Paper 19 - COST AND MANAGEMENT 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.

1. Answer the four Questions [15×4=60]

(a) (i) From the following figures extracted from the financial and cost accounting records, you are required to compute:

(i) Value Added.

(ii) Ratio of Operating Profit to Sales.

(iii) Ratio of Operating Profit to Value Added.

Particulars	₹ in lacs
Net Sales excluding Excise Duty	42,000
Increase in Stock of finished goods	500
Expenses:	
Raw Materials consumed	8,600
Packing materials consumed	2,560
Stores and spares consumed	1,120
Power and fuel	9,200
Insurance	240
Direct salaries and wages	960
Depreciation	1,770
Interest paid	2,796
Factory overhead:	
Salaries and wages	480
Others	500
Selling and distribution expenses:	
Salaries and wages	240
Additional sales tax	914
Administration overheads:	
Salaries and wages	240

[10]

Answer:

(i) Computation of Value Added	₹ in lacs	₹ in lacs
Net Sales+ Increase in Stock of Finished Goods		42,500
Less:		
Cost of bought out materials and services:		
Raw Materials	8,600	
Packing Materials	2,560	
Stores and Spares	1,120	
Power and fuel	9,200	
Insurance	240	
Other factory overhead	500	22,220
i) Value Added		20,280
Composition of Value Added:		
Depreciation	1,770	
Interest	2,796	
Additional Sales tax	914	
Salaries and wages (960+480+240+240)	1,920	7,400
Profit before tax (balancing figure)		12,880
Operating Profit:		
PBT		12,880
Interest paid		2,796
		15,676

(ii) Ratio of operating profit to net sales = $\frac{\text{Operating profit}}{\text{Net sale}} = \frac{15{,}676}{42{,}000} \times 100 = 37.32\ \%$

(iii) Ratio of operating profit to value added = $\frac{\text{Operating profit}}{\text{Value Added}} = \frac{15{,}676}{20{,}280} \times 100 = 77.30\ \%$

(a) (ii) What are the matters that are relevant in formulating audit strategy and drawing up the audit plan? [5]

Answer:

As per CAAS – 101, matters that are relevant in formulating audit strategy and drawing up the audit plan are as following:

i. The cost reporting framework generally prescribed by the Cost Audit Report Rules on which the cost information to be audited has been prepared, including need for reconciliation with financial reporting framework.

ii. The specific requirements of industry specific cost accounting record rules.

iii. Industry regulators' requirement as to how costs will be handled.

iv. Unique features of an industry that influence audit requirements e.g. definition of product in the newspaper industry.

v. Reliance that can be placed on the work of financial auditors, other cost auditors appointed by the entity and internal auditors for example their attendance in annual stocktaking.

vi. State of IT implementation, whether the entity is using an ERP system or internally developed systems and the reliance that can be placed on them.

vii. Statutory timelines for cost reporting which can be modified by managements for early completion.

viii. Timelines for Board/ audit committee meetings which can set the time limits for completion of audit work.

ix. Resources required and available in terms of manpower, equipment and others and the assignment of these to specific parts of the work.

(b)(i) Give the following data, compute the relevant variances –

Particulars	Skilled	Semi-skilled	Un-skilled
Number in Standard gang (for 40 hour week)	**16**	**6**	**3**
Standard rate per hour (₹)	**3**	**2**	**1**
Actual number in the gang (for 42 hour week)	**14**	**9**	**2**
Actual rate of pay (₹)	**4**	**3**	**2**

In the week, the gang as a whole produced 900 Standard Hours, during the week, 4 hours per worker was considered idle time due to machine breakdown. [10]

Answer:

i. Computation of Standard Hours (SH)

Total Standard Hours (Given) = 900 hours

Grade	Skilled	Semi-Skilled	Unskilled
Standard Mix	16	6	3
Standard Hours	576 hours	216 hours	108 hours

ii. Computation of Revised Actual Hours (RAH)

Total AH = (14×42) + (9×42) + (2×42) = 1,050 DLH

Grade	Skilled	Semi-Skilled	Unskilled
Standard Mix	16	6	3
RAH	672 hours	252 hours	126 hours

iii. Variance Computation Chart (based on Labour Mix, and without considering Idle Time Effect)

