Paper-17 - Cost Audit & Operational Audit

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

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

SECTION I (50 Marks)
(Cost Audit)
Answer Question No. 1 (carrying 14 marks) which is compulsory and answer any two (carrying 18 marks each) from the rest in this Section.

(1)(a) Choose the most correct answer among four alternative statements: **[8×1=8]**

(i) Joint costs are allocated:
(a) Based on a measure of the number of units, weight, or volumn of the joint products.
(b) Based on the values attributed to the joint products.
(c) (a) and (b).
(d) None of the above.

Answer: (c) (a) and (b)

(ii) CAS 6 deals with the following issues:
(a) Principle of Valuation of receipt of materials.
(b) Principle of Valuation of issue of materials.
(c) Assignment of material cost to cost objects.
(d) All of the above.

Answer: (d) All of the above

(iii) Part D, Para 4 of the Cost Audit Report deals with:
(a) Product group details.
(b) Quantitative information of each product group separately.
(c) Financial Position and ratio analysis (for the company as a whole).
(d) Abridged cost statement for each product group separately.

Answer: (c) Financial Position and ratio analysis (for the company as a whole).

(iv) The Cost Accounting Standard which deals with the principles and methods of classification, measurement and assignment of Direct Expenses, for determination of the cost of product or service, and the presentation and disclosure in cost statements, is:
(a) CAS-6;
(b) CAS-10;
(c) CAS-11;
(d) CAS-9.

Answer: (b) CAS -10

(v) The Cost Audit and Assurance Standard which deals with Planning an Audit of Cost Statements, is:

a. CAAS-101;

b. CAAS-102;

c. CAAS-103;

d. CAAS-104.

Answer: a. CAAS-101

(vi) As per ----------------- Outward Transportation Cost shall form part of cost of sales. (Fill in the gap from the below)

a. CAS-5
b. CAS-6
c. CAS-9
d. CAS-10

Answer: a. CAS -5

(vii) Profit Reconciliation under Part D, Para 2 of the Cost Audit Report to be furnished for:

a. Last year only;

b. Previous three years;

c. Current year and previous 2 years;

d. Current year and previous year.

Answer: d. Current year and previous year.

(viii) The main purpose of 'efficiency Audit' is to ensure that -

a. Every rupee invested gives optimum returns
b. Planned expenditure gives optimum returns
c. Various policies of management are implemented
d. Activities of business are beneficial to Society at large

Answer: a. Every rupee invested gives optimum returns

(b) State whether the following statements are TRUE or FALSE with justification for your answer. No credit will be given for merely answering TRUE or FALSE — without giving any justification/reasoning: [6×1=6]

(i) Dumping is an 'illegal' practice.

Answer: False. Dumping is an 'unfair' practice.

(ii) Assurance engagements involve three separate parties.

Answer: True. The parties are a public accountant in practice, a responsible party and intended users.

(iii) Excise Audit 2000 was initiated from 1st April 2000.

Answer: False. Excise Audit 2000 was initiated from 1st December 1999.

(iv) "Firm of Cost accountants" should have at least two partners who are practicing Cost Accountants.

Answer: False. "Firm of Cost accountants" means sole proprietorship concern, the sole proprietor of which is a Cost Accountant in Practice or a firm, wherein all partners are Cost Accountants and such firm is approved by the Council.

(v) GATT and its agreement are permanent.

Answer: False. GATT was ad hoc and provisional

(vi) "Organisation Development" (OD) is a "Sensitivity Training" intervention.

Answer: True. The most commonly used Organizational Development intervention is sensitivity training. It is called laboratory training as it is conducted by creating an experimental laboratory situation in which employees are brought together, in groups, to interact in an unstructured environment. The members are encouraged to interact with new members and new individual behaviors.

(2)(a) VRC Ltd. has its own power plant, which has two users, Cutting Department and Welding Department. When the plans were prepared for the power plant, top management decided that its practical capacity should be 1,50,000 machine hours. Annual budgeted practical capacity fixed costs are ₹9,00,000 and budgeted variable costs are ₹4 per machine-hour. The following data are available:

	Cutting Department	Welding Department	Total
Actual Usage in 2013-14 (Machine hours)	60,000	40,000	1,00,000
Practical capacity for each department (Machine hours)	90,000	60,000	1,50,000

Required:

(i) Allocate the power plant's cost to the cutting and the welding department using a single rate method in which the budgeted rate is calculated using practical capacity and costs are allocated based on actual usage.

(ii) Allocate the power plant's-cost to the cutting and welding departments, using the dual – rate method in which fixed costs are allocated based on practical capacity and variable costs are allocated based on actual usage.

