Paper-19 - COST AUDIT & MANAGEMENT AUDIT

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

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

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

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

1. (a) Write short note on - True and Fair Cost of Production. [5]

Answer:

True and Fair Cost of Production: 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 Cost Audit (Report) Rules, 1996 prescribe the rules regarding the cost audit report. The prescribed format of the report contains assertions regarding whether cost accounting records have been properly kept so as to give a true and fair view of the cost of production/ processing/ manufacturing/ mining activities and marketing of the product under reference. It may be noted that unlike in the case of audit of financial statements, the cost auditor does not have to state whether the cost statements reflect a true and fair view. In any case, the true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:

(i) Determination of cost following the generally accepted cost accounting principles and cost accounting standards;

(ii) Application of the costing system appropriate to the product;

(iii) Materiality;

(iv) Consistency in the application of costing system and cost accounting principles;

(v) Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents;

(vi) Elimination of material prior-period adjustments;

(vii) Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

1. (b) State the provision for maintaining cost records in case of company having its branch both within and outside India. [6]

Answer:

Section 209 of the Companies Act 1956 deals with the books of accounts to be maintained by a body corporate. The section provides as follows:

(1) Every company shall keep at its registered office proper books of account with respect to -

(a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;

(b) all sales and purchases of goods by the company;

(c) the assets and liabilities of the company; and

(d) In the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account.

Provided that all or any of the books of account aforesaid may be kept at such other place in India as the Board of Directors may decide and when the Board of Directors so decides, the company shall, within seven days of decision, file with the Registrar a notice in writing giving the full address of that other place.

(2) Where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarized returns, made up to dates at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place referred to in sub-section (1).

1. (c) (i) What do you understand by the term "Pollution Control" as per CAS-14?

(ii) How would you assign administrative overheads as per CAS-11? [2+2=4]

Answer:

(i) As per CAS-14, Pollution Control means the control of emissions and effluents into environment. It constitutes the use of materials, processes, or practices to reduce, minimize, or eliminate the creation of pollutants or wastes. It includes practices that reduce the use of toxic or hazardous materials, energy, water, and / or other resources.

(ii) According to CAS-11, Assignment of administrative overheads to the cost objects shall be based on either of the following two principles:

(a) Cause and Effect – Cause is the process or operation or activity and effect is the incurrence of cost.
(b) Benefits received- Overheads are to apportioned to various cost objects in proportion to the benefits received by them.
The cost of shared services should be assigned to user activities on the basis of actual usage. General management costs should be assigned on rational basis.

2. (a) (i) State the applicability of Companies (Cost Accounting Record) Rules,2011;
(ii) Define - Product ; Manufacturing Activity ; Turnover, as per the Companies (Cost Accounting Record) Rules,2011. [3+(1+2+1)]

Answer:

(i) The Companies (Cost Accounting Record) Rules, 2011, is applicable to every company including a foreign company engaged in production, processing, manufacturing or mining wherein:

- the aggregate value of net worth as on the last date of the immediately preceding financial year exceeds ₹ 5 crores, or
- the aggregate value of the turnover made by the company from all products or activities during the immediately preceding financial year exceeds ₹ 20 crores, or
- the company's equity or debt securities are listed or are in the process of listing on any stock exchange.

(ii) Product - "Product" means any tangible or intangible good, material, substance, article, idea, know-how, method, information, object, service, etc. that is the result of human, mechanical, industrial, chemical, or natural act, process, procedure, function, operation, technique, or treatment and is intended for use, consumption, sale, transport, store, delivery or disposal.

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

(i) transformation of raw materials, components, sub-assemblies, 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.

Turnover - "Turnover" means gross turnover made by the company from the sale or supply of all products or services during the financial year. It includes any turnover from job work or loan license operations but does not include any non-operational income;

2. (b) How do you define a Service Cost Centre according to CAS-13? [3]

Answer:

The cost centre which primarily provides auxiliary services across the enterprise . The cost Centre which provides services to production, operation or other service Cost Centre but not directly engaged in manufacturing process or operation is a SERVICE COST CENTRE. A Service Cost Centre renders services to other Cost Centre / other units and in some cases to outside the parties. Examples of Service Cost Centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, pollution control etc. However the definition excludes utilities and repairs & maintenance services dealt with in CAS-8 and CAS – 12 respectively.

2. (c) X Ltd. claims "Turnover" for the purpose of Cost Records to be ₹20,00,00,000 for the financial year 2013-14. The company claims that since the turnover has not exceeded ₹20 crores during the financial year, they are excluded from the ambit of maintaining cost accounting records. The company is listed not listed in any stock exchange and has a net worth of ₹4 crores. On examination of financial records, the following relevant information was identified:

Particulars	Amount (₹)
Income from Operating Activities - Sale of Goods (exclusive of taxes) **- Rendering of Services**	**5,00,00,000** **15,00,00,000 (inclusive of service tax)**
Income from Job Work	**2,17,93,000**
Income from Loan License operations	**1,43,45,000**
Subsidies received from the Government	**41,50,000**
Export Incentives received from Government	**31,20,000**
Profit on sale of Non-current Assets	**12,50,000**
Discount received in Cash from Vendor (15 days after full payment was made)	**3,20,000**

Calculate "Turnover" as per Companies (Cost Accounting Record) Rules,2011. [5]

Answer:

As per Companies (Cost Accounting Record) Rules,2011, "Turnover" means total turnover made by the company from the sale or supply of all products or services during the financial year and it includes any turnover from job work or loan license operations and the subsidies or grants or incentives received but does not include any non-operational income.