Particulars	Col. (1): SH × SR	Col. (2): RAH × SR	Col. (3): AH × SR	Col. (4): AH × AR
Skilled	576 × ₹ 3 = 1,728	672 × ₹ 3 = 2,016	(14 × 42) × ₹ 3 = 1,764	(14 × 42) × ₹ 4 = 2,352
Semi-skilled	216 × ₹ 2 = 432	252 × ₹ 2 = 504	(9 × 42) × ₹ 2 = 756	(9 × 42) × ₹ 3 = 1,134
Unskilled	108 × ₹ 1 = 108	126 × ₹ 1 = 126	(2 × 42) × ₹ 1 = 84	(2 × 42) × ₹ 2 = 168
Total	**₹ 2,268**	**₹ 2,646**	**₹ 2,604**	**₹ 3,654**

Labour Sub-efficiency Variance = ₹ 2,268 – ₹ 2,646 = ₹ 378 A

Labour Mix Variance = ₹ 2,646 – ₹ 2,604 = ₹ 42 F

Labour Rate Variance = ₹ 2,604 – ₹ 3,654 = ₹ 1,050 A

Labour Efficiency Variance = Labour Sub-efficiency Variance + Labour Mix Variance

= ₹ 2,268 – ₹ 2,604 = ₹ 336 A

Total Labour Cost Variance = ₹ 2,268 – ₹ 3,654 = ₹ 1,386 A

Grade-wise Breakup of Labour Variance (without considering Idle Time Effect)

Particulars	Skilled	Semi-skilled	Unskilled	Total
(a) Sub-Efficiency Variance = Col. (1) – Col. (2)	₹ 288 A	₹ 72 A	₹ 18 A	₹ 378 A
(b) Mix Variance = Col. (2) – Col. (3)	₹ 252 F	₹ 252 A	₹ 42 F	₹ 42 F
(c) Efficiency Variance (a+b) = Col. (1) – Col. (3)	₹ 36 A	₹ 324 A	₹ 24 F	₹ 336 A
(d) Rate Variance = Col. (3) – Col. (4)	₹ 588 A	₹ 378 A	₹ 84 A	₹ 1,050 A
(e) Total Labour Cost Variance (c+d)= Col.(1) –Col. (4)	₹ 624 A	₹ 702 A	₹ 60 A	₹ 1,386 A

iv. Variance Computation Chart (based on Idle Time Concept, without considering Mix Effect)

Particulars	**Col. (1): SH × SR**	**Col. (2): Net AH × SR**	**Col. (3): AH × SR**	**Col. (4): AH × AR**
Skilled	576 × ₹ 3 = 1,728	14 × (42 – 4) hours x ₹ 3 = 1,596	(14 × 42) × ₹ 3 = 1,764	(14 × 42) × ₹ 4 = 2,352
Semi-skilled	216 × ₹ 2 = 432	9× (42 - 4) hours × ₹ 2 = 684	(9 × 42) × ₹ 2 = 756	(9 × 42) × ₹ 3 = 1,134
Unskilled	108 × ₹ 1 = 108	2 × (42 - 4) hours × ₹ 1 = 76	(2 × 42) × ₹ 1 = 84	(2 × 42) × ₹ 2 = 168
Total	**₹ 2,268**	**₹ 2,356**	**₹ 2,604**	**₹ 3,654**

Labour Net efficiency Variance = ₹ 2,268 – ₹ 2,356 = ₹ 88 A

Labour Idle Time Variance = ₹ 2,356 – ₹ 2,604 = ₹ 248 A

Labour Rate Variance = ₹ 2,604 – ₹ 3,654 = ₹ 1,050 A

Labour (Gross) Efficiency Variance = ₹ 2,268 – ₹ 2,604 = ₹ 336 A

Total Labour Cost Variance = ₹ 2,268 – ₹ 3,654 = ₹ 1,386 A

Labour-wise Breakup of Variances

Particulars	Skilled	Semi-skilled	Unskilled	Total
(a) Net Efficiency Variance = Col. (1) – Col. (2)	₹ 132 F	₹ 252 A	₹ 32 F	₹ 88 A

(b) Idle Time Variance = Col. (2) – Col. (3)	₹ 168 A	₹ 72 A	₹ 8 A	₹ 248 A
(c) Gross Efficiency Variance (a+b)= Col. (1) – Col. (3)	₹ 36 A	₹ 324 A	₹ 24 F	₹ 336 A
(d) Rate Variance = Col. (3) – Col. (4)	₹ 588 A	₹ 378 A	₹ 84 A	₹ 1,050 A
(e) Total Labour Cost Variance (c+d)= Col. (1)–Col. (4)	₹ 624 A	₹ 702 A	₹ 60 A	₹ 1,386 A

Note: Alternatively, instead of the above chart, Labour Idle Time Variance can be computed as = Abnormal Idle Hours × Std Rate ph, and Labour Net Efficiency Variance = Gross or Basic Efficiency Variance less Idle Time Variance.