(iii) Allocate the power plant's cost to the cutting and welding departments using the dual-rate method in which the fixed-cost rate is calculated using practical capacity, but fixed costs are allocated to the cutting and welding department based on actual usage. Variable costs are allocated based on actual usage.

(iv) Comment on your results in requirements (i), (ii) and (iii). **[10 Marks]**

Solution:

(a) Working notes:

1. Fixed practical capacity cost per machine hour:

Practical capacity (machine hours)	1,50,000
Practical capacity fixed costs (₹)	9,00,000
Fixed practical capacity cost per machine hour (₹9,00,000/1,50,000 hours)	₹ 6

2. Budgeted rate per machine hour (using practical capacity):
= Fixed practical capacity cost per machine hour + Budgeted variable cost per machine hour
= ₹6 + ₹4 = ₹10

(i) Statement showing Power Plant's cost allocation to the Cutting & Welding departments by using single rate method on actual usage of machine hours

	Cutting Department	Welding Department	Total
Power plants cost allocation by using actual usage (machine hours) (Refer to working note 2)	6,00,000 (60,000 hours × ₹ 10)	4,00,000 (40,000 hours × ₹ 10)	10,00,000

(ii) Statement showing Power Plant's cost allocation to the Cutting & Welding departments by using dual rate method

	Cutting Department	Welding Department	Total
Fixed cost (Allocated on practical capacity for each department i.e.): (90,000 hours: 60,000 hours)	5,40,000 (₹9,00,000 × 3/5)	3,60,000 (₹9,00,000 × 2/5)	9,00,000
Variable cost (Based on actual usage of Machine hours)	2,40,000 (60,000 hours × ₹4)	1,60,000 (40,000 hours × ₹4)	4,00,000
Total cost	7,80,000	5,20,000	13,00,000

(iii) Statement showing power plant's cost allocation to the cutting & Welding departments using dual rate method

	Cutting Department	Welding Department	Total
Fixed cost (Allocation of fixed cost on actual usage basis (Refer to working note 1)	3,60,000 (₹60,000 × 6)	2,40,000 (₹40,000 × 6)	6,00,000
Variable cost (Based on actual usage)	2,40,000 (60,000 hours × ₹4)	1,60,000 (40,000 hours × ₹4)	4,00,000
Total cost	6,00,000	4,00,000	10,00,000

(iv) Comments:

Under dual rate method, under (iii) and single rate method under (i), the allocation of fixed cost of practical capacity of plant over each department *are* based on single rate. The major advantage of this approach is that the user departments *are* allocated fixed capacity costs only for the capacity used. The unused capacity cost ₹ 3,00,000 (₹ 9,00,000 - ₹ 6,00,000) will not be allocated to the user departments. This highlights the cost of unused capacity. Under (ii) fixed cost of capacity *are* allocated to operating departments on the basis of practical capacity, so all fixed costs *are* allocated and there is no unused capacity identified with the power plant.

(b) Basic pay ₹5,00,000; Lease rent paid for accommodation provided to an employee ₹2,00,000, amount recovered from employee ₹40,000, Employer's Contribution to P.F. ₹75,000, Employee's Contribution to P.F. ₹75,000; Reimbursement of Medical expenses ₹67,000, Hospitalisation expenses of employee's family member borne by the employer ₹19,000, Festival Bonus ₹30,000, Festival Advance ₹30,000. Compute the Employee cost. (5 Marks)

Solution:

Computation of Employee Cost

Particulars		**Amount (₹)**
	Basic Pay	5,00,000
Add	Net cost to employer towards lease rent paid for accommodation provided to an employee [= lease rent paid less amount recovered from employee] = [2,00,000 (-) 40,000]	1,60,000
Add	Employer's Contribution to PF	75,000
Add	Reimbursement of Medical Expenses	67,000
Add	Hospitalisation expenses of employee's family member paid by the employer	19,000
Add	Festival Bonus	30,000
	Employee Cost	**8,51,000**

Note:

(i) Festival advance is a recoverable amount, hence not included in employee cost.

(ii) Employee's contribution to PF is not a cost to the employer, hence not considered.

(c) State the meaning of Captive Consumption. What types of goods covered under CAS-4? (3 Marks)

Answer:

Meaning of Captive Consumption:

"Captive Consumption" means that the goods are not sold by the assessee but are used for consumption by him or on his behalf in the production or manufacture of other articles in the same premises or elsewhere.

When goods manufactured are supplied to a related party who does not sell the goods but consumes the same in manufacture of another product(s), such goods are also deemed to be "captively consumed" for the purpose of valuation under Excise Laws.

In some cases during the manufacture, certain intermediate goods emerge and are used in manufacture/production of other goods. The use of such intermediate product within the factory is also termed as "Captive Consumption".