Computation of "Turnover" as per Companies (Cost Accounting Record) Rules,2011 for the financial year 2013-14

Particulars	**Amount (₹)**
Income from Operating Activities - Sale of Goods (exclusive of taxes)	5,00,00,000
- Rendering of Services - [(15,00,00,000 x 100)/112.36] (net of service tax)	13,34,99,466
Add: Income from Job Work	2,17,93,000
Add: Income from Loan License operations	1,43,45,000
Add: Subsidies received from the Government	41,50,000
Add: Export Incentives received from Government	31,20,000
Turnover	**22,69,07,466**

Note:
The following Non-operational Incomes are not considered:
(i) Profit on sale of Non-current Assets ₹2,50,000;
(ii) Discount received in Cash from Vendor (15 days after full payment was made) ₹20,000

3. (a) (i) State the areas covered under Cost Accounting Policy in the light of Companies (Cost Audit Report) Rules,2011.
(ii) Discuss the provisions relating to " Ceiling on Number of Cost Audits" as per Companies Act,1956. [5+6]

Answer (i):

In the light of Companies (Cost Audit Report) Rules,2011, the Cost Accounting Policy , inter alia, covers the following areas:

(i) Identification of cost centres/cost objects and cost drivers.

(ii) Accounting for material cost including packing materials, stores and spares etc., employee cost, utilities and other relevant cost components.

(iii) Accounting, allocation and absorption of overheads

(iv) Accounting for Depreciation/Amortization

(v) Accounting for by-products/joint-products, scarps, wastage etc.

(vi) Basis for Inventory Valuation

(vii) Methodology for valuation of Inter-Unit/Inter Company and Related Party transactions.

(viii) Treatment of abnormal and non-recurring costs including classification of other non-cost items.

(ix) In case the Company has adopted IFRS, variations (if any) in treatment of cost accounting arising out of adoption of IFRS in Financial Accounting.

(x) Other relevant cost accounting policy adopted by the Company

Answer (ii):

The provisions relating to "Ceiling on Number of Cost Audits" is prescribed vide sub-Section (2) of Section 233B inter-alia provides that before the appointment of any auditor is made by the Board, a written certificate shall be obtained by the Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with the provisions of sub-Section (1B) of Section 224.

Section 224(1)(B) provides that no company or its Board of directors shall appoint or re-appoint any person who is in full time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. The proviso to Section 224(1B) further provides that the provisions of this sub-Section shall not apply, on and after the commencement of the Companies (Amendment) Act, 2000, to a private company.

Explanation I to the Section 224 provides that for the purposes of sub-Sections (1B) and (1C), “specified numbers” means :

(a) in case of a person or firm holding appointment as auditor of a number of companies each of which has a paid-up share capital of less than rupees twenty-five lakhs, twenty such companies;

(b) in any other case, twenty companies, out of which not more than ten shall be companies each of which has a paid-up share capital of rupees twenty-five lakhs or more.

Explanation II to the Section 224 provides that in computing the specified number, the number of companies in respect of which or any part of which any person or firm has been appointed as an auditor, whether singly or in combination with any other person or firm shall be taken into account.

In view of aforesaid provisions, the ceilings on the number of cost audits can be clarified as under:

(a) In the case of firm of cost accountants: Twenty companies for each such partner of the firm who is not in full time employment. However, not more than ten such companies should have a paid up share capital of ₹ 25 lakhs or more;

(b) In the case of an individual cost accountant, who is not in full time employment: Twenty companies, out of which not more than ten should have a paid-up share capital of Rs. 25 lakhs or more.

It can be seen from above that Section 224(1B) and Explanation I to Section 224 refers to the ceilings for the number of companies and not to the number of cost audit orders or products. Therefore, if more than one products of a particular company are covered under cost audit for the same year, a cost auditor should count their number as one company only, since the audits for all the products relate to the same company despite the fact that separate cost audit orders have been issued with respect to each such product. Similarly, if that company appoints different cost auditors for different products, each auditor shall count the company as one company for counting their individual quota for number of audits.

It should be noted that the Companies (Amendment) Act, 2000 has inserted a provision (Explanation II) to Section 224, whereby the provisions of sub-section 1-B shall not apply to a Private Company.

It means that for computing the limit on number of companies for audit, Private Companies should not be counted.