Particulars	Skilled	Semi-skilled	Unskilled	Total
(a) Gross Efficiency Variance = Col. (1) – Col. (3) (as above)	₹ 36 A	₹ 324 A	₹ 24 F	₹ 336 A
(b) Idle Time Variance = Abnormal Idle Hours × Std Rate ph	14×14 × ₹ 3 = 168 A	9×4× ₹2 =72 A	2×4× ₹1 =8 A	₹ 248 A
(c) Net-Efficiency Variance = (a) – (b)	₹ 132 F	₹ 252 A	₹ 32 F	₹ 88 A

(b)(ii)Discuss briefly the role of the Cost Accountant In a manufacturing Firm. [5]

Answer:

The Cost Accountant performs the following functions in a manufacturing organization -

i. Accounting and MIS: The Cost Accountant establishes the Cost Accounting Department in the Firm. He ascertains the information requirements of Managers at different levels in the organizational hierarchy. He defines the system to account for costs and to transmit relevant cost information on a timely basis to all Managers.

ii. Costing Manual: The Cost Accountant develops the Cost Accounting Manual. The manual specifies the functions of the Cost Accounting Department. It also provides the format of various documents, vouchers, forms and reports for compilation, accounting and dissemination of cost information.

iii. Cost Ascertainment: Cost of products, services, departments etc. are ascertained by effective implementation of the Cost Accounting System. The Cost Accountant supervises the operation of the accounting system and is thus responsible for cost ascertainment.

iv. Cost Reports: The Cost Accountant is responsible for preparation of various cost reports. These reports assist Managers in reviewing their own performance and in identifying critical areas where control measures should be taken to avoid cost escalation.

v. Cost Comparison: The Cost Accountant provides cost comparison information which is useful for decision making. Some bases of comparison may be - (a) Standard Costs with Actual Costs, (b) Budget and Actual activity levels, (c) Financial and Costing Profits, etc.

vi. Cost Analysis: The Cost Accountant analyses costs based on information available internally and externally. Such analysis is useful for decisions such as acceptance of additional orders, quotations for new products and orders, make or buy of components, sub-contractor own make, etc.
vii. Cost Control: The Cost Accountant suggests techniques for cost reduction and cost control. He may also supervise the implementation of the cost control techniques.

(c)(i) A Company uses a purchased component in an assembly. It follows a policy of Economic Order Quantity for procurement of the component. The Purchase Price of the component is ₹800 each and the cost of carrying one unit is 15% per annum. The cost of placing an order is ₹150. The Company has estimated the total cost of carrying and order placement at ₹36,000. The Supplier has offered a discount of 3% on the Purchase Price if the entire requirement of the component is covered in two purchase orders in a year.

i. Find the Economic Order Quantity.

ii. Calculate the Total Cost of Component Procurement and Storage, if the Discount Offer is accepted. Compare this cost with the Total Cost of the EOQ.

iii. What further discount if any, should be negotiated for minimising the cost? Assume that the inventory carrying cost does not vary according to discount policy. [7]

Answer:

i. Computation of EOQ

It is given in the question that at EOQ, Total Cost of Carrying and Order Placement, i.e. Associated Cost p.a. = ₹ 36,000. Hence, Buying Cost p.a. = Carrying Cost p.a. = ½ of Associated Cost p.a. = ½ of ₹ 36,000 = ₹ 18,000.

Equating Carrying Cost p.a. we have –	Equation Buying Cost p.a. we have –
Carrying Cost p.a. = (Avg. Inv. × Carrying Cost p.u. p.a.) $18{,}000 = \frac{Q}{2} \times$ (15% of ₹ 800). So, $18{,}000 = \frac{Q}{2} \times 120$ On solving, Q = 300 units. Hence, EOQ = 300 units. Note: The Company follows EOQ policy. Hence Q = EOQ.	Buying Cost p.a. = (No. of Orders × Cost per Order) $18{,}000 = \frac{A}{Q} \times$ ₹ 150. $18{,}000 = \frac{A}{300} \times 150$ On solving, A = 36,000 units.

ii. Discount Analysis

Particulars	EOQ	3% Discount
(a) Quantity Ordered every time	300 units	36,000 ÷ 2 = 18,000 units
(b) Number of Orders p.a.	36,000 ÷ 300 = 120 orders	(Given) = 2 orders
(c) Buying Costs p.a. at ₹150	120 × ₹ 150 = ₹ 18,000	2 × ₹ 150 = ₹ 300