Sometimes the goods are not removed from the factory but are used in the further manufacture/production of goods and in such cases also, duty is payable as soon as the goods are manufactured/produced within the factory unless exempted. Goods captively consumed in the same factory of the manufacturer are exempted from duty as per Notification No. 67/95-CE dt.16.03.1995, if duty is payable on the final product. For example, the manufacturer of motor vehicles manufactures various parts of the motor vehicles like brakes, panels etc. These parts are also excisable goods and have separate entry in the schedule to Central Excise Tariff Act, 1985. If these parts are removed from the factory, duty is payable but if these parts are used in the same factory of the manufacturer in the assembly / further manufacture of motor vehicles then the use of parts and components is called as captive consumption, and is not subject to excise duty in view of above notification.

Type of Goods:

Following type of goods are covered under CAS-4:

1. Goods manufactured not sold but captively consumed.
2. Goods manufactured partly sold and partly captively consumed.
3. Goods manufactured sold to related party for captive consumption.

(3)(a) Whether finance costs incurred in connection with the acquisition of materials shall form part of material cost? (3 Marks)

Answer:

Finance costs incurred in connection with the acquisition of materials shall not form part of material cost.

Finance costs are interest and the like, on borrowed funds. Finance costs are excluded from cost of material. The letter of credit charges are for credit risk or a transaction risk (demand bill) and are part of bank charges which form part of administrative overheads.

Sometimes goods are kept in bonded warehouse and clearance of goods is delayed. This may happen due to any financial stringency delaying the payment to the bank. Such payments of storage are to be excluded from cost of material calculation and are dealt with in the financial accounts.

(b) How would you deal the following items in the cost accounts of a manufacturing concern?

(i) Research and Development Cost;
(ii) Packing Expenses;
(iii) Fringe Benefits;
(iv) Expenses on Removal and Re-erection of Machinery;
(v) Training Costs. (3×5=15 Marks)

Answer:

(i) Research and Development Cost:

Research and Development Cost is the cost/expense incurred for searching new or improved products, production method's/techniques or plants/equipments. Research Cost may be incurred for carrying basic or applied research. Both basic and applied research relates to original investigations to gain from new scientific or technical knowledge and understanding, which is not directed towards any specific practical aim (under basic research) and is directed towards a specific practical aim or objective (under applied research).

Treatment in Cost Accounts

Cost of Basic Research (if it is a continuous activity) shall be charged to the revenues of the concern. It may be spread over a number of years if research is not a continuous activity and amount is large.

Cost of applied research, if relates to all existing products and methods of production then it should be treated as a manufacturing overhead of the period during which it has been incurred and absorbed. Such costs are directly charged to the product, if it is solely incurred for it.

It applied research is conducted for searching new products or methods of production etc., then the research costs treatment depends upon the outcome of such research. For example, if research findings are expected to produce future benefits or if it appears that such findings are going to result in failure then the costs incurred may be amortised by charging to the Costing Profit and Loss Account of one or more years depending upon the size of expenditure. If research proves successful, then such costs will be charged to the concerned product.

Development Costs, begins with the implementation of the decision to produce a new or improved product or to employ a new or improved method. The treatment of development expenses is same as that of applied research.

(ii) Packing Expenses:

It includes the expenses incurred on wrapping, tying, bottles, boxes, containers or bags etc. In

Cost Accounts they are treated as follows:

(i) It is treated as a direct material cost in the case of those products which cannot be sold without the use of a packing. For example Ink-pot; Bread; Paste etc.

(ii) It may be treated as distribution overhead if packing expenses are incurred, to facilitate the transportation of finished products.

(iii) It may be treated as advertisement cost and included in selling overheads if it is incurred for advertisement to make the product attractive.

(iii) Fringe Benefits:

Additional benefits paid to the employees of a concern and are not related to the direct efforts of the employees, are called fringe benefits. They include holiday pay; leave pay; employer's contribution to provident fund; gratuity and pension schemes; slate insurance; medical benefits; subsidised canteen facility etc.

Expenditure incurred on fringe benefits in the case of factory workers should be treated as factory overheads and are apportioned among all the production and service departments on the basis of the number of workers in each department.

Fringe benefits to office and selling and distribution staff should be treated as administration and selling and distribution overheads respectively and are recovered accordingly.

(iv) Expenses on Removal and Re-erection of Machinery:

Expenses are sometime incurred on removal and re-erection of machinery m factories. Such expenses may be incurred due to factors like change in the method of production an addition or alteration in the factory building, change in the flow of production, etc. All such expenses are treated as production overheads. When amount of such expenses is large, it may be spread over a period of time.

If such expenses are incurred due to faulty planning or some other abnormal factor, then they may be charged to Cost Profit and Loss Account.