3. (b) In the case of sugar industry, the installed capacity is always expressed as cane crushing capacity per day. How would you measure the installed capacity of sugar? [4]

Answer:

Sugar is a seasonal industry. Sugarcane is available only during part of the year, during which period cane crushing is carried on and sugar produced. For every region of this country the normal duration of a crushing season is determined as number of days. Similarly, the quantity of sugar normally recoverable in a region from cane crushed which is known as the recovery factor is also available as a percentage figure. The normal days of crushing for the region multiplied by the crushing capacity per day gives the normal capacity. Against this actual quantity of cane crushed is compared and the percentage capacity utilisation applied on the actual quantity of cane crushed will give the normal quantity of sugar that must be produced. This when compared with the actual quantity of sugar produced gives the percentage of capacity utilised in terms of sugar. As the uniform accounting year of March covers two partial seasons, the number of days, cane crushed, etc. of two partial seasons must be aggregated to give capacity utilisation and recovery for one year.

4. (a) Z Ltd. furnished the following information related to the net margin (profit/loss) as per cost records, which is different from such as per financial records.

Particulars	Prod A	Prod B	Prod C	Prod D	S1	S2	S3
Product/Service Group	0401	0401	0405	0405	XA	XB	XB
Turnover (excluding Excise Duty and/or other statutory levies (₹ crores)	10.50	11.25	14.75	18.60	3.69	7.91	12.45
Cost of Sales (₹ crores)	8.39	9.98	11.37	21.75	2.08	4.27	8.67
Margin (₹crores)	2.11	1.27	3.38	(3.15)	1.61	3.64	3.78

Other information:

(i) Discount allowed by vendor was subsequently received in cash for products A,B,C & D to the extent of ₹0.15 crores; ₹0.07 crores; ₹0.02 crores and ₹0.07 crores respectively, not considered in cost accounts.
(ii) Premium on forward contract for Product A ₹0.03 crores not considered in cost accounts;

(iii) Liquidated damages paid to vendor for Product A - ₹0.15 crores not considered in cost accounts;

(iv) Dividends received on investment outside the business ₹0.30 crores considered in financial records only;

(v) Profits on sale of non-current assets ₹ 0.15 crores considered in financial accounts only;

(vi) Unabsorbed Administrative Overheads due to under-utilization of capacities ₹0.27 crores not considered in cost accounts;

(vii) Margin from Trading Activities ₹4.05 crores both as per financial and cost records;

(viii) Value of Stock

Value of Stock as per	As per Cost Records	As per Financial Records
Opening Balance	3.98 crores	4.15 crores
Closing Balance	2.67 crores	2.12 crores

Prepare Margin (Profit/Loss) Reconciliation Statement considering cost accounts and financial accounts. [12]

Answer:

Reconciliation Statement

Net Margin (Profit/Loss) as per Cost Accounts	₹ Crores
A. From Product/ Manufactured Product Groups	
(i) Product Group 0401 (2.11 + 1.27)	3.38
(ii) Product Group 0405 (3.38 - 3.15)	0.23
B. From Services Groups	
(i) Service Group XA	1.61
(ii) Service Group XB (3.64 + 3.78)	7.42
C. From Trading Activities	4.05
Total as per Cost Accounts	**16.69**
Add: Incomes not considered in Cost Accounts (if any)	
Profits on sale of non-current assets ₹ 0.15 crores considered in financial accounts only	0.15
Dividends received on investment outside the business ₹0.30 crores considered in financial records only	0.30
Discount allowed by vendor was subsequently received in cash for products A,B,C & D to the extent of ₹0.15 crores; ₹0.07 crores; ₹0.02 crores and ₹0.07 crores respectively, not considered in cost accounts	0.31
Less: Expenses not considered in Cost Accounts (if any)	
Premium on forward contract for Product A ₹0.03 crores not considered in cost accounts	(0.03)

Liquidated damages paid to vendor for Product A - ₹0.15 crores not considered in cost accounts	(0.15)
Unabsorbed Administrative Overheads due to under-utilization of capacities ₹0.27 crores not considered in cost accounts	(0.27)
Less: Difference in Opening Stock Valuation	
Understated cost of opening stock as per Cost Records by ₹ (3.98 - 4.15) crores = ₹0.17 crores. This leads to a decrease in cost of sales as per cost records. Hence, there is an overstatement of profit as per cost records, as the sales realization is same under both cost records and financial records	(0.17)
Less: Difference in Closing Stock Valuation	
Overstated cost of closing stock as per Cost Records by ₹ (2.67-2.12)crores = ₹0.0.55 crores. This leads to a decrease in cost of sales as per cost records. Hence, there is an overstatement of profit as per cost records as the sales realization is recorded same under both cost records and financial records	(0.55)
Profit/ (Loss) as per Financial Accounts	**16.28**

4. (b) A company has produced all the cost accounting records within the stipulated time for your audit. It however is unable to produce audited financial accounts, as financial audit is not complete. [3]

Answer:

The cost audit report is based on the cost records and hence the cost auditor and the company need not wait till the completion of financial audit to present the cost audit report. Note (4) to the prescribed annexure to the cost audit report rules allows a cost auditor to submit a supplementary report after the auditor under section 224 of the Companies Act. 1956 presents his report. However such report is to be limited to the extent of reconciling the statements annexed to the cost audit report with the final audited financial accounts of the company. Such a supplementary report is however to be submitted to the Company Law Board before the date fixed for the annual general meeting of the company.

