforts given to banks and financial institutions.
- Company may have sold some subsidiaries / businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer.
- Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- Tax liability under direct and indirect taxes.
- Long pending sales tax assessment.
- Cases of custom duty where only provisional assessment has been made and final assessment is yet to completed.
- Agreement to buy back shares at a stated price.
- Future lease liabilities.
- Claims against the company including third party claims.
- Unfunded retirement benefit of employees.
- Labour claims under negotiations.

Regularly Overvalued assets : The auditor shall have to specifically examine the following areas :

- Uncollectable receivables.
- Obsolete, slow and non-moving inventories and inventories valued above net realizable value, if any.
- Obsolete and unused plant and machinery and their spares.
- Assets value which have impaired due to sudden fall in market value.
- Assets shown in books above market value due to capitalization of expenditure / foreign exchange fluctuation or capitalisation of revenue expenditure.

- Assets under litigation.
- Investment shown at cost whose market value is much lower.
- Investment carrying very low rate of return.
- In fructuous project expenditure.
- Intangibles of no value.

Q. 21. As a practicing cost accountant do you approve the following? If not, state reasons.

(a) CMA B, a Cost Accountant in practice takes up the appointment as Managing Director of a Public Limited Company.

(b) CMA Y, Chairman of an Audit Committee of a BIC Ltd., who is a cost accountant asked the firm in which he was previously a partner to quote their fee on a success fee basis so as to ensure that a professional work is assigned to such firm.

(c) The offer document of a listed company in which Mr. S, a practicing Cost Accountant is a director mentions the name of Mr. S as a director along with his various professional attainments and spheres of specialization.

Answer 21. (a)

Clause (10) of Part I of the First Schedule to the Cost and Works Accountants Act, 1959 aims to restrain a member in practice from engaging himself in any business or occupation other than that of a cost accountant except when permitted by the Council to be so engaged. Accordingly, in the absence of specific and prior approval cost accountant would be held guilty of professional misconduct.

Answer 21. (b)

Professional services cannot and should not be offered under an agreement which entails that fees shall be payable on a success fee basis. The fees payable, therefore, become contingent in nature. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings is prohibited. Therefore, the action of the firm to quote fees in such a manner on the advice of the Chairman of the Audit Committee to ensure their appointment could not be accorded approval and the member would be held guilty of professional misconduct under Clause (9) of Part I of the Cost and Works Accountants Act, 1959.

(**Note :** In the instant case, the Chairman of Audit Committee who also happens to be a cost accountant would also be guilty of misconduct under the Cost and Works Accountants Act, 1959.)

Answer 21. (c)

The Council of the Institute of Cost Accountants of India has in a communication to members stated that if a public company, in which a cost accountant in practice is a director, issues a prospectus or gives any announcement that gives descriptions about the Cost Accountant's expertise, specialization and knowledge in any particular field, it shall constitute a violation of Clauses 6 and 7 of Part I of the First Schedule to the Cost and Works Accountants Act, 1959. The Council has further stated that in such cases the member concerned has to take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the members. Thus in the instant case, Mr. S would be held to be guilty of professional misconduct and liable for disciplinary action.

Q. 22. (a) Evaluation of the personnel function of an organization by management auditor is by no means an easy task. In your view what areas are to be covered and points to be kept in mind while assessing the personnel function of an organization?

(b) Write short note on – Corporate Governance .

Answer 22. (a)

The personnel management is concerned with managing people at work for development of efficient and loyal employees for attainment of organization goals. So evaluation personnel function is not an easy task. The important areas to be covered by management auditor while evaluating personnel function are as follows :

(i) Methods followed for manpower planning, recruitment , training, promotion and transfers.

(ii) Action plan for reducing absenteeism.

(iii) Procedure for analysis of labour turnover and steps taken for reduction of the same.

(iv) Method adopted for developing wage and salary structure.

(v) Incentives plan –both financial , i.e bonus, increment etc and non financial e.g job enrichment, promotion etc.

(vi) Welfare and safety measures adopted including social security measures and community development programmes.

(vii) Performance appraisal system of the organization.