(v) Training Costs:

These costs comprises of — wages and salaries of the trainees or learners, pay and allowances of the training and teaching staff, payment of fees etc. for training or for attending courses of studies sponsored by outside agencies and cost of materials, tools and equipments used for training, costs incurred for running the training department, the losses arising due to the initial lower production, extra spoilage etc. occurring while providing training facilities to the new recruits.

All these costs are booked under separate standing order numbers for the various functions. Usually there is a service cost centre, known as the Training Section, to which all the training costs are allocated. The total cost of training section is thereafter apportioned to production centres.

(4)(a) State the needs & elements of planning in a Cost Audit? (6 Marks)

Answer:

Planning and Structuring the Cost Audit

Need for Planning an Audit.

The Cost Auditor should always plan to conduct an effective cost audit in an efficient and timely manner. This is very necessary to attain objectives of the cost audit. Audit plan for new client will be generally more detailed than in case of a repeat audit. In case of new audit, the cost auditor has to collect all information about the company like nature of business, organization structure, key personnel, accounting system etc. Similarly, he has to also collect information about other peers in the industry, nature of problems etc. The details required shall be much less in case of a repeat audit. The proper planning helps in:

(a) appropriate attention to all the areas for comprehensive audit;

(b) identification of key areas needing more attention;

(c) timely completion of work;

(d) optimum utilization of assistants;

(e) no overlapping and proper co-ordination between the work done by different assistants, other auditors and experts.

Elements of Planning:

Planning of cost audit involves:

(a) Familiarization about the company and applicable cost accounting record rules;

(b) Collection of all relevant information;

(c) Evaluation of internal control procedures and the system;

(d) Preparation of appropriate cost audit programme; and

(e) Audit of working papers and cost sheets.

Cost Built up, Cost Audit Report and Compliance Report.

(b) Discuss the essential features of a cost accounting system. (6 Marks)

Answer:

Essentials

If a cost accounting system is to effectively serve the various purposes set forth e, it must incorporate in itself the following essential features.

a) Recognition of Diverse Behaviour of Cost Components

Cost of a product, a process or function comprises of several components, such as raw materials, direct operating labour, electricity, rent etc. It is now well recognized that all these do not behave in similar fashion with respect to volume of output and/or time. Obviously, larger quantities of raw materials are necessary to produce larger volumes of a finished product. However, supervision and rent might remain the same as long as the increased production can be handled with existing facilities.

b) Fixation of Control Responsibility for various Costs

A cost accounting system must recognize that control of costs be best exercised at the source. This implies that costs can be appropriately controlled by persons which in fact incur or have authority to incur them. Since the authority to incur various costs is not vested in one individual or place in the organization but is delegated to several individuals and functional areas throughout the organization, it is obvious that the control responsibility for various costs must likewise fall on several persons or places in the organization. A cost accounting system must, therefore, appropriately assign responsibility for different types of costs and must provide for classification, accumulation and reporting of cost information in accordance with control responsibility which in turn will aid the management in exercising effective control.

c) Provision of Yardstick for Performance Management

From control angle, the knowledge of actual cost of a product, a process, an event or an activity is not enough in itself. Simultaneously, one would like to know just how much it should have been in normal circumstances, and further would like to compare the actual with what "should have been". In other words, one would desire to measure one's own cost performance or the cost performance of those responsible to him. The measurement of cost performance helps to reveal and direct attention to the inefficient areas.

(c) What are the objectives and functions of the Cost Audit and Assurance Standards? (6 Marks)

Answer:

Objectives and Functions

The following are the objectives and functions of the Cost Audit and Assurance Standards

Board:

a) To identify areas in which Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services need to be developed.

b) To develop Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services so that they may be issued under the authority of the Council of the Institute.

c) To develop Guidance Notes on issues arising out of any Standard or on auditing issues pertaining to any specific industry or on generic issues so that they may be issued under the authority of the Council of the Institute.

d) To formulate and issue Technical Guides, Practice Manuals and other Papers under its own authority for guidance of Cost Accountants in the cases felt appropriate by the Board.

e) To review the existing Standards, Guidance Notes, Technical Guides, Practice Manuals and other Papers to assess their relevance in the changed conditions and to undertake their revision, if necessary.

f) To provide Interpretations or formulate General Clarifications, where necessary, on issues arising from the Standards.

SECTION II (50 Marks)

(Operational Audit)

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

5. (a) Fill in the blanks in the following sentences by using appropriate word(s)/ phrase(s) : **[8×1=8]**

(i) The main emphasis of Management Audit is problem <u>identification</u> rather than problem solving.

(ii) Pareto distribution is technique used in <u>inventory</u> control.

(iii) <u>Corporate Governance</u> is needed to create corporate culture of transparency.

(iv) SALVAGE is considered as <u>credit</u> by insurer against what is owed under the policy for an insured loss.