5. (a) Write a note on Cost Audit and Assurance Standards Board . [4]

Answer:

Cost Audit and Assurance Standards Board :

The Institute of cost Accountants of India (ICAI) is committed to the goal of enabling the cost and management accounting profession in India to provide services of high quality in the public interest as per the international standards. ICAI has developed and promulgated technical standards and other professional literature to realize this goal. The ICAI being one of the founder members of the IFAC, the standards are being developed and promulgated by the Cost Audit and Assurance Board (CAAB) under the authority of the council of ICAI are in conformity with the corresponding international standards issued by the International Auditing and Assurance Standards Board (IAASB) established by IFAC.

The primary objectives of CAAB is to identify the areas in which standards on Quality Control and Engagement Standards are required to be developed after reviewing the existing and emerging audit practices worldwide. It serves the public interest by formulating and setting high quality auditing and assurance standards. It demonstrates to the regulators, investors, businesses community, interested third parties. It provides support and guidance to help audit firms to develop and improve their practices.
It takes up a programme of practice review which applies to all practicing members in India who hold a certificate of practice (COP) of ICAI.

5. (b) How would you treat the following as per CAS-9 related to Packing Material Cost?
(i) Primary and Secondary packing material cost.
(ii) Self manufactured packing material.
(iii) The forex component of imported packing material. [2×3=6]

Answer:

(i) As per CAS-9, the cost of primary materials shall form part of the cost of production. Cost of secondary packing materials shall form part of distribution overheads.
(ii) 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 administrative and share of research and development cost incurred for development and improvement of existing process or product.
(iii) The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.

5. (c) Describe the information to be collected before starting Cost Audit for the first time in a Company ? [5]

Answer.

The Cost Auditor should obtain the following information from the company when he begins Cost Audit for the first time.

- History of the company and its activities;
- Copies of Annual Reports and Accounts for the past 3 years;
- A list and addresses of factories, branches, offices and depots;
- Organisation chart of the company;
- Collaboration agreement, if any, including agreements for payment of royalty;
- Details of installed capacity and basis of its computation (on single or multiple shift basis);
- A note outlining the systems and procedures in force in the various departments;
- Copies of systems and procedure manuals, if any, in use;
- Detailed description of manufacturing process with flow charts;
- Peculiarities or complexities of the production flow with particular reference to cost ascertainment;
- Major raw materials used with quantity requirements per unit of product-standard and achievements;
- Methods adopted for treatment of joint & by-products;
- Labour incentive scheme, if any, in vogue and agreements with unions;
- Details of important contracts/agreements regarding purchases, sales and services;
- Details of Budgetary control if any, in use;

- Functioning of Internal Audit.

Section B

Answer any two Questions [2x10=20]

6. (a) Outline the Internal Control aspects in relation to Fixed Assets. [6]

Answer:

(a) Authorisation for Capital Expenditure: Expenditure for purchase or in-house construction of fixed asset should be authorised by responsible officials. It should be evidenced by way of Board Resolution, Budget Sanction, Notes in the Asset File, etc.

(b) Accounting for Assets: Fixed Assets purchased should be properly accounted for by making suitable entries in the Fixed Assets Register and also the General Ledger. While recording cost, revenue-capital distinction should be observed.

(c) Ownership Rights: Documents evidencing the ownership e.g. Title deeds of properties, RC Book for vehicles etc. should be in the custody of responsible officials. A tracking register may be used in case of deposit of ownership documents with Bankers / Lenders.

(d) Asset Registers: Arrangements should be made for maintaining Plant and Property Registers. They should be frequently agreed with the relevant accounts and physically verified. Care should be taken to distinguish between Fixed Assets and Current Assets (e.g. A Company engaged in manufacturing and selling vehicles, may have vehicles as part of Fixed and Current Assets).

(e) Physical Verification: Arrangements should be made to ensure that Fixed Assets are properly maintained and applied in the service of the Company (e.g. by periodic physical checks as to their location, operation and condition).

(f) Asset Transfers: Where Fixed Assets are transferred between branches or members of the same group, guidelines should be laid down in respect of pricing, depreciation and accounting.

(g) Sale, Scrapping of Assets: Sale, scrapping or transfer of Fixed Assets should be properly authorised and evidenced. Receipts from such disposals should be controlled and properly dealt with in the accounts.

(h) Safeguarding: Adequate insurance cover should be made available for all relevant Fixed Assets.

(i) Depreciation: The accounting policy of the Company should specify the method and rate of depreciation. It should be properly authorised and evidenced. Responsible persons should carry out the calculation of depreciation and asset values.