(viii) Measures undertaken to boost employee morale.

The following points to be kept in mind while assessing the personnel function of an organization :

(i) It is difficult to exactly quantify the influence of human factors and its contribution to success or failure of the organization.

(ii) Development of a uniform yard stick for measurement of performance of a large group of workers is also not easy.

(iii) Workers get influenced by the overall industrial environment.

(iv) Motivating the employees towards achievement of organization goals is a very important as well as difficult task.

(v) The management auditor should assess whether the managers possess necessary leadership qualities and dynamic ideas to motivate their personnel.

(v) The personnel function is a very important function because in the absence of a well organized personnel function, the company will not be able to utilize the other resources in optimum manner. Human resource is the most important resource in any organization.

Answer 22. (b)

Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. The Board of Directors are responsible for governance of their companies. A number of reports and codes of corporate governance have been published internationally. The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. Based on this report, SEBI has by circular in February 2000 directed stock exchanges to amend the Listing Agreement between them and the entities whose securities are listed on such stock exchanges and include a new Clause 49 in such Listing Agreement. Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc. Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

Q. 23. (a) Write short note on – Probable format of environmental statement.

(b) Write short note on Preliminary Report under Peer Review.

Answer 23. (a)

The following are the main aspects which may be covered in the probable format of Environmental Statement :

(i) Name and address of the owner/occupier of the industry, operation or process.

(ii) Date of last environmental audit report submitted.

(iii) Consumption of water and other raw materials during current and previous year.

(iv) Pollution generated in air and water alongwith the output and the types of pollutants and the deviation from standards.

(v) Generation of hazardous waste in current year and previous year from processes.

(vi) Quantity of solid waste generated during current year and previous year and from recycling or reutilisation of waste, etc.

(vii) Disposal practice for different type of waste.

(viii) Practice in operation for conservation of natural resources.

(ix) Additional investment proposal for environmental protection including abatement of pollution.

Answer 23. (b)

In the process of peer review, at the end of the on-site review, the reviewer would send a preliminary report to the practice unit before making any report the Board on the areas in case systems and procedures of the practice unit reviewed have been found to be deficient or where non-compliance with reference to any other matter has been noticed by the reviewer during the course of review. The reviewer has to take care that the report does not contain name of any individual practice unit. However no preliminary report is required if no deficiency or non-compliance is observed. In preparing the report, he should assess the conclusion drawn from the review that indicates deficiency. The report is addressed to the practice unit. The report should also contain a paragraph that discusses the scope of the review. Limitations on the scope of review, if any, with fact thereof should also be communicated in the report. The report should be prepared on the letterhead of the reviewer with date, signature, and membership number and code number allotted to the reviewer.

Q. 24. List the task to be performed by CMAs in practice in the following areas:

(a) Central Excise

(b) Banks

Answer 24. (a)

Central Board of Excise and Customs (CBEC) authorizes Cost Accountants in practice for the following work :

(i) **Special Audit** under Section 14A & 14AA of the Central Excise Act 1944;

(ii) Certification of refund of additional duty of Customs on the goods imported for subsequent sale under Customs Act;

(iii) **Special Audit in certain cases** under Section 11 of Customs Act, 1962, The Chief Commissioner of Customs may, for reasons to be recorded in writing, direct a manufacturer to get the accounts of his warehouse, office, stores, godowns, factory, depot, or other establishment audited by a Cost Accountant, nominated by him in this behalf.

(iv) Under Rule 5 of **Customs valuation (Determination of Value of Export Goods) Rule s, 2007**, the proper officer shall give due consideration to the cost-certificate issued by a Cost Accountant;

(v) Under the **Fixation of brand rate of Drawback without pre-verification - Simplified procedure Scheme**, unless there are any special reasons, drawback rates are to be fixed without pre-verification of the date filed, (which should be duly verified by the applicant and Chartered Accountant/ Chartered Engineers / Cost Accountant) and the exporter would be authorised by provisional brand rate letters issued by the Ministry to claim the drawback rate considered admissible from the concerned Customs House (s);