(v) Operation audit is an audit for the <u>management</u>.

(vi) Operational auditing concentrates on effectiveness, efficiency and economy of operations and therefore it is <u>future oriented</u>.

(vii) Operational audit is considered as a <u>specialized management information</u> tool to fill the void that conventional information sources <u>fails</u> to fill.

(b) State whether the following statements are TRUE or FALSE with justification for your answer. No credit will be given for merely answering TRUE or FALSE — without giving any justification/reasoning : **[6×1=6]**

(i) Operational audit is a part of Internal Control.

Answer:

No. Operational audit is not a part of Internal Control. This is over and above the regular internal control system.

(ii) The main function of the operational audit is to safeguard the assets of the enterprise.

Answer:

No. The main function of the operational audit is to provide suggestions for improvement.

(iii) Operational Audit's focus is on effectiveness of management decisions and actions.

Answer:

No. Operational audit's focus is on efficiency and economy in operations.

(iv) The efforts which are directed towards humanizing and harmonizing the jobs and their content are collectively knows as "Job Enlargement".

Answer:

False – The efforts, which are directed towards humanizing and harmonizing the job and their content are collectively known as "Job Enrichment" and not "Job Enlargement".

(v) Consumerism is a movement protecting the interest of the consumers.

Answer:

True – The statement is true.

(vi) Principles of management audit remain valid irrespective of the nature of an enterprise.

Answer:

True – Irrespective of the nature of an enterprise, the principles of Management Audit will remain valid.

(6)(a) What are the scopes of internal control of a company. (6 Marks)

Answer:

Scope of internal control

Internal control is an essential pre-requisite for efficient and effective management of any organisation and is therefore, a fundamental ingredient for the successful operation of the business in modern days. In fact, an effective internal control system is a critical success factor for any organization in the long term. They are indispensable tools for the ever-increasing risks, exposures, and threats to accounting systems, data, and assets. It embraces the whole system of controls – financial, operational or otherwise, established by the management in the functioning of a business including internal check, internal audit and other forms of control. In fact, internal control has now been recognized as fundamental and indispensable to modern auditing. Thus internal control has its all-embracing nature and is concerned with the controls operative in every area of corporate activity as well as with the way in which individual controls interrelate.

The scope of internal control, according to the aforesaid definitions, extends well beyond accounting control. Thus, the latest definition of internal control encompasses operational controls like quality control, work standards, budgetary control, periodic reporting, policy appraisals, quantitative control, etc., as all parts of the internal control system. In an independent financial audit or the statutory audit, the auditor is concerned mainly with the financial and accounting controls. However, in an operational audit (as part of internal controls), the auditor reviews all the controls including operational functions. The internal controls can be broadly classified into following four main categories: financial & accounting controls, administrative controls, operational controls and compliance controls.

(i) Administrative control – Administrative controls include all types of managerial controls related to the decision-making process. An example of administrative controls is the maintenance of records giving details of customers contacted by the salesmen.

(ii) Operational control – This is exercised through "management accounting" techniques viz. budgetary control, standard costing etc.

(iii) Financial and Accounting control – This control refers primarily the management plans, objectives and procedures that are concerned with the safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records, and timely preparation of reliable financial information.

(iv) Compliance control - These controls aim at ensuring compliance with applicable laws and regulations. These Controls also help to ensure compliance with laws regarding the system and intellectual property.

(b) What are the factors need to be considered while designing an internal control system?

(6 Marks)

Answer:

While designing an internal control system, the following factors must be considered to ensure greater chances of successful internal control system.

- **Segregation and Rotation of duties:** It is very necessary for successful internal control system that no one person handles the complete transaction i.e., those who physically handle assets are not those who record the asset movements also. The systems are so designed that no single individual is responsible for all the stages involved in a transaction i.e., duties are allocated in such a way that no single individual has an exclusive control over any one transaction or a group of transactions. Similarly, the people responsible for authorizing these transactions or reconciling of the records should also be different i.e., the work done by one person is either complementary to the work done by other person or the accuracy or correctness of work done by one person is independently checked by another person. The broad functions which are generally segregated are:

  (a) Execution of transactions;

  (b) Authorization of transactions;

  (c) Maintenance of records and documents; and

  (d) Physical custody of related assets.

  Apart from segregation of duties, it is sometimes considered more desirable to rotate the duties of various officers and staff in an attempt to ensure that a fraud or error, if any may not remain undetected for a very long time. It also ensures that a person does not develop a vested interest by holding to a post for a very long time. In addition, it removes the impression of indispensability about an employee. This also ensures that the job profile of each post is well defined because employees can be rotated only if the content of each respective job is well defined.