(d) Average Inventory = ½ of (a)	½ × 300 = 150 units	½ × 18,000 = 9,000 units
(e) Carrying Costs p.a. at ₹120	150 × ₹ 120 = ₹ 18,000	9,000 × ₹ 120 = ₹ 10,80,000
(f) Purchase Costs p.a. [Note: The Question requires Total Costs. Hence, Discount Approach is not applied here.]	36,000 units × ₹ 800 = ₹ 2,88,00,000	36,000 units × (₹ 800 less 3%) = ₹ 2,79,36,000
(g) Total Costs p.a. = (c + e + f)	₹ 2,88,36,000	₹ 2,90,16,300

Conclusion: 3% Discount Offer is not worthwhile, due to additional costs of ₹ 2,90,16,300 – 12,88,36,000 = ₹ 1,80,300, when compared with EOQ.

iii. Computation of Additional Discount required

Additional Discount to be negotiated to justify 2 purchase orders p.a. = $\frac{₹\ 1,80,300}{36,000\ \text{units}}$ = ₹ 5 p.u. approximately.

Hence, Additional Discount Percentage required = $\frac{₹\ 5}{₹\ 800}$ = 0.626% of Purchase Price.

(c)(ii) DDR Manufacturers, a small scale enterprise, produces a single product and has adopted a policy to recover the production overheads of the factory by adopting a single blanket rate based on machine hours. The budgeted Production Overheads of the Factory are ₹10,08,000 and budgeted Machine Hours are ₹96,000.

For a period of first six months of the financial year, following information were extracted from the books:

• **Actual Production Overheads ₹6,79,000**		
• **Amount included in the Production Overheads:**		
	(a) Paid as per Court's order	**₹45,000**
	(b) Expenses of previous year booked in current year	**₹10,000**
	(c) Paid to workers for strike period under an award	**₹42,000**
	(d) Obsolete Stores written off	**₹18,000**

Production and sales data of the concern for the first six months are as under:

Production:	**Finished Goods**	**22,000 units**
	Work-in-Progress (50% complete in every respect)	**16,000 units**
Sales:	**Finished Goods**	**18,000 units**

The actual machine hours worked during the period were 48,000 hours. It is revealed from the analysis of information that ¼ of the under-absorption was due to defective production policies and the balance was attributable to increase in costs.

You are required to:

i. Determine the amount of under-absorption of Production Overheads for the period,

ii. Show the accounting treatment of under-absorption of Production Overheads, and

iii. Apportion the Unabsorbed Overheads over the items. [8]

Solution:

Difference in Absorption = Absorbed OH (-) Actual OH
= (48,000 hours x ₹ 10.50 per hour) (-) ₹6,79,000 = ₹ 1,75,000 (Under-absorption)

Normal Increase in OH Costs = Total ₹1,75 000 - Abnormal ₹1,30,000 = ₹ 45,000

Treated as Cost and apportioned to

Units Sold (18,000 units) = ₹27,000

Closing Stock of Finished Goods (4,000 units) = ₹6,000

Closing Stock of WIP (16,000×50% = 8,000 units) = ₹ 12,000

So, Supplementary OH Recovery Rate = ₹ 1.50 per unit

Abnormal Items	₹
1. Labour Court Award	45,000
2. Prior Period Item	10,000
3. Strike Period Wages	42,000
4. Obsolete Stores written off	18,000
5. Defective Policies = 1/4th of (₹ 1,75,000 - Total of Items 1 to 4)	15,000
Total of above	1,30,000

Treated as Loss and debited to Costing P & L

Notes:

i. Budgeted OH Recovery Rate = $\frac{\text{Budgeted OH}}{\text{Budgeted Machine Hours}} = \frac{₹\,10,08,000}{96,000 \text{ units}}$ = ₹10.50 per machine hour.

ii. Supplementary OH Recovery Rate = $\frac{\text{Total OH}}{\text{Total Output Qtty}} = \frac{₹\,45,000}{30,000 \text{ units}}$ = ₹ 1.50 per unit.

This calculation can be based on either Units Sold, (or) Closing Stock of FG, (or) Closing Stock of WIP, (or) Total of all these.