(vi) **Under Rules 6 and 7 of the Customs and Central Excise Duties Drawback Rules, 1995** the exporters may be asked to furnish the purchase invoice as to the procurement of the raw hides/wet blue leather. They should also furnish a certificate from the Chartered Accountant/Cost Accountant as to the consumption and cost of processing chemicals used for its processing and other incidental overhead charges incurred;

(vii) The Commissioner of Customs/Central Excise may direct the concerned developer to get his accounts audited by a Cost Accountant nominated by him in this behalf. The expenses of and incidental to such audit shall be borne by the concerned developer, vide **Circular No. 52/2002-Customs dated 14th August, 2002;**

(viii) Accepting services of the Cost Accountant's may also be considered by the respective Commissionrates depending upon the extent of complexity of the cases as provided under **Circular No.04/2006 dated 12th January, 2006** in respect Computation of freight of time chartered/daughter vessel and its inclusion in the assessed value as extended cost of transportation;

(ix) **Certified Facilitation Centres (CFCs)- under ACES-CBEC Scheme:** As per MOU with Central Board of Excise and Customs (CBEC), Ministry of Finance, Government of India, Cost Accountants are authorised to act as facilitators under Certified Facilitation Centre Scheme in filing various Excise and Service Tax Returns under the provisions of Central Excise Act and Service Tax Act.

Answer 24. (b)

Banks :

(i) **Compliance Audit** of Reserve Bank of India (India's Central Bank) for the purpose Lending under Consortium Arrangement / Multiple Banking Arrangements, the banks are required to obtain regular certification from professional like Cost Accountants regarding compliance of various statutory prescriptions that are in vogue.

(ii) **Stock Audit and Concurrent Audit** of many Public Sector and Private Sector Banks in India;

(iii) Public Sector Banks have empanelled cost accountants for variety of work viz. Cost Management, Techno-economic Study, Systems, Computerization, ERP, Insurance companies and other Financial Institutions, Financial Management, Project Consultancy, Materials Management, Management Accountancy, Tax Planning, Diagnostic Accounting & Revival of Sick Units, Merchant Banking, Investment Counseling & Portfolio Management, Internal Management and Operational Audits, Organization Structure Review, Training and Executive Selection, Incentive Plans, Productivity, Conservation of Energy and Energy Audit and Environmental Audit etc.

Q. 25. Write short notes on :

(a) Audit Committee

(b) Safeguard Duty

(c) Margin of dumping

(d) Professional behaviour in relation to an accountant

Answer 25. (a)

The Companies (Amendment) Act, 2000 provides for constitution of Audit Committees in case of every public company having paid up capital of ₹ 5 crore and above. The salient features of the Audit Committee are as follows:

(i) The audit committee shall have minimum three directors as members.

(ii) All the members must be financially literate.

(iii) The Chairman shall be an independent director.

(iv) The Company Secretary shall act as secretary to the committee.

(v) The Chairman of the committee shall be present at the Annual General Meeting to answer shareholders' queries.

(vi) The committee shall have powers as follows :

 (1) To investigate any activity.

 (2) To seek information from an employee

 (3) To obtain outside legal or other professional advice.

(vii) The role of the committee shall include the following :

 (1) Reviewing the adequacy of internal control systems.

 (2) Reviewing the performance of statutory and internal auditors.

 (3) Recommending to the Board appointment, reappointment, replacement of Statutory and Internal auditors.

 (4) Reviewing with management the annual financial statements before submission to the board for approval.

 (5) Discussion with statutory and internal auditors before commencement of audit as well as post audit discussions to ascertain any area of concern.

 (6) Carrying out any other function as is mentioned in terms of reference of the audit committee.

Answer 25. (b)

Safeguard Duty is a step in providing a need based protection to domestic industry for a limited period with ultimate objective of restoring free and fair competition. Central Government is empowered to impose 'safe guard duty' on specified imports if it is satisfied that goods are being imported in large quantities and are causing serious injury to domestic industry. Such duty is permissible under WTO agreement, only condition is that discrimination cannot be done among imports from different Most Favoured Nations.