- **Competence and integrity of people:** Internal control systems are not an end to themselves unless these systems are manned by the competent people, who are honest enough to consistently do so. The controls to be successful and effective necessitate the need for competent people to enforce such controls. In other words, the presence of detailed procedures may have no meaning unless these procedures are carried by the competent people, who can also envisage the changes required in the system over a period of time.

- **Appropriate levels of authority.** A common error usually made is to grant too much authority within control boundaries. Sometimes, this is deliberately done to expedite the things or to handle the emergencies. This is sometimes done to reduce the number of people i.e., cost reduction. However, controls to be effective require the authority to be granted on a need-to have basis only. If there is no need for a particular person to have a specific authority, he/she should not be granted such authority.
- **Accountability.** The internal controls to be successful presuppose that there is full accountability for all the decisions taken and there are controls present, which allow the determination with acceptable level of confidence of a person taking particular decision or authorizing particular transaction or took specific action. However, mere presence of these controls may have no meaning or may give a false sense of security unless strict action is taken every time, a discrepancy is noticed. Other wise these controls may be left with no meaning.
- **Adequate resources.** Controls that are enforced with inadequate resources (manpower, finance, equipment, materials, and methodologies) will generally fail whenever they come under stress. Therefore, it is very necessary that minimum resources necessary to enforce the controls must always be present to enable the controls to be successful and effective.
- **Supervision and periodical updation:** Unfortunately, many people prefer to work only if they are being supervised or watched. It is, therefore very necessary for the controls to be adequately supervised and periodically updated in line with changing environment to be effective and successful. For example, in case of banks, if new service i.e., internet banking is also being started, it is very necessary that internal control system is also updated accordingly.

(c) Explain the main area of operation of an internal audit of a company? (6 Marks)

Answer:

Internal audit involves five areas of operations:

1. ***Reliability and integrity of financial and operating information*:** Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measures, classify and report such information.
2. ***Compliance with laws, policies, plans, procedures and regulations:*** Internal auditor should review the systems established to ensure compliance with those policies, plan and procedures, law and regulations which could have a significant impact on operations and reports and should determine whether the organisation is in compliance thereof.
3. ***Safeguarding of Assets*:** Internal auditors should verify the existence of assets and should review the means of safeguarding assets.
4. ***Economic and efficient use of resources:*** Internal auditor should ensure the economic and efficient use of resources available.
5. ***Accomplishing of established objectives and goals for operations:*** Internal auditor should review operation or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.

It is said that scope of internal audit is very much related to business phases. The first phase of business is basically the planning stage, and the decisions are on issues like whether to make or buy, whether to undertake a new project or export etc. These are more of managerial decisions and the scope of internal audit is often not much practical, in the initial stage, unless it takes to what is called management audit. The 2nd phase is the execution stage having its base in the subsequent recording in the books of account. In this stage, the scope of internal audit emerges out of need for correctness of accounts and proper classification of heads in a required manner. The third and final phase is the review of transactions where scope of internal auditing is immense.

(7)(a) What are the documentations required for an internal audit as per Standard on Internal Audit-3? (6 Marks)

Answer:

Internal Audit Documentation (SIA 3):

i. Internal audit documentation should be designed and properly organized to meet the requirements and circumstances of each audit. To formulate policies for standardization of internal audit documentation.

ii. It should be sufficiently complete and detailed for an internal auditor to obtain an overall understanding of the audit.

iii. All significant matters which require exercise of judgment, together with internal auditor's conclusion thereon should be included in the internal audit documentation. Documentation prepared by internal auditor should enable reviewer to understand:
   - the nature, timing and extent of audit procedures performed to comply with SIAs and applicable legal and regulatory requirements;
   - the results of audit procedures and audit evidence obtained;
   - significant matters arising during the audit and conclusions reached thereon; and
   - terms and conditions of an internal audit engagement/requirements of internal audit charter, scope of work, reporting requirements, any other special conditions, affecting the internal audit.

iv. It should cover all the important aspects of an engagement viz., engagement acceptance, engagement planning, risk assessment and assessment of internal controls, evidence obtained and examination/evaluation carried out, review of the findings, communication and reporting and follow up.

v. The internal audit file should be assembled within sixty days after the signing of the internal audit report.

vi. To formulate policies as to the custody and retention of the internal audit documentation within the framework of the overall policy of the entity in relation to the retention of documents.

(b) Prepare the checklist of Purchasing Function. (12 Marks)

Answer:

(i) Purchasing Function Checks

(a) Are there effective arrangements for minimizing the price of purchases, e.g. total purchases for multi location organizations, contract pricing, forward purchasing, quantity controls and correct timing?

(b) What arrangement are there for controlling stock investment, in particular for controlling deliveries of raw materials, perhaps as a result of contracts placed for raw materials to be called off as required?

(c) Is there evidence that the purchasing budget is developing on sound lines?