(d)(i) TUR Ltd. has two divisions. Division – I is involved in manufacturing of Railway and tramway locomotives & Division – II is involved in providing after sale service to their customer. His Aggregate annual turnover from manufacturing division is ₹ 70 crores and annual receipts from service division is ₹ 35 crores. State whether Companies (Cost Records and Audit) Rules, 2014 is applicable to the company? [6]

Answer:

As per Rule 3 of Companies (Cost Records and Audit) Rules, 2014, the class of companies including foreign companies, engaged in the production of the goods or providing services, specified in the Table, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, shall maintain cost records for such products or services in their books of account.

In the given case, the product is covered under item (B) as non-regulated sector of rule 3. The overall turnover of the company is ₹ 105 crores. Hence the company is required to maintained cost records under Rule 3 and also the aggregate turnover of the individual product "Railway and Tramway Locomotives" manufacturing by the company is not less than ₹ 35 crore. Hence, the company is also required to conduct cost audit.

(d)(ii) Opening stock of raw materials (10,000 units) ₹ 1,80,000; Purchase of Raw Materials (35,000 units) ₹ 7,00,000; Closing stock of Raw Material 7,000 units; Freight Inward ₹ 85,000; Self-manufactured packing material for purchased raw materials only ₹ 60,000 (including share of administrative overheads related to marketing sales ₹ 8,000); Demurrage charges levied by transporter for delay in collection ₹ 11,000; Normal Loss due to shrinkage 1% of materials; Abnormal Loss due to absorption of moisture before receipt of materials 100 units. [9]

Solution:

	Particulars	Quantity (units)	Amount (₹)
	Opening Stock of Raw materials	10,000	1,80,000
Add	Purchase of raw materials	35,000	7,00,000
Add	Freight inwards		85,000
			9,65,000
Less	Abnormal Loss of raw material (due to absorption of moisture before receipt of material) = [(7,00,000 + 85,000)× 100]/35,000	(100)	(2,243)
Less	Normal Loss of material due to shrinkage during transit [1% of 35,000 units]	(350)	-
Add	Cost of self-manufactured packing materials for purchased		52,000

	raw materials only (60,000 – 8,000)		
	Cost of raw materials	44,550	10,14,757
Less	Value of Closing Stock = Total cost/(Total units – Units of Normal Loss) [10,14,757/(10,000 + 35,000 – 350)] × 7,000	(7,000)	(1,59,088)
	Cost of Raw materials consumed	37,550	8,55,669

Note:

(i) Units of normal loss adjusted in quantity only and not in cost, as it is an includible item.

(ii) Cost of self-manufactured packing materials does not include any share of administrative overheads or finance cost or marketing overheads. Hence, marketing overheads excluded.

(iii) Abnormal loss of materials arises before the receipt of the raw materials, hence, valuation done on the basis of costs related to purchases only. Value of opening stock is not considered for arriving at the valuation of abnormal loss.

(iv) Demurrage charges paid to transporter is not includible item.

(e)(i) What are the duties of the Companies in relation to provisions of Section 148 of the Companies Act, 2013 and the Rules framed thereunder? [5]

Answer:

Every company required to get cost audit conducted under Section 148(2) of the Companies Act, 2013 shall:-

a) Appoint a cost auditor within one hundred and eighty days of the commencement of every financial year;

b) Inform the cost auditor concerned of his or its appointment;

c) File a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in **form CRA-2**, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014;

d) Within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in **form CRA-4** along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

(e)(ii) CRA-3 requires Details of Material Consumed, Details of Utilities Consumed and Details of Industry Specific Operating Expenses respectively [Part B and Part C, Para 2(a), 2(b) and 2(c)]. In case of companies where number of materials or utilities or industry specific operating expenses is more than 10 each, which items should be disclosed in the respective paras? [3]

Answer:

It is to be noted that the cost audit report is required to be filed in XBRL mode and there is no provision for extending the number of items under any of the heads to accommodate more than 10 items. Hence, in cases where number of such items is more than 10 under any of the heads of material or utility or industry specific operating expenses, the 9 main items in terms of value should be provided separately and the balance items should be clubbed together under "Others" and shown as the tenth item.

(e)(iii) Basant & Co. furnish the following expenditure incurred by them and want you to find the assessable value for the purpose of paying excise duty on captive consumption. Determine the cost of production in terms of rule 8 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 and as per CAS-4 (cost accounting standard) (i) Direct material cost per unit inclusive of excise duty at 10% - ₹ 1,320 (ii) Direct wages - ₹ 500 (iii) Other direct expenses - ₹ 100 (iv) Indirect materials - ₹ 75 (v) Factory Overheads - ₹ 200 (vi) Administrative overhead (25% relating to production capacity) ₹ 100 (vii) Selling and distribution expenses - ₹ 150 (viii) Quality Control - ₹ 25 (ix) Sale of scrap realized - ₹ 20 (x) Actual profit margin - 15%.