Government has to conduct an enquiry and then issue notification[Section 8B(1) of Customs Tariff Act.] Total period of duty cannot be more than 10 years[sec 8B(4) of Customs Tariff Act]. Once imposed the duty is valid for 4 years unless revoked earlier. Incase of imports from developing countries, such duty can be imposed only if value is more than 3% of total imports of the article in India. [sec 8B(10) of Customs Tariff Act.]

Answer 25. (c)

'Margin of dumping' is the difference between the Normal value and the export price of the goods under reference. It is generally expressed as a percentage of the export price. Both 'normal value' and export price must be compared at the same level, i.e. ex-factory level. 'Normal value' means comparable price at which goods under consideration are sold in ordinary course of trade in the domestic market of the exporting country. 'Export price' is the price at which the goods are allegedly dumped in the importing country.

Answer 25. (d)

The principle of professional behaviour imposes an obligation on professional accountants to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession. This includes actions which a reasonable and informed third party, having knowledge of all relevant information, would conclude negatively affects the good reputation of the profession.

In marketing and promoting themselves and their work, professional accountants should not bring the profession into disrepute. Professional accountants should be honest and truthful and should not :

(i) Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or

(ii) Make disparaging references or unsubstantiated comparisons to the work of others.

The conceptual framework requires a professional accountant to identify, evaluate and address threats to comply with the fundamental principles, rather than merely complying with a set of specific rules, which may be arbitrary. If threats to ethics are not clearly insignificant, a professional accountant should apply safeguards to eliminate the threats or reduce them to an acceptable level.

Q. 26. Write short notes on :

(a) Confederation of Indian Industries (CII)

(b) South Asian Federation of Accountants (SAFA)

Answer 26. (a)

The Confederation of Indian Industry (**CII**) is a non-government, not-for-profit, industry-led and industry-managed organisation, seeking to play a proactive role in India's development process. The organisation works to create and sustain an environment conducive to the growth of industry in **India**, partnering industry and government alike through advisory and consultative processes. The confederation is headquartered in **New Delhi**. CII was established in 1895. The initial partners were five engineering firms, all members of the **Bengal Chamber of Commerce and Industry**.

CII aims to usher change by working closely with government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialised services and global linkages. It also provides a platform for sectoral consensus building and networking. Major emphasis is laid on projecting a positive image of business, assisting industry identify and execute corporate citizenship programmes. CII undertakes research, interacts with key government officials and disseminates information through publications, seminars and events.

One of the USPs of CII has been the uncanny ability of its membership to perceive global trends, build technical capabilities and then spread the trend among the industry members.

'Confederation of Indian Industries' services includes and covers –

- WTO.
- TQM.
- TPM.

- Technology & IPR.
- SME.
- Skills Initiative.
- Library.
- Invest India Services.
- Intellectual Property Rights (IPRs).
- Information Risk Management.
- Green Business.
- Exports.
- Environment Management.
- Energy.
- Defense Technical Assessment and Advisory Service.
- Corporate Advisory.
- Climate Change.

Answer 26. (b)

SAFA as a forum of professional accountancy bodies is committed to positioning, maintaining and developing the accountancy profession in SAARC Region and ensuring its continued eminence in the world of accountancy; in the public interest and towards broad economic development of the region.

Objectives and functions :

SAFA shall, in the public interest work towards strengthening the accountancy profession and subserve in the interest of the broad economic development of SAARC Region. For this purpose SAFA shall undertake such functions as are necessary for achievement of its mission including the following :

(i) to understand the profession in the regional context and continuously work towards its development in keeping with global trends;

(ii) to participate and play the leadership role on the International forums;

(iii) to promote harmonize accountancy profession in SAARC Region and in keeping with global development;

(iv) to play promotional role for the countries within its jurisdiction, where the accountancy profession does not exist or is not sufficiently developed;

(v) to promote and set professional standards;

(vi) to act as interface between international bodies and member-bodies;

(vii) to promote and develop state-of-the-art research compact; and

(viii) to carry out such other activities as are considered incidental or ancillary to the above or considered expedient in furtherance of the development of Accountancy profession in the SAARC Region.

