PAPER – 19: Cost and Management Audit

Paper – 19 : Cost and Management Audit

Time Allowed: 3 Hours **Full Marks: 100**

Answer Question No. 1 which is compulsory and Carries 20 Marks and any 5 questions from Question No. 2 to 8.

I. Answer the following

1. (a) Fill in the blanks:

(i) Profit & Loss Account
(ii) filing Compliance
(iii) Management Audit
(iv) CRA – 3
(v) 30 days

(b) State whether the following statements are true or false:

(i) True
(ii) True
(iii) False
(iv) False
(v) True.

(c) Answer any five of the following in one or two sentences

(i) Cost of Utilities generated for the purpose of Inter unit transfers shall comprise of direct material cost, direct employee cost, direct expenses, factory overheads and the distribution cost incurred for such transfers.

(ii) As per CAS – 15, the demurrage charges levied by transportation (or) other authorities in respect of distribution Activity shall not form part of setting and Distribution overheads.

(iii) Corporate Branding is the process of creating and maintaining a favourable reputation of the company and its constituent elements.

(iv) Sun Set Clause is a measure within a statute regulation or other law that provides that the law shall cease to have effect after a specific date, unless further legislative action is taken to extend the law.

(v) Cost accounting policy of a company state the policy adopted by the company for treatment of individual cost components in cost determination.
The Cost accounting system of a company, on the other hand, provides a flow of the cost accounting data / information across the activity flow culminating in arriving at the lost of final product / service.

(vi) The Companies (Cost Records and Audit) Rules, 2014 is not applicable to a company which is classified as a micro enterprise or a small enterprise including as per the turnover criteria under section 7(9) of the Micro, Small and Medium Enterprises Development Act, 2006.

II. Answer any 5 from Question No. 2 to 8. Each question carries 16 marks.

2.(a) Sub-rule (7) of Rule 6 of the Companies (Cost Records and Audit) Rules 2014 states that ―the provisions of sub-section (12) of section 143 of the Companies Act, 2013 and the relevant rules made there under shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

As per sub-section (12) of section 143 of the Companies Act 2013, extract of which is given above, it is obligatory on the part of cost auditor to report offence of fraud which is being or has been committed in the company by its officers or employees, to the Central Government as per the prescribed procedure under the Rules.

As per the provision to above sub-section, it has been stated that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

(b) (I) The Cost Auditor has to report whether the Cost Accounting System followed is adequate for determination of the fair cost of production.

(II) He has to report on the financial performance of the company as well as of the product under cost audit, along with various ratios and offer comments on the ratios.

(III) He has to indicate the percentage of production in relation to the installed capacity expressed in appropriate units of measurement. He has also to state reasons for the shortfall in production bringing out clearly the extent to which they are controllable both in short term as well as long term.

(IV) He has to give observations as regards variations, if any, in the rate of major raw materials, power and fuel etc. in terms of rate per unit as compared to previous year, if any.

(V) He has to give details of wages and salaries including direct labour cost per unit of output and as compared to the previous year.

(VI) He has to indicate the amount of overheads along with reasons for any significant variations in expenditure incurred against the items of factory, administration, selling and distribution overheads as compared with previous two years.

(VII)The cost auditor has also to mention any abnormal feature affecting the production indicating their effect on the unit cost of production. Again the cost auditor may offer suggestions as regard the following matters for improvements in performance of the company under audit with reference to:-

(i) Rectification of general imbalance in production facilities
(ii) Fuller utilization of installed capacity
(iii) Concentration on areas offering scope for cost reduction, increased productivity and key limiting factors causing production bottlenecks; and
(iv) Suggesting improved inventory policies As far as possible data for the earlier years has to be furnished. The cost auditor could also interpret the data from the trend for the earlier years, and offer suggestions. The opinions shall be based on verified data, reference to which shall be made and shall be included after the company has been given an opportunity to comment on items.

3. (a) A questionnaire for review of 'Marketing Policies' of the company:

(i) Consumer needs assessment -
- Is the policy rationable in terms of marching customers' needs with the firm's offering and capabilities?
- What is the likely consumer reaction?

- What are the evaluation studies undertaken to assess consumer reaction, particularly, in respect of product features, price, distribution outlets, new product concept, new product introduction?

(ii) Market segmentation -
- What is target market conceived?
- Is market segmentation based on empirical data, such as-usage, demographic, benefits sought, consume characteristics etc.?

(iii) Competition and product position -
- How many are competitive producers?
- What is company's share in the total market?
- How many competitors have left the market over the last few years?
- What is the general competitive environment?
- What particular product characteristics does the firm possess that contribute to the market place?
- What is the relative market position of the products at different stages of their life cycle?