[7]

Solution:

Computation of Cost of Production (as per CAS-4)

Particulars	**Amount (₹)**
Direct Material (exclusive of Excise Duty) [1,320 x 100/112.36]	1,174.80
Direct Labour	500.00
Direct Expenses	100.00
Works Overhead [indirect material (75) plus Factory OHs (200)]	275.00
Quality Control Cost	25.00
Research & Development Cost	Nil
Administration Overheads (to the extent relates to production activity)	25.00
Less: Realizable Value of scrap	(20.00)
Cost of Production	2,079.80
Add: 10% as per Rule 8	208
Assessable Value	2287.78

(2) Answer any two questions [10×2=20]

(a)(i) What are the objectives of Management Audit? [5]

Answer:

Management audit is carried out to –

i. appraise the management performance at all the levels;
ii. spotlight the decision or activities, that are not in conformity with organizational objectives.
iii. ascertain that objectives are properly understood at all levels;
iv. ascertain that controls provided at different levels are adequate and effective in accomplishing management objectives or plans of operations;
v. evaluate plans which are projected to meet objectives.
vi. review the company's organizational structure, i.e. assignment of duties and responsibilities and delegation of authority.

The main objectives of management audit can be summarized as follows:-

- to ensure optimum utilization on all the resource employed, including money, materials, machines, men and methods;
- to highlight efficiencies in objectives, policies, procedures and planning;
- to suggest improvement in methods of operations;
- to highlight weak links in organizational structure and in internal control systems, and suggest necessary improvements;
- to help management by providing health indicators and help prevent sickness or help cure in case of sickness; and
- to anticipate problems and suggest remedies to solve them in time.

(a)(ii) What are the pre-condition for initiating Management Audit? [5]

Answer:

Pre -conditions for Management Audit

(i) Overall Objectives: The objectives of the enterprise should be clearly perceived, identified and stated in specific terms.
(ii) Operational Plans: The overall objectives of the organisation are to be analysed into quantifiable, detailed targets and plans for various segments like production, sales, etc.
(iii) Management Hierarchy: An organisational structure should be created, with specific targets and objectives for each function, and also their reporting responsibilities.
(iv) Performance Measurement: There should be a mechanism for measuring the performance of each functional area or responsibility centre. Performance expressed in quantitative terms facilitates comparison with objectives and targets. MIS: A suitable Management Information System (MIS) should provide timely and adequate information to the Management Auditor on various efficiency aspects.

(v) Attitude: There should be co-ordination between the Management Auditor and various department heads. A motivation system may be adopted, e.g. incentives for best performance.

(b) Distinguish the followings –

(i) Operational Audit and Internal Audit

(ii) Operational Audit and Management Audit **[2x5=10]**

Answer:

(i) Distinguish between Operational Audit and Internal Audit.

Particulars	Operational Audit	Internal Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	Function of internal control with the objective of determining whether other internal controls are well designed and in place.
Link with Internal Control	This is not a part of Internal Control. This is over and above the regular internal control system.	This operates as a part of Internal Control System.
Objectives	1. Appraisal of controls. 2. Evaluation of performance. 3. Appraisal of objectives and plans. 4. Appraisal of organizational structure.	1. To determine whether internal controls are well designed and properly operated, and 2. To assist all members of Management in the objective discharge of their responsibilities by reviewing activities and procedures.
Function	Constructive Function, i.e. to provide suggestions for improvement.	Protective Function, i.e. to safeguard the assets of the enterprise.
Areas	All aspects of operations are analysed to see whether they are in tune with Management Policies, Objectives and Goals.	The traditional field of internal Auditors is restricted to financial accounting and internal control.

Aspect	Qualitative Aspects are analysed. For example in Cash Management, the Operational Auditor would analyse - 1. Whether quantum of cash in hand is related to requirement of cash? 2. Whether surplus cash is promptly invested in short-term securities for maximizing return? 3. Whether maximum possible protection has been given to cash?	1. The Internal Audit Function is said to focus more on quantitative aspects when compared to Operational Audit. 2. Internal Auditors view and examine internal controls in financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not found. 3. They check the accounting books and records to see whether the internal checks work properly and the resulting accounting data are reliable.