Q. 27. As the Management Auditor of a NBFC, which is engaged in the acquisition of securities and trading in such securities, list out the special points that may be covered in your audit.

Answer 27.

As per RBI Act, 1934, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. A company which is engaged in the acquisition and trading in such securities to earn profit falls in the category of investment company. First of all it is quite important to ascertain the principal business of company since based on the classification of a company, such a company shall have to comply with various positions relating to limits of public deposits, etc. Second most important point would be ensure that the NBFC has complied with registration requirements and a certification of registration should be seen by the auditor. In case of an investment company, the following special points would also have to be given due attention.

(i) *Physical Verification* : Physical verification of all the shares and securities held by a NBFC. When any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified. Necessary certificates from depositories, etc. shall also have to be seen.

(ii) *Compliance with Prudential Norms* : NBFC Prudential Norms stipulate that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities have been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC.

(iii) *Income from Investments* : Dividend income wherever declared by a company, has been duly received by NBFC and interest wherever due (except in case of NPAs) has been duly accounted for. NBFC prudential Norms directions requires dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General meeting and its right receive the payment has been established. Income from bonds/debentures of corporates bodies are to be accounted on accrual basis only if the interest rates on these instruments is predetermined and interest is serviced regularly and not in arrears.

(iv) *Classification of Valuation of Investments* : Classification of investments as to whether the same are current investments or Long Term investments. The application of NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions. Application of the requirements of AS 13 “Accounting for Investments” (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

(v) A list of subsidiary/group companies from the management and investments made in such companies during the year as also ascertain the basis for arriving at the price paid for the acquisition of such shares.

(vi) In terms of NBFC Directions on Prudential Norms, the NBFCs accepting/holding public deposits have to ensure maintenance of minimum prescribed CRAR at all times. The requirement of CRAR is applicable not only on the reporting dates but also on an on-going basis. The compliance with CRAR and other prudential norms is monitored through the half yearly returns on reporting dates (March 31 and September 30). The return is required to be certified by the Managing Director / Chief Executive Officer of NBFC accepting / holding public deposits stating, *inter alia*, that the company has complied with prudential norms and that the CRAR as disclosed in the return has been correctly determined. The statutory auditors of company also append a report to support the veracity of the certificate given by the company.

(vii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verify the agreement entered into with the approved intermediary (i.e., the person through whom the lender will deposit and the borrower will borrow the securities for lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities any provision for the return including pre-mature return of the securities deposited/lent.

(viii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof i.e., dividends, rights, bonus, interest or any other rights or benefit accruing thereon.

Q. 28. (a) Discuss some problems that will be encountered in an EDP system in implementation of internal control.

(b) Briefly discuss- CERA- Audit of C and AG.

Answer 28. (a)

The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programs. Such manual and computer control procedures comprise the overall controls affecting the EDP environment (general EDP controls) and the specific controls over the accounting applications (EDP application controls). The following problems normally arise in implementation of internal control in an EDP system:

(i) *Separation of duties* : In a manual system, separate individuals are responsible for initiating transactions, recording them and the custody of the assets. This separation of duties helps in preventing or detecting errors and other irregularities. In the EDP environment, this traditional segregation of duties may not always apply. For example, a program may reconcile a vendor invoice against a receiving document and print a cheque for the amount owed to a creditor. Thus, the program is performing functions that in a manual systems would be considered incompatible.

(ii) *Delegation of authority and responsibility* : Normally a clear line of authority and responsibility is essential aspect of control in any system. In a computer system, however, delegating authority and responsibility may prove difficult because some resources are shared among multiple users. When multiple users have access to the same data, it is not always easy to trace or find out who is responsible for any corruption of the data and for identifying and correcting errors. Some organizations have attempted to overcome these problems by designating a single user as the owner of data. This user assumes ultimate responsibility for the integrity of the data.

(iii) *Competent and trustworthy personnel* : A good EDP system requires competent and trustworthy personnel for its flawless operation. Highly skilled personnel are needed to develop, modify, maintain and operate the computer systems. Getting competent and trustworthy personnel for working in the EDP environment is, however, difficult as well-trained and experienced people in this field are normally in short supply.