6. (b) Distinguish between Financial Audit and Operational Audit. [4]

Answer:

Differences between Financial Audit and Operational Audit:

Particulars	Financial Audit	Operational Audit

Purpose	Concerned with opinion that whether the historical information recorded is correct or not.	Emphasizes on effectiveness and efficiency of operations for future performance.
Area	Restricted to the matters directly affecting the appropriateness of the presented Financial Statements.	Covers all activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.
Reporting	Financial Audit Report is sent to all Shareholders, Lenders, Stakeholders and Regulatory Authorities.	Operational Audit report is primarily for the Management and internal use.
Scope	Limited to reporting the findings of audit to the persons entitled to the Report, i.e. Shareholders.	Operational Auditing is not limited to reporting, it also includes suggestions for improvement.

7. What are the Characteristics of a good Performance Appraisal Report? [10]

Answer:

Characteristics of a good Performance Appraisal Report are as follows –

(i) It should be remembered that the Performance Appraisal Report is meant to be used by the company and this report is confidential.

(ii) The report, being an annexure to the cost audit report, should basically lay more thrust on the cost management aspect of the business and should effectively bring out comments on how the business performance could be improved by elevating the cost performance.

(iii) When commenting on or analyzing the cost performance, the cost auditor could assess the impact of changes in the costs on the profitability of the products, profitability by customers or market segments.

(iv) The cost drivers that are the fulcrum of the cause and effect relationship in the cost statement, are the ones which form the first level of KPIs that are easily understood and actionable for the operational executives. The cost auditor while evaluating the KPIs can also look at the efficacy of the cost drivers. This evaluation will also enable the operational executives to relate what is being done at the shop floor to the cost statements that are the end product of the cost accounting system.

(v) It would be necessary to analyze the use of various resources to boost economy, efficiency and effectiveness of the operations. Economy indicates incurring of the least possible cost for acquiring and/or utilizing the resources, without compromising the quality. Efficiency denotes maximization of the output-input ratio. Effectiveness means achieving the desired goals. The Performance Appraisal Report should cover, at the minimum, all the three aspects of cost management.

(vi) For being a valuable report, Performance Appraisal Report should portray analysis of a range of performance measures. While selecting these measures, care should be taken to include those having a material impact on the past or future performance of an organisation. These measures could change over period of time and may require to be reconsidered for inclusion to or exclusion from the Performance Appraisal Report.

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

- Effect on profitability
- Effect on resource utilisation
- Effect on liquidity
- Effect on risks
- Effect on quality
- Effect on competitiveness
- Effect on responsiveness to the market etc.

(viii) The Performance Appraisal Report should include non-financial performance indicators in addition to the use of traditional financial ratio analysis. The non-financial measures provide useful information about the probable future of performance of the company. E.g. a consistently good customer satisfaction index would guarantee a certain growth in business.

(ix) An ideal Performance Appraisal Report should possess the following characteristics:

- Objectivity
- Capability of being predictive value
- Comprehensiveness
- No information overload
- Coverage of strategic thrust
- Trend measures and current status
- Timeliness
- Segmented and enterprise-wide coverage

8. "To-day's customer is the more demanding than the customer of yesterday"- In view of this how would you evaluate, as a Management Auditor, the performance of " Customer Services Department". [10]

Answer:

A customer is the most important person for business because it is he who provides the profit. Therefore, the starting point in any marketing strategy is identifying the customers, their needs and organizing the efforts of the company towards satisfying such needs.
In order to create and retains customers, certain services are to be provided by properly attending to their needs and supplying right quality goods at the right price. Such services would not only stimulate the demand for the products of the company but also will help to establish product acceptability and widen the scope of potential customers.
Customers services may be evaluated on the following lines:

• Do the products manufactured by the company meet the needs of the customers of different purchasing power and different tastes?
• Are the prices of the products reasonable, considering the product quality?
• Are the prices competitive to similar other products available in the market?
• Are the customers given prompt and personal attention?
• Does the company guarantee the quality of its products?
• Does the company provide after-sales services?
• Are the customers complaints carefully and promptly attended to?
• Are spare parts of the products easily available in the company offices and in the open market?
• Are the product properly packed to avoid any damage to its products?
• Is there any provision for home-delivery services?
• Does the company undertake marketing research in regard to customer behaviour and customer services?
• Does the company make use of marketing research data to improve customer services?
• Does the company's product bear ISI Mark / AGMARK?
• Are the company's products easily available at various retail outlets?
• How effective are the various channels of distribution used by the company?
• Does the company educate the customers about the use of the products through printed material and other means?
• Are the sales man retailers continuously motivated to provide the best attention and services while selling company's products?