(iv) Marketing mix -
- How is the optimum mix of pricing, distribution and promotional policy for each of the products of firms determined?
- What are the company's approaches to issue like product Design, products positioning, Price-range, advertising and promotion media etc.?

(v) Marketing programme -
- Is the marketing program of the company designed to emphasise lower price, mass distribution channels and mass advertising to reach numerous market segments?

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

(b) Operational auditing is review of operational methods and procedures. To that extent it is no more than internal audit extended to operational areas. However, as applied to operational areas the attempt must be not only evaluate controls, but also assess the effectiveness of existing procedures to meet the objectives and plans of the department which is being audited.

The objectives of operational audit may be briefly listed as appraisal of the relevant departments.
- Objectives and plans
- Controls.
- Existing procedures to achieve the objectives and plans.
- Quantitative measures to monitor of performance.
- Productivity

Since operating departments would be structuring their methods and procedures based on their objectives and plans, such objectives and plans have to be appraised. Restatement or changes in definitions of the objectives could have an impact on the plans and similar change in plans may make it advisable to redefine the objectives. Hence appraisal of plans and objectives becomes essential and the first step in operational audit.

The procedure in the department has to be reviewed and appraised to assess their effectiveness in achieving the objectives and plans with the given resources.

It is necessary that every department should develop a few quantitative measures to monitor their performance. Such measures may be in simple or composite units. The trend of such measures, the usefulness of such indicators as well as their reliability may have to be appraised as part of operational auditing. Appraisal of productivity could be complex as the term 'Productivity' is all embracing and covers the effectiveness of entire operations of the concerned department.

4. (a)

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 = [2,00,000 – 40,000]	1,60,000
Add: Employers contribution to P.F	75,000
Add: Re-imbursement of Medical expenses	67,000
Add: Hospitalization expenses of employees family member paid by the employer	19,000
Add: Festival bonus	20,000
Employee cost	8,41,000

(b) Statement for Total Cost per MT for 2014-15:

	₹/MT	
Raw material		600
Labour		150
Power		65
Consumable		20
Packing		80
Variable cost / MT		915
Fixed overhead (120 lakhs/ 2.5 lakhs)	48	
Depreciation (100 lakhs / 2.5 lakhs)	40	
Power (3,375 lakhs / 2.5 lakhs)	1.35	
	1,004.35	

Total Cost per MT for 2015-16:

Production	1,25,000 MT	
	₹/MT	
Raw material	642	Escalated 7%
Labour	160.5	
Power	69.55	

Consumable	21.4	
Packing	85.6	
Variable cost / MT	979.05 (A)	
	₹ Lakhs	
Fixed overhead		120
Depreciation		100
Power (MD charges)		3.375
		223.375

50% of total fixed cost = ₹ 223.375 lakhs / 2 i.e. ₹ 111.6875 lakhs
Now, Cost per MT = ₹ 111.6875 lakhs / 1.25 lakhs = ₹ 89.35 per MT (B)

(i) Total cost per MT = (A) + (B) = ₹ 979.05 + ₹ 89.35 = ₹ 1,068.40
(ii) 50% since half of the production loss due to uneven demands of the fixed cost will be considered as abnormal.

This will be ₹ 111.6875 lakhs.

5. (i) Capital Employed

			In ₹ lakh 2016	2015
Gross block			1450	1360
Less Depreciation			(630)	(580)
Net Block			820	780
Less Revaluation Reserve			250	280
Net Fixed Assets			570	500
Current Assets (A)				
Inventories	934	882		
Sundry Debtors	364	390		
Loans & Advances	288	274		
Cash and Bank	42	38		
	1,628	1,584		
Current Liabilities (B)				
Creditors (others)	370	394		
Prov. For Taxes	128	142		
Term Loan (due in 12 months)	192	168		
	690	704		
Net Working capital (A) – (B)			938	880
Capital Employed			1508	1380

Average Capital Employed (1508 + 1380)/2 = ₹ 1444 lakhs

(ii) Net Worth

	2016 (₹ lakh)
Share capital	600
Debentures Redemption reserve	50
Capital Subsidy	60
General Reserve	320
Profit and Loss A/c	96
	1126

Less: Miscellaneous Expenses	192
	934

(iii) Debt – Equity ratio

Secured Loans	550
Unsecured Loans	246
	796
Less Due in 12 months	192
	604

Ratio = 604/1126 × 100 = 53.64% or 0.5364:1

(iv) PBT to capital Employed (160/1444) × 100 = 11.08%
(v) PBT to Net worth (160/934) × 100 = 17.13%