(ii) Distinguish between Operational Audit and Management Audit.

Particulars	Operational Audit	Management Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	The Audit of the Management focuses on evaluating Managers' ability to manage.
Areas Covered	Operational Areas where standards and actual performance defined and expressed in quantitative terms are considered.	It is concerned with appraising - • Management's accomplishment of organizational objectives, • Management functions of planning, organizing, directing, and controlling, and • Adequacy of Management's decisions and action in moving towards its objectives.
Focus	Focus is on efficiency and economy in operations.	Focus is on effectiveness of Management decisions and actions.
Standards	Expectations or standards are expressed in quantitative terms, for comparison of actual therewith.	Standards are not defined in quantitative or monetary terms.
Evaluation	It is objective in nature, since standards are quantifiable.	Evaluation is comparatively subjective, since standards are not defined in monetary terms.
Technical Background	Operational Auditor should have a strong technical and operational background.	Management Auditor should have conceptual background. Technical Background is desirable, but not compulsory.

(c)(i) Explain the Scope of Internal Control. [5]

Answer:

It is clear from above that 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.

(c)(ii) Explain the silent features of special reports for Banks, Shareholders, Employees & Small Business. [5]

Answer:

Salient features for these special reports are briefly discussed below:-

(i) Reports for banks and creditors

Form and content of financial statements and schedules re-important to the lender but explanatory notes to the statements and schedules are perhaps more important to them. They require accuracy in report and confirmation of statement made, which should be properly verified and certified. Bankers are more oriented towards security due to their long-term expectation of debt servicing by the business. Hence, reliability of report is an important factor. All statements by the auditor should be clear and positive.

(ii) Report to shareholders

The reports are read by financial experts, bankers, tax authorities, public officials and research people. The report should, therefore, be useful in analytical details for its user, and give full facts of the organisation's business. The report should also convey the right and correct message to a lay man. The reports are often used as a public relation exercise to improve relations with investors and to promote loyalty. In India, auditor's report in the prospectus at the time of public issue is very important. Experts read "between the lines" of the auditor's report. It will ultimately reflect in the auditor.

(iii) Reports to employees

Reports for employees are mainly prepared for better understanding of the business, to dispel any misconceptions, counter charges by unions, or explain the need for continuance of the business in times of strike, competitions or sickness. The report to employees must gain the confidence of employees and earn respect for the statements. The report should consider the needs of employees, when the employee morale is low or where the relations with employees are strained. Auditor's views will be expected to be totally unbiased.

(iv) Reports for small business

The form of annual accounts and other requirements under the Companies Act is the same for a large or a tiny private company. However, the management auditor should design his report in a very simple way as the report for a small business if specifically directed to a person or a small group of persons only. A great deal of reporting for small business is subjective, due to lack of adequate data. This poses problems an analyzing and comparing data. Suggestions in the report must be based on proper appraisal of the problem.

(3) Answer any two questions [10×2=20]

(a) Explain the Impact of IFRS on the Cost Structure, Cash Flows and Profitability. [10]

Answer:

The new era of accounting standards has started in India after India committed to converge to the IFRS. The Ministry of Corporate Affairs had notified 35 new Ind AS in 2011. The timeline for the adoption of these new standards is not yet given. The date had been postponed in view of pending the suitable amendments required to be done in the other enactments.

However, it will be useful for the cost auditor to run through the effects that the new standard may have on the organizations in the new ear. The cost auditor should get acquainted with the requirements of the new standards and the differences as compared to the existing standards.

In the Performance Appraisal Report, the cost auditor many point out the impact of IFRS on the existing cost structure, cash flows, and profitability. It may be noted that the new standards provide a principle based framework in place of rule based standards, and as such the companies may need to assess the effect of their actions and choices made for accounting.

The five main elements of financial statements are assets, liabilities, equity, income and expenses. The IFRS provide for recognition, measurement and disclosure criteria for these elements. In cases, where the measurement criteria change, there will be an impact on the costs. The changed recognition criteria may impact the profitability and cash flows of the company.

The most important effect on valuation will happen through the adoption of “fair value” concept in measuring various assets and liabilities. The cost auditor must enumerate the ceses where use of fair value is mandatory or permitted as management’s choice. It should be noted that any change in the fair value as on the reporting date has to be taken to the profit and loss a/c.

It may not be possible to split the effect of new standards on individual product or product group costs and profitability. It could be assessed for the organization as a whole.