Section C
Answer any two Questions [2x10=20]

9. A company undertakes manufacture of Steel Pipes and Steel Tubes. Its sales and profit data for the financial year ended 31st March, 2014 are :

Total Net Sales	**₹2,70,40,000**
Gross Profit	**₹59,20,000**
Net Profit	**₹17,70,000**

The Balance Sheet as at 31st March, 2014 (not in Revised Schedule VI)

Liabilities	₹ (crores)	Assets	₹ (crores)
Capital	1,14,00	Cash in hand	1,20
Reserves and Surplus	17,70	Cash at Bank (SBI)	10,20
Secured Loans (IFCI)	1,77,30	Bills Receivables	1,90
Unsecured Loans	52,00	Sundry Debtors	90,00
Sundry Creditors	37,40	Finished Goods—	
		Pipes & Tubes	31,20

Outstanding Liabilities :		**Work-in-Progress**	**15,50**
Rent for March'14	**1,00**	**Raw Materials - H.R. Skelp**	**8,20**
Salaries for March'14	**60**	**- C.R. Sheets**	**4,20**
Power Charges	**10**	**Deposits (long term)**	**27,00**
Telephone Charges	**10**	**Income Tax paid in advance**	**1,00**
Bonus	**1,90**	**Furniture**	**30**
		Buildings	**77,60**
		Plant & Machinery	**1,33,80**
	4,02,10		**4,02,10**

(i) You are required to calculate —

a. Current Ratio,
b. Acid-test Ratio,
c. Debt-equity Ratio,
d. Turnover-fixed Assets Ration,
e. Net working Capital-Turnover Ratio,
f. Return on Capital Employed Ratio,
g. Net Profit Turnover Ratio,
h. Value of Production to Net Worth Ratio, and
Offer your comments against each.

(ii) Can you draw any conclusions from the study of the ratios ? [10]

Answer;

(i) Ratios and Comments :

Before calculation of the various ratios, we can process the given information as under :

Particulars	Amount (₹'000)	Amount (₹'000)
Current Assets		
Cash in hand	1,20	
Cash at Bank	10,20	
Bills Receivables	1,90	
Sundry Debtors	90,00	
Finished Goods	31,20	
Work-in-progress	15,50	
Raw Materials - H.R.Skelp 8,20 - C.R. Sheet 4,20	12,40	
Income Tax paid in Advance	1,00	
	1,63,40	
Current Liabilities:		
Sundry Creditors	37,40	
Outstanding Liabilities:		
- Rent	1,00	
- Salaries	60	
- Power	10	
- Telephone	10	

- Bonus	1,90	
	41,10	

Particulars	Amount (₹'000)	Amount (₹'000)
Liquid Assets		
Cash in hand	1,20	
Cash at Bank	10,20	
Bills Receivables	1,90	
Sundry Debtors	90,00	
	1,03,30	
Liquid Liabilities (in this case same as current liabilities as there is no Bank Overdraft)		
Sundry Creditors	37,40	
Outstanding Liabilities:		
- Rent	1,00	
- Salaries	60	
- Power	10	
- Telephone	10	
- Bonus	1,90	
	41,10	

Particulars	Amount (₹'000)	Amount (₹'000)
Borrowed Funds		
Secured Loans	1,77,30	
Unsecured Loans	52,00	
Sundry Creditors	37,40	
Outstanding Liabilities	3,70	
	2,70,40	
Own Funds		
Capital	1,14,00	
Reserves & Surplus	17,70	
	1,31,70	
Fixed Assets		
Furniture	30	
Buildings	77,60	
Plant and Machinery	1,33,80	
	2,11,70	
Net Working Capital		
Current Assets	1,63,40	
Less: Current Liabilities	41,10	
	1,22,30	
Capital Employed	**1,14,00**	
Value of production:		
Net Sales	2,70,40	

Less : Gross profit	(-) 59,20	
	2,11,20	
Net Worth		
Capital	1,14,00	
Add: Reserves and Surplus	17,70	
	1,31,70	

(a) Current Ratio :

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{1{,}63{,}40}{41{,}10} = 3.976.$$

This indicates that the company has ₹3.976 of current assets for every rupee of current liability. So, if can meet its current obligations even if it can realise only 1/4th of the current assets. But, it has to be borne in mind that while the current assets can decline in value on account of doubtful debtors and unsaleable finished goods' stock, the liabilities do not fall in value as they have to be paid for. Thus, it is simply a quick measure of the company's liquidity.

(b) Acid – Test Ratio :

$$\frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} = \frac{1{,}03{,}30}{41{,}10} = 2.51$$

This indicates that the company is in a much better position and has the ability to meet its obligations without delay.

(c) Debt – Equity Ratio :

$$\frac{\text{Borrowed Fund}}{\text{Own Fund}} = \frac{2{,}70{,}40}{1{,}31{,}70} = 2.05$$

This indicates that the company is dependent on borrowed funds, i.e., depends on the external sources of finance to a considerable extent.

(d) Turnover – Fixed Assets Ratio :

$$\frac{\text{Total Net Sales}}{\text{Fixed Assets}} = \frac{2{,}70{,}40}{2{,}11{,}70} = 1.28$$

This is a test to know as to how the investment in the company's business is serving the desired purpose of generating sales. Here, the ratio indicates that the company could make sales worth ₹1.28 only against each rupee of investment in fixed assets. So the position is not satisfactory. This indicates that the assets are not fully employed.