(d) Is the budget, once prepared, used as an effective control on the purchasing function?
(e) Are 'make-or-buy' proposals made to ensure optimum supply arrangements?
(f) What is the system for synchronizing deliveries with the scheduled production requirements?
(g) What follow-up is there on scheduled deliveries?
(h) Is the receipt of goods adequately controlled?
(i) What procedures are there for dealing with over-deliveries and under-deliveries?
(j) Is there an effective system of inspection of materials received?
(k) Are 100 percent of the goods received inspected, or are they sampled, or what other inspection method is used?
(l) What accounting procedures are there for ensuring that rejected goods are debited to the supplier, either on return, or when scrapped, and for charging the supplier for any re-work done to make the goods acceptable?
(m) Are there any statistical routines to determine the quality standards of suppliers and the rejection rates of goods supplied by them?
(n) Are there similar routines to determine the supplier's relative ability to deliver on time?
(o) Are standards conditions printed on the order forms, and do they adequately cover the purchaser for the commercial and business hazards applying to the purchase of goods? For example, do the conditions make clear whether the carrier is to be construed the agent of the seller or the buyer?
(p) What system is used for validating incoming invoices for goods?
(q) What method of control prevents duplicate payment for goods?
(r) What purchasing measuring are taken to rationalize cash flow and the amount of capital locked up in stocks?
(s) Are there means for assessing buyers' workloads?

(8)(a) Harsh Ltd has the following extract Balance Sheets as on 31 March 2015 and 31 March 2014:

Particulars	**₹ in lakhs**	
	31 March 2015	**31 March 2014**
EQUITY AND LIABILITIES:		
Shareholder's Fund	**2,677**	**1,772**
Loan Funds	**3,470**	**2,983**
	6,147	**4,755**
ASSETS:		
Fixed Assets	**3,566**	**3,000**
Cash & Bank	**389**	**370**
Debtors	**1,895**	**1,568**
Stock	**2,667**	**2,207**
Other Current Assets	**1,667**	**1,504**
Less: Current Liabilities	**(4,037)**	**(3,894)**
	6,147	**4,755**

The Income Statement of the Harsh Ltd for the year that ended is as follows:

	₹ in lakhs	
	31 March 2015	**31 March 2014**
Sales	**24,265**	**14,982**
Less: CGS	**22,960**	**13,644**
GP	**1,305**	**1,338**
Less: Selling, General & Administrative Expenses	**1,035**	**652**
Earnings before Interest and Tax (EBIT)	**270**	**686**
Less: Interest Expense	**113**	**105**
Profit before tax	**157**	**581**
Less: Tax	**23**	**192**
Profit after Tax	**134**	**389**

Required:

(i) Calculate for the year 2014-15:

- **a. Inventory Turnover Ratio**
- **b. Return on Net worth**
- **c. ROI**
- **d. ROE**
- **e. Profitability ratio**

(ii) Give a brief comment on the financial position of Harsh Ltd. (10 Marks)

Solution:

i. a . Inventory Turnover Ratio (for the year 2014-15) = $\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \frac{22{,}960}{2{,}437} = 9.42$

b. Return on Net Worth (for the year 2014-15)= $\frac{\text{Profit after tax}}{\text{Net Worth}} = \frac{134}{2{,}677} = 5\%$

Net Worth = Shareholder's Fund

c. ROI (for the year 2014-15) = $\frac{\text{Net Profit before Interest but after tax}}{\text{Average Capital Employed}} \text{x}100$

$= \frac{247}{5{,}451} \text{x}100 = 4.53\%$

Net Profit before interest but after tax = 134 + 113 = 247

Average Capital Employed = Average of Opening and closing of Net Current Assets + Average of Opening and closing of Net Current Assets

= (6,147 + 4,755)/2 = 5,451

d. ROE (for the year 2014-15) = $\frac{\text{Net Profit available to Equity Shareholders}}{\text{Average Equity Shareholders' Fund}} \text{x}100$

$$= \frac{134}{(2,677+1,772)/2} \times 100 = 6.02\%$$

e. Profitability ratio (for the year 2014-15) –

(i) Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{1,305}{24,265} \times 100 = 5.38\%$

(ii) Operating Profit Ratio = $\frac{\text{Operating Profit}}{\text{Sales}} \times 100 = \frac{157+113}{24,265} \times 100 = 1.11\%$

(iii) Net Profit Ration = $\frac{\text{Profit before tax}}{\text{Sales}} \times 100 = \frac{157}{24,265} \times 100 = 0.65\%$

Profitability of operation of the company remarkably decline from ₹686 (₹ in Lakh to ₹270 (₹ in Lakhs), due to a huge increase in the operating expenses during the year 2014-15. NP of the company also reduces due to an increase in the interest expenses. During the year 2014-15, both Fixed operating expenses as well as fixed financial expense have increased, as a consequence of which the NP of the company radically reduced. During 2014-15, both operating and Financial Leverages have become adverse, as a result of which the company has been crucially suffering from a liquidity crisis during the year 2014-15.