(iv) *System of authorizations* : Any good system of internal control has a system of authorizations at various levels. General authorizations establish policies for the organization to follow; for example, a fixed price list is issued for personnel to use when products are sold. Specific authorisations apply to individual transactions; for example, acquisitions of major capital assets may have to be approved by the board of directors. In a manual system, auditors can evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system, however, the procedures are often embedded within a computer program. In such a case when evaluating the adequacy of authorisation procedures, auditors will not only have to examine the work of the employees but also find out the veracity of program processing.

(v) *Adequate documents and records* : In a manual system, adequate documents and records are necessary to provide an audit trail of the various activities within the system. In a computer system, however, documents may not be used to support the initiation, execution and recording of some transactions. There would be therefore no visible audit trail to trace a transaction. This absence of a visible audit trail will not hinder the auditor's work if systems are designed to maintain a record of all events and there is a means of accessing these records. The auditor therefore needs to find out whether the computer system environment provides for such a record of the events and also enables access to the records.

(vi) *Physical control over assets and records* : Physical control over access to their assets and records is critical in both manual systems as well as computer systems. In computer systems, however, there is a concentration of the data processing assets and records of an organisation. This means that in such an environment, if any fraud is to be perpetrated, the person does not have to go to long distances but only have access to the computer systems. Hence it is important that a good EDP environment restricts access to the data processing assets and records.

(vii) *Adequate management supervision* : In a manual system, the management supervision of employee activities is relatively simple because the managers and employees are often at the same physical location. In computer systems, however, the employees handling the data processing may be remotely located. Supervisory controls must therefore be built into the computer system to compensate for the controls that usually can be exercised through observation and inquiry.

(vii) *Comparing recorded accountability with assets* : In any good system, the data and their assets that the data purports to represent should be compared to determine the completeness and accuracy of the data. In a manual system, there is normally an independent staff to prepare the basic data for such comparison. In a computer system, however, programmes are used to prepare this data. Therefore, care must be taken that there are no unauthorised modifications to this programs or to any of the data files database programs use otherwise the irregularity may not be discovered.

Answer 28. (b)

Comptroller and Auditor General of India also carry out audits of all assessees. These are called 'CERA' i.e. Central Revenue Audit. These audit parties audit accounts of excise as well as customs assessees. C&AG Audit Report shall be submitted to President of India, who causes these to be laid before each House of Parliament. CERA audits are conducted as a part of audit of Government accounts. Thus, these audits are conducted under Constitutional authority and are in no way connected or related to internal audits carried out by the staff of excise department. Frequency of CERA Audits is as per the importance attached and availability of time to CERA audit parties.

Q. 29. (a) As a Management Auditor of a large organization you have been asked to carry out the review of 'Marketing Policies' as a part of corporate development. Prepare a questionnaire for carrying out such a review.

(b) What do you understand by valuation auditunder Central Excise.

Answer 29. (a)

A questionnaire for review of 'Marketing Policies' of the company :

(i) Consumer needs assessment –

- Is the policy rationable in terms of marching customers' needs with the firm's offerings and capabilities?
- What is the likely consumer reaction?
- What are the evaluation studies undertaken to assess consumer reaction, particularly, in respect of –product features, price, distribution outlets, new product concept, new product introduction?

(ii) Market segmentation–

- What is target market conceived?
- Is market segmentation based on empirical data, such as –usage, demographics, benefits sought, consumer characteristics etc?

(iii) Competition and product position –

- How many are competitive producers?
- What is company's share in the total market?

- How many competitors have left the market over the last few years?
- What is the general competitive environment?
- What particular product characteristics does the firm possess that contribute to the market place?
- What is the relative market position of the products at different stages of their 'life cycle'?

(iv) Marketing Mix –

- How is the optimum mix of pricing, distribution and promotional policy for each of the products of firms determined?
- What are the company's approaches to issue like Product Design, Product Positioning, Price – range, advertising and promotion media etc?