These effects arise due to the balance sheet orientation of IFRS rather than the P&L smoothing practices follows by companies. Given below is an illustrative list of areas where major impact would be arising out of the IFRS provisions related to:

- Revenue recognition – companies may have to defer part or whole of their revenues.
- Inventory valuation – explicit rejection of LIFO method could change the inventory costs and thus profitability.
- Property, plant and equipment – recognition of assets and depreciation may change, provisions on revaluation of assets are noteworthy.
- Financial instruments-accounting for hedges and FOREX may result in profits or losses to be recognized or derecognized.
- Construction contracts – there could be changes in contract revenues and profit measurement thereon
- Impairment of assets-recognition of provisions may impact profitability
- Intangible assets-certain existing assets may have to be derecognized
- Business combinations – some costs of M & A cannot be capitalized

The impact of changeover has been explained in the Ind AS 101 – first time adoption. It may be noted that the impact based on this standard would be in the first year in which the new standards are applied. In the first financial statements, the adjustments will have to be made in the retained earnings, subject to some exceptions and exemptions. This standard may required an entity to

(i) Recognize all assets and liabilities whose recognition is required by Ind AS
(ii) Not to recognize items as assets or liabilities if Ind AS do not permit such recognition;
(iii) Reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under Ind AS and
(iv) Apply Ind ASs in measuring all recognized assets and liabilities.

The Performance Appraisal Report should include comments of the potential changes for the understanding of the Board and Audit Committee members. The cost auditor could provide them an insight to the likely changes in the cost structure. This content area is an important aspect to be covered till the new standards are not adopted. In subsequent years, it may lose its relevance.

(b) Prepare the checklist for Production Function check. [10]

Answer:

Production Function Checks

(i) How are the production requirements for raw materials communicated to the purchasing function?

(ii) How is the production scheduled and controlled against the schedule?

(iii) Are these methods suitable for the type, size and complexity of the production processes?

(iv) What is the system for amendments to the production schedule?

(v) How is rescheduling carried out when production is not to schedule, or there are machinery or labour troubles?

(vi) What methods are used to control the supply of raw materials for production?

(vii) How are labour requirement determined?

(viii) What system is there for ensuring good utilisation for machinery and what statistics on the subject are available?

(ix) Similarly, what is the system for ensuring good utilisation of labour and what statistics on this subject are available?

(x) What is the inspection system during production and at the final product stage?

(xi) How are scrap items to be re-worked and controlled?

(xii) What methods are used for forecasting the production levels that will be required for the future months/years?

(xiii) How is scheduled production broken down into its constituent items, to be produced at times which will make them available when required to merge with the part forming the finished product?

(xiv) Are there efficient preventive maintenance programs for production equipment and machinery?

(xv) Is replacement cost information readily available for major items of plant?

(c) As a management consultant, you have an assignment to conduct a Management Audit of the production function of a medium-scale engineering unit. Prepare a check list of the points on which you should undertake the study. [10]

Answer:

Checklist for carrying out management audit of production function in a medium sized engineering unit:

1. How is the production plan prepared? Is it based entirely on market forecasts, or does it also take into account limitations of materials, personnel and finance?

2. Are the product-mix decisions based on optimum profitability? What is the proportion of standard products and tailor-made items?
3. Whether all infrastructure like machinery, materials, manpower and money have been assured at the scheduled time for uninterrupted production.
4. Are there any constraints in achieving maximum capacity utilization? Are there any imbalances in the plant? If so, what steps are being contemplated to set right the imbalance?
5. Is it possible to subcontract some jobs to increase production capacity or maintain production in times of power-cuts etc.?
6. What is the percentage of scrap, waste and rejects? Is it reasonable?
7. Is the idle time being monitored regularly? Is it being analysed reason-wise? How much of it is due to machinery breakdown which is controllable by production department?
8. Is there excess or shortage of manpower? How is the control exercised – time & motion study, incentives, labour budgets or any other means?
9. Is there any wastage in consumption of utilities like power, fuel, steam, compressed air, etc.?
10. How effective is the material handling system? Are there any avoidable movements of materials?
11. What is the system for preventive maintenance? If the in-house maintenance capability is not adequate, are there annual maintenance contracts for all important items of plant and machinery?
12. How is the control exercised on inventory of stores and spares?
13. What is the procedure to handle breakdown emergencies?
14. Are all statutory requirements in regard to safety measures complied with?
15. Are history cards available for all plant and machinery giving details of downtime, replacement of parts, etc?
16. Does the system provide for flexibility or change of production schedules to execute urgent orders or changes in the product mix?