(e) Net Working Capital Turnover Ratio :

$$\frac{\text{Total Net Sales}}{\text{Net Working Capital}} = \frac{2{,}70{,}40}{1{,}22{,}30} = 2.21$$

This is a test to measure the efficiency of the firm in the employment of its working capital. This indicates that the company could make 2.21 times sales turnover for every rupee of working capital employed. This may be considered to be satisfactory.

(f) Return on Capital Employed Ratio :

$$\frac{\text{Net Profit}}{\text{Capital Employed}} \times 100 = \frac{17{,}70}{1{,}14{,}00} \times 100 = 15.53\%$$

This indicates that the profitability in relation to the capital employed is reasonably satisfactory. The company earns a fair return on investment in its own industry.

(g) Net Profit Turnover Ratio :

$$\frac{\text{Net Profit}}{\text{Sales turnover}} \times 100 = \frac{17{,}70}{2{,}70{,}40} \times 100 = 6.54\%$$

This indicates that net profit is much lower than what is reasonably expected. This test, of course is not indicative of profitability. It is test which signifies a profit on sales. Ratio at (f) above is a good indicator for the company.

(h) Value of Production To Net Worth :

$$\frac{\text{Value of Production}}{\text{Net Worth}} = \frac{2{,}11{,}20}{1{,}31{,}70} = 1.60 \ = \qquad \underline{\text{Value of production}}$$

This ratio measures the efficiency in the use of funds for value of production. The result is not satisfactory as the value of production is not even double the value of net worth.

Conclusions :

The following conclusions can be drawn from the study of the ratios :

(i) The liquidity position of the company is good as the current ratio and acid-test ratio are 3.976 and 2.51 respectively.

(ii) The solvency position is not satisfactory as the debt-equity ratio is 2 : 1 — which means that the company is dependent upon external finance. The company may run into difficulties in case these external funds are withdrawn and the creditors put pressure for repayment.

(iii) The Gross Profit to Net Sales comes to : $\frac{59{,}20}{2{,}70{,}40} \times 100 = 121.90\%$, whereas net profit to sales is 6.54%. The profitability in relation to capital employed is 15.53% — which is an indicator of fair return for the company in the industry in which it is operating under the present circumstances.

(iv) The operating efficiency of the company is not upto the expectations as : Turnover-fixed assets ratio and Net working capital Turnover ratio are 1.28 and 2.21 respectively. The Net worth utilisation by the value of production is only 1.6 times.

10. (a) In a factory, the production department has worked at 50% of its normal capacity on account of shortages of skilled labour and raw materials during the year. The cost records contain the following information among other :

Particulars	**Amount (₹)**	**Amount (₹)**
Direct Labour Cost		**5,00,000**
Works Overhead - Fixed	**2,00,000**	
Works Overhead- Variable	**2,50,000**	**4,50,000**

The company charges the works overhead to work –in-process as a percentage of direct labour cost. Accordingly, its Accounts Officer claims that 90% should be charged ; whereas you (as a cost auditor) claim that it should be much than this.

A. Establish your claim with reasons, and
B. Give your opinion, if any. [4]

Answer :

(A) Computation to establish claim :

Particulars	Amount (₹)	Amount (₹)
Works Overhead- Variable	2,50,000	
Works Overhead - Fixed (50% of Rs.2,00,000)	1,00,000	
Amount chargeable to work -in- process		3,50,000

So, the Rate of Overhead application (according to the company 's practice) should be:

$$\frac{₹3,50,000}{₹5,00,000} \times 100 = 70\% \text{ of Direct Labour Cost.}$$

This percentage should be charged to the work - in - process, the reason being that the department worked only 50% of its normal capacity and that the fixed overhead is to be absorbed on the basis of the capacity level attained.

(B) Opinion

The balance of the fixed works overhead (i.e. 50% of ₹2,00,000 = ₹1,00,000) amounting to ₹1,00,000 represented the idle capacity cost and was therefore not a part of the manufacturing cost. It was a loss on account of non –functioning of the department to its normal capacity.

10. (b) Following are the sales and cost data of a manufacturing firm for two years :

Particulars	**2012-13 (₹crores)**	**2013-14 (₹crores)**
Mfg. Cost of goods sold	**14.5**	**16.0**
Selling expenses	**0.9**	**1.2**
Administration expenses	**1.2**	**1.5**
Financial Charges	**0.4**	**0.3**
Excise Duty	**2.0**	**2.0**
Sales (including excise)	**20.0**	**22.0**

Required : (i) Prepare a Profit Variation Statement and (ii) Account for the cause-wise changes in profit. [6]

Answer: (i) Profit Variation Statement (₹in crores) :

Particulars	2012-13		2013-14		Profit Variation	
					Increase	Decrease
Sales		20.0		22.0	2.0	
Less: Excise Duty		2.0		2.0	-	-
Net Sales		18.0		20.0	2.0	-
Less: Mfg Cost		14.5		16.0	-	1.5
Gross Profit		3.5		4.0	-	0.5
Less: Expenses					0	0.5
Selling	0.9		1.2			0.3
Administrative	1.2		1.5			0.3
Financial	0.4	2.5	0.3	3.0	0.1	
Net Profit	**1.0**		**1.0**			

Note : Net increases in sales and in expenses being equal, there has been no change in 'net profit' position.