(v) Marketing Program –

- Is the marketing program of the company designed to emphasize lower price, mass distribution channels and mass advertising to reach numerous market segments?

(vi) Resource Allocation –

- Does the marketing program take into account the interdependencies among the various options and a resource allocation procedure to direct the company's commitment of resources among products, markets segments and the related marketing strategies to accomplish the objectives?
- If so, how is the resource allocation procedure has been established for different marketing decisions?

Answer 29. (b)

Valuation is one of the most vital and critical aspects 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. Valuation Audit under section 14A can be ordered at any stage of enquiry, investigation or any proceedings before Assistant/Deputy Commissioner regarding assessable value of the goods manufactured by assessee, if the Assistant/Deputy Commissioner is of the opinion that the value has not been correctly declared by a manufacturer or any person. It may be noted that under rule 173C(3), 'enquiry' in respect of 'value' can be made as soon as Invoice is raised or 'Declaration regarding Assessable Value' is filed with Assistant/Deputy Commissioner. The special audit for valuation can be ordered by Dy./Asst. Commissioner with prior approval of Chief Commissioner.

Q. 30. (a) What precautions and safeguards a CMA in practice should take before issuing a certificate to a client? List the qualities of a good certificate/report.

(b) How should a Cost Auditor evaluate MIS of an organization?

Answer 30. (a)

A Cost Accountant in practice has to be very careful in his certification by taking adequate precaution on the information certified particularly when they are in the nature of projections for the future.

In case of facts and past information, he has to certify with reference to proper evidences and records, whereas in the case of projected information he is required to look into the reasonableness of simulated information and apply his fair judgment. A Cost Accountant in practice is required to take adequate care of his professional ethics and code of conduct as prescribed for the profession in all its aspects while giving his certificate.

In cases where alternative methods are available for compiling certain data, the certification shall cover clearly specify the method followed by the Cost Accountant, justifying the reasons for method selected by him. If certain matters are excluded from the purview of certification, such exclusion shall be specifically stated. A Cost Accountant should take adequate care of consistency in the methods followed without which the information may get distorted.

While issuing any certificate/report, a Cost Accountant should ensure that it contains the following information :

(i) Name and address of the concern and the product/purpose for which the certificate is issued.

(ii) It should be in the prescribed form, and where there is no prescribed form it should be in the form that gives the required information.

(iii) It should be based on verified data presented and produced before the practicing Cost Accountant or compiled by him for the purpose.

(iv) It should contain the required explanatory notes, reservation or qualifications depending on the records produced before him.

(v) The primary responsibility for the contents of a certificate/statement rests with the enterprise and therefore a suitable declaration or authentication by the management on the face of the certificate/ statement should be obtained.

(vi) Certified data should also bear signature of a Director or General Manager of the company preceding the matter in the certificate together with explanatory notes as may be essential by the Cost Accountant.

(vii) Every certificate and every page of the statement and appendices attached to the certificate should bear the date, signature and seal of the Cost Accountant.

(viii) The language used and the information presented in the certificate should always be unambiguous and clear to the authorities calling for the certificate.

(ix) If certain items of expenses/income or any other data are excluded from the calculation for issuing the certificate the Cost Accountant should give a proper note in the certificate to this effect.

(x) The certificate should be so drafted as to convey the factual situation without the ambiguity. Subjective opinion should not be expressed unless there are strong grounds to do so and the opinion could be supported by factual data.

(xi) The certificate should be a self-contained document and should include as relevant information, contained in such certificate and not a mere reference to another report or a certificate.

(xii) The certificate should include a statement showing the reconciliation between the figures in the general purpose financial statements and the figures appearing in the report/certificate.

(xiii) The certificate may be addressed to a client, the public authority, or the person requiring it. In appropriate cases, certificates may be issued without reference to any particular person/authority by using the words “to whomsoever it may concern”.

(xiv) A suitable reference to the notes attached to a certificate should be mentioned in the main certificate.

(xv) Where the Cost Accountant wishes to qualify his report, he may indicate such qualifications under “Notes”.