(b) What are the limitations in implementation of an effective internal control system of a company? (8 Marks)

Answer:

Limitations of internal control

An important ingredient in development of an effective internal control system aimed at the achievement of management's objectives is to ensure that the organization has adequate relevant policies accompanied by effective monitoring and reporting mechanism. Moreover, while establishing the management objectives, the management must take into consideration the cost of attempting to achieve them. In other words, the cost of achieving objectives must be less than the anticipated benefits to be derived by achieving the objectives. One extreme is to achieve objectives "*As quickly as possible*" implying zero controls, while other extreme of achieving of objectives with "*No errors*" implies strong internal controls covering all aspects of objective. Controls must therefore be practical, useful, achievable, and compatible with both operating and control goals and there is always a trade-off between cost and benefit. Since all controls cost resources in terms of money, personnel, equipment, and time, internal controls always imply a trade-off between the anticipated cost and benefit envisaged. (Is it worth to spend rupees ten thousand to prevent a possible loss of rupees five thousand?).

For example, those risks that have a low probability and low cost should simply be *ignored.* But for those with high probability and high costs, control activities need to be implemented to *prevent* the risk from occurring. For example, a disaster may have a low probability but it has a high cost, therefore management should employ *insurance and/or backup plan* as an appropriate control activity. This model requires management to identify what needs protecting, what the risks are for those assets, and the level of cost impact and probability for each risk. Therefore, the organization must do a comprehensive risk assessment before actually designing an internal control system, i.e., identify the risks to which it is subjected to and the corresponding amount of loss if that risk comes true. In other words, any Internal Control System must ensure that all anticipated risks are taken care up to the point of cost benefit analysis i.e., cost of effecting control or managing a risk does not exceed the estimated amount of losses, if that risk actually happens or comes true. However, this condition may not be strictly applicable to those controls, which are aimed at ensuring compliance with applicable laws and regulations.

The second ingredient or evaluation parameter is that of reasonable assurance. Even though in actual practice, there is no such thing as 'perfect internal control system'. No computer system is impervious to hacking attacks, malicious activities or sometimes genuine errors. Moreover as already stated above, controls have a cost and the concept of cost-benefit needs to be applied even to controls also. If it costs Rs. 2 crores per annum to make computer hacking free or error free and the risk assessment shows an estimated loss of Rs. 5 lakhs only, it may be better to have reasonable controls only to avoid prohibitive costs. Therefore, internal controls are designed to provide management with *reasonable assurance* regarding the achievement of these objectives.

It may be added here that most of the internal controls are aimed at anticipated risks or transactions of usual nature. Therefore, un-anticipated event or the transactions of un-usual nature may still escape all controls despite all precautions. Further, all controls need to be updated regularly to keep pace with changing conditions. So rigorous and effective internal controls of past may no longer be effective in present or future.

Lastly no depth of internal control can avoid losses due to potential human error or due to collusion between two or more persons. For example '*Disgruntled employees*' probably present the highest risk—even more than hackers external to the firm. These people can always be motivated to cause harm to the organization and depending on their knowledge and access to systems, data or other assets, they can cause extensive damage. Similarly, a person who has an extreme cash flow problem for any reason (like gambling, excessive lifestyle, etc.) may sometimes be tempted to steal assets to cover personal losses; often with the intention to "pay back" after some time. It is also sometimes possible that someone in the organisation may become an industrial spy.

Sometimes, *management* itself is a risky group. They can very easily override controls because of their unique position and hence can more easily commit fraud etc. Sometimes, managements are forced to do 'window dressing' of their balance sheets to show higher profits to contain the declining share prices or to earn their bonuses (if based on profits). Even the normal aggressive nature of managers can sometimes become a risk if not mitigated by strong personal and corporate ethics, and an effective internal control system (e.g., audit committee). For example, one management accountant reported his dilemma when his boss wanted him to reverse a correct accounting transaction because it resulted in the department missing its profit goals for the first time in three years. Such actions are indicative of ethical soft spots that can lead to fraud, theft, or material misstatements. These risks are very difficult to anticipate because of their nature. However this aspect should be thoroughly analyzed by external auditors during financial audits.

Therefore, an evaluation of internal controls is necessary to establish the effectiveness of those controls. The Auditor should keep in mind the following two sets of basic objectives while evaluating internal control –

(a) to safeguard assets and control transactions; and

(b) to provide reasonable assurance, through his opinion report' that there is no material errors in the financial statements.