6. (a) Statement Showing Reconciliation of Profit:

Particulars	Amount	Amount
Profit (loss) as per financial accounts		26,28,000
Less: Amount of incomes not considered in cost accounts Trading on sale of assets Profit on sale of old assets Interest received on outside investment	 -75,000 -80,000 -1,50,000	 -3,05,000
Add: Amount of expenses not considered in cost accounts Overhauling charges (3/4 not provided in cost accounts) Depreciation provided on revaluation of assets	 3,00,000 2,25,000	 5,25,000
Difference in stock valuation as per cost & financial records Add: difference in valuation of WIP		 1,30,000
Total profit (loss) as per cost accounts		29,78,000

(b)

Particulars		₹ Lakhs
Computation of value added: Net sales + increase in stock of finished goods		 21,250
Less: cost of bought out goods & services: Raw materials Packing materials Stores and spares Power and fuel Repairs and maintenance Insurance Other factory overhead Other selling and distribution overhead Other administration overheads	 2600 1200 550 4600 200 120 250 1700 80	 11,300
Value added:		9,950
Composition of value added: Depreciation		 885

Interest Additional sales tax. Salaries & wages Profit before tax		1398 457 960 6250
Total		9950

7. (a) Calculation of overtime wages of A:

	₹
Basic wages	150.00
Dearness allowance (80% of ₹ 150)	120.00
Total Wages	270.00
Wage rate per hour (270/200)	1.35
Overtime wages [18 hrs × (1.35 × 2)]	48.60

Computation of total earnings of A and B:

Particulars	A (`)		B (`)
Basic wages		150.00	210.00
Dearness Allowance (80% of Basic)		120.00	168.00
Overtime Wages		48.60	
Gross wages earned		318.60	378.00
Less: P.F @ 10% of Basic		15.00	21.00
E.S.I. @ 4% of Basic		6.00	8.40
Net wages earned		297.60	348.60

Computation of labour cost per hour:

	A(₹)	B(₹)
Basic + Dearness Allowance	270.00	378.00
Add: Employers contribution to PF and ESI (@ 14% of basic)	21.00	29.40
	291.00	407.40
Labour rate per hour	1.455	2.037

Statement showing allocation of wages to job:

	Total (₹)	X (₹)	Y (₹)	Z (₹)
A's wages (3:3:4)	291.00	87.30	87.30	116.40
A's overtime wages	48.60	-	48.60	-
B's wages (2:3:5)	407.00	81.40	122.10	203.50
Total	746.60	168.70	258.00	319.50

(b) Need for Operational Audit:

Operational Audit overcomes the following problems/gaps faced by the Management in operational areas:-

1. Information needs: Managers require full objective and current information about conditions prevalent in their operational areas, and also in areas beyond their direct observation. Operational Audit provides the required information to them.

2. Fill up Communication Gaps: Conventional sources of Management Information are-
   (I) Departmental Manager's routine performance report
   (II) Internal Audit Reports,
   (III) Periodic special investigation, and
   (IV) Survey.
   These sources create communication gaps on activities, which do not come under the direct observation of managers. Hence, operational audit is required.

3. Effectiveness of Managers: Executives and Managers are too pre-occupied with implementation of plans and achieving targets. They are left with very little time to collect information and locate problems. Hence, an independent operational audit team should provide them data inputs on the effectiveness of operations.

4. Undetected Cracks: Even when a department is working well and smoothly, there may be some crack or gap in operations or in controls. Operational audit is a management information source since it will find out the possibilities of such undetected gaps/ lapses in control.

5. Analytical Evaluation: Departmental Managers and their aides generally routine transmit information. But an Independent Operational Audit Team will be able to evaluate the operations analytically.

6. Unbiased Reports: Performance Reports contained in the annual accounts and routine reports prepared by the operating departments have their own limitations, may be subjective, manipulated or biased. Hence, operational audit is required.

7. Shortcoming of internal Audit: Conventional Internal Audit reports are often routine and mechanical in character and have definite leaning towards accounting and financial information. They are historical in nature. Operational audit overcomes this limitation of internal audit.

8. Need for current control: Surveys and special investigations are occasional in character. They are costly, time consuming and keep the departmental key personnel busy during that period. They are undertaken mostly to find causes of certain affairs or to fix responsibility rather to give a signal for dangers and forthcoming disasters. Operational Audit is required to ensure day-to-day control of activities.