While issuing a certificate a cost accountant should be clear on the following matters :

– Be clear what you are certifying

– Understand precisely the purpose for which the certificate is required and its possible implications.

– Study the relevant Act and Rules affecting the operations to which the certificate is required and its possible implications.

– Study the relevant Act and Rules affecting the operations to which the certificate relates.

– Understand accounting system of the client.

– Study relevant case laws on the topic to determine any accounting principle that could be applied to your client's case.

– Verify as much data as you need to enable you to give an opinion.

– Keep notes of your verification drill and file working papers properly for easy access at a later date, if need be.

– Draft your report carefully.

– You should be responsibly certain and definite on facts (which you must state along with their sources). You must give valid reasons for your opinions (including citation of authorities, if required).

– In matters of verification and certification, checking of the figures and tracing them in the books of accounts is a must. At the same time, depending upon the volume of data, a cost accountant may adopt sampling techniques.

– Books of accounts and other registers/report is scrutinized and verified shall be affixed with the official seal and initial. Technical data should not be quoted unless absolutely necessary and unless your source of information is dependable.

– As a professional, the Cost Accountant should be consistent, logical and factual. Consistency should be not only with one's own opinion expressed earlier or in respect of some other client, but also with views expressed by other accountants also.

– Cross check the information certified with similar information available in any other context and reconcile it. The reasonableness of the data certified should be established.

– Apply uniform accounting/cost accounting principles consistently.

– Ascertain if there are any control systems in existence and if so, the controls can be a great help in ascertaining the accuracy of the figures. If they do not exist or not disclosed, the Cost Accountant should develop controls to present as accurate as assessment as possible.

– Whether adjustment is made for exceptional items of income and expenditure.

It is essential to obtain an appointment letter in writing, to avoid any misunderstanding, with scope and items and reference of the assignment. Normally certificates are issued whenever specifically required by any specific authority and therefore, it is preferable to address a certificate to a particular authority. In case, an engagement letter is issued in this connection, the certificate may be addressed to an engaging party or to the authority whom the engaging party wishes. The reporting format will vary from case to case depending on the nature of the specific assignment and the circumstances calling for such certificate and also the probable uses of the report. Therefore it is difficult to prescribe any particular form of certificate applicable to all circumstances.

Answer 30. (b)

MIS is an essential managerial tool. It provides for identification of relevant information needs of managers at various levels, collection of data, processing the same to become usable to managers and timely dissemination of processed information to the users to help them to make effective decisions for planning, directing and controlling the respective operations.

A Cost Auditor should take into consideration the following aspects while evaluating MIS of an organization :

(i) Content, quality and source of information;

(ii) Flow of information

(iii) Correlation of information in decision areas.

These points are discussed in detail in the below :

(i) Content, quality and source of information include the following :

(1) Whether the information collected is relevant to the decision problem so as to improve the quality of decisions?

(2) Whether the reporting of MIS is uniform and regular both for financial and nonfinancial information?

(3) Whether the information adequately caters to the needs of the decision makers?

(4) Whether unwanted data is included in the information?

(5) Whether the manager uses the data effective or merely as a post mortem exercise?

(ii) Flow of information: A cost auditor has to proceed on the following lines :

(I) **System organization :**

(A) Whether the system is centralized or decentralized?

(B) How the information flows from various units to the control section?

(C) Estimating the volume of data involved, transmission time and cost.

(D) Benefit-cost analysis of centralized vs. decentralized information.

(II) **Data collection and management :** Appraisal includes the following points :

(A) Data collection methods,

(B) Filtration and classification of data.

(C) Matching of data with decision problems.

(D) Extent of study carried out by management with regard to existing frequency.

(E) Constraints if any in the system design.

(III) Correlation of information in decision areas. The cost auditor is required to appraise this aspect from the following angles :

(A) Whether input- output analysis is attempted?

(B) Whether MIS helps in reducing uncertainty?

(C) Cost effectiveness of MIS.

(D) Effectiveness of information supplied to users.

(E) Provision of feedback by MIS for corrective action.

(F) Ability of MIS to optimize the value of information.