(ii) Statement of changes in Profit (Cause-wise) :

	₹ (in crores)	**₹ (in crores)**	**₹ (in crores)**
Increase in Profit by			
Net Sales	2.0		
Less: Mft. Cost	1.5		
		0.5	
Add: Financial Charges (savings)		0.1	
Total increase			**0.6**
Decrease in Profit by			
Selling Cost	0.3		
Administration Cost	0.3		
Total decrease			**0.6**
Profit Increase/Decrease (Net)			**NIL**

11. M/s. Zenith Steel Tube co. Ltd. manufactured three products, A, B and C during the year 2011-12. From the cost records of the company, the following information is extracted :

(a) The total of material and labour costs per unit of each product was ₹20 only.

(b) The company (for product costing) used an overhead rate of application of ₹2.00 per machine hour, based on the actual works over head of ₹ 6,00,000 and actual machine hours of 3,00,000 as follows :

	4 Hi Mill	**Annealing**	**ERW Mill**
Actual Works Overhead (₹)	**2,40,000**	**1,00,000**	**2,60,000**
Actual Machine Hours	**1,00,000**	**1,00,000**	**1,00,000**

(c) Each of these products used the following number of machine hours at the process centres:

	A	B	C
4 Hi Mill	**2**	**1**	**3**
Annealing	**2**	**2**	**1**
ERW Mill	**1**	**2**	**1**

	5	5	5

(d) There was no work-in-progress at the end of the year. There were 2,000, 4,000 Finished Units, respectively, of product A, B and C on hand.
(e) The company fixed the selling prices by adding 40 percent to cover profit and selling and administrative expenses.

As a Cost Auditor of the company, you are required to give your observations and conclusions and illustrate the same with necessary workings. [10]

Answer :

Workings :

Element of Overhead in closing Stocks:

A. According to Company's Rate of overhead Absorption : 8,000 x 5 x ₹ 2 = ₹ 80,000

B. According to Departmental (suggested) overhead rates :

Product A : 2,000 x (2 x 2.40 + 2 x 1.00 + 1 x 2.60) = ₹ 18,800
Product B : 4,000 x (1 x 2.40 + 2 x 1.00 + 2 x 2.60) = ₹ 38,400
Product C : 2,000 x (3 x 2.40 + 1 x 1.00 + 1 x 2.60) = ₹ 21,600 ₹ 78,800

Therefore, difference in net income (i.e., Profit increase)
= (A) – (B) = ₹ 80,000 – ₹ 78,800 = ₹ 1,200

* Department Overhead rates :
4 Hi Mill : ₹ 2,40,000/1,00,000 = ₹ 2.40 per m/c. hour.
Annealing : ₹ 1,00,000/1,00,000 = ₹ 1.00 per m/c. hour.
ERW Mill : ₹ 2,60,000/1,00,000 = ₹ 2.60 per m/c. hour.

Effect on Selling Price : Company's Overhead Rates Vs. Departmental Overhead Rate.

Cost elements etc.	As per company's Overhead rate Product A/B/C (₹)	As per Department Overhead Rates		
		Product A (₹)	Product B (₹)	Product C(₹)
Material & Labour	20.00	20.00	20.00	20.00
Works Overhead**	10.00	9.40	9.60	10.80
40% Mark up	30.00	29.40	29.60	30.80
	12.00	11.76	11.84	12.32
Selling Price	42.00	41.16	41.44	43.12
Increase / (Decrease) in Price		(0.84)	(0.56)	(0.12)

** Works Overhead: As per company's rate: ₹ 2.00 x 5 – ₹ 10 for each product.
As per Suggested Department Overhead rates —
Product A : 2 x 2.40 + 2 x 1.00 + 1 x 2.60 = 4.80 + 2.00 + 2.60 = ₹ 9.40.
Product B : 1 x 2.40 + 2 x 1.00 + 2 x 2.60 = 2.80 + 2.00 + 2.20 = ₹ 9.60.

Product C : 3 x 2.40 + 1 x 1.00 + 1 x 2.60 = 7.20 + 1.00 + 2.60 = ₹ 10.80.

Observations and Conclusions:

The Company has wrongly adopted a blanket rate of overhead absorption to the products irrespective of the fact that each product requires different procession time when it passes through the cost centres 4 Hi Mill, Annealing and ERW Mill. In doing so, there has been an over-valuation of closing inventory of Finished Units. This resulted in the profit increase of ₹1,200. Again, the amount of works overhead having been equally charged to each of the products, the fixation of selling price was incorrect. It was a fact that all the three products passed through all process centres, but different processing time clearly indicated that the quality or specification variations were definitely achieved in the products. The selling price fixed by the company did not reflect this important factor. The company should, therefore, adopt the departmental rates of overhead absorption to the products.