9. Environmental Changes: Operational audit is required to analyse whether the activities, operations, procedures, methods and objectives of the enterprise are in tune with its present environmental conditions. There is a need for an instrument, which should signal change in advance

8. (a) Corporate Social Responsibility:

As part of the infrastructure requirements for running any business or manufacturing industry, a company has to depend on the Society and community of people living in the area in which the factory is situated.

Therefore, the company owes a duty and responsibility for ensuring that the normal life of the community is not affected by the manufacturing process. Although the Government of the state and the Central Government have enacted legislations for prevention of environmental pollution and provision of safety measures, the company on its own should take measures for community development besides protection of environment. Many companies provide medical facilities and run educational institutions not only for their own employees, but also for the public in general in the areas in which they are operating. This is termed as "corporate social responsibility".

The following are some of the types of pollution which need to be prevented or controlled:-

(1) Air Pollution- caused by burning or letting out of chemicals in the air leads to respiratory diseases.

(2) Water Pollution - caused by letting out of effluents in water bodies or agricultural lands by industries like Tanneries, Dyeing units etc. result in contamination of ground water making it unsuitable for human consumption and in pollution of quality of soil affecting agriculture.

(3) Noise Pollution- by the running of heavy industries water well drilling etc. lead to loss of hearing and psychological disorders.

(4) Radiation Pollution- caused by Nuclear Power Plants will affect the health of the people living in the vicinity.

(5) Smell Pollution - Discharge of industrial products unclear dumps open sewers etc. It affects well being and even causes psychological dis-orders.

(6)Visual Pollution- Effluents from chemical plants and washeries are discharged into waterways causing reduced visibility. Industrial fumes and dust causing loss of landscape attractiveness and strain to vision of pedestrians and motorists may cause more road accidents and traffic.

(7) Thermal pollution - Thermal pollution is radiation of heat generated by plants in industries. Warmer temperatures lower dissolved oxygen content and cause aquatic organisms to increase their respiration rates consume oxygen faster and increase their susceptibility to disease, parasites, and toxic chemicals. Thermal pollution affects ecological balance and thereby the inhabitants.

(8) Climate pollution - Radiation of heat in highly industrial centres leading to "micro climate zones" causing deforestation, shortening plants growth and affecting surroundings. It affects ecological balance and causes damages to plant and surroundings.

(9) Soil/land pollution - Indiscriminate use of fertilizers and pesticides, pollution of soil with man-made chemicals, indiscriminate disposal of solid use etc. Due to pollution

the quality of soil deteriorates to the extent that they fail to support vegetation. It affects global climate also.

(b) In case of a company having more than one cost auditor, it would be necessary for the company to appoint/designate one cost auditor as the lead cost auditor for consolidation of the report.

The individual cost auditors appointed for specific units/products would be required to audit and provide para numbers A-4, B – 1, B-2, B-2A, B-2B, B-2C, C-1, C – 2, C-2A, C-2B, C-2C (as applicable), D-1 in respect of the products/services coming under the purview of their respective audits. The individual auditors would also be required to submit to the Board of Directors the individual cost audit report as per Form of the Cost Audit Report given in CRA-3.

The lead auditor would be responsible for preparing the Para number A-3, D-2, D-3, D-4, D-5, D-6 and consolidate Para numbers A-4, B-1, B-2, B-2A, B-2B, B-2C, C-1, C-2, C-2A, C-2B, C-2C(as applicable), D-1 received from the individual cost auditors.

The consolidated report should contain the reports of all the individual cost auditors including the report of the lead cost auditor. In case individual cost auditors have any observations or suggestions or qualifications, they would be required to mention the same under Para 2 of the cost audit report and the lead auditor would have to mention the specific observations and/or qualifications of all the individual cost auditors in the place provided for the same in the under Para-A-1.

The consolidated report so prepared would be converted to XBRL and submitted to the Central Government by the Company in Form CRA-4.

(c) A good internal control system should possess the following feature:-

1. Proper organization structure:
   (A) A good internal control system should involve segregation of duties in such a manner that error or fraud cannot take place.
   (B) Proper division of duties, with respect to access to assets, authorization of transaction, execution of transactions and record keeping should be based on the organization structure.

2. Scheme of authorization and procedures: A good internal control System should define proper authorizations and procedures. The scheme of authorization should ensure that-
   (A) Every transaction is duly authorized by the competent official
   (B) Every transaction is properly accounted in the books, and
   (C) Supervisory procedures are laid down based on the responsibilities of each official.

3. Internal Check:
   (A) Accounting procedures should be designed in such a manner that no single person is authorized to carry out all the operations involved in a transaction.
   (B) The system should institute a prompt and independent verification of an individual's work by prescribing cross-checks and cross-reconciliations as a part of the operating procedure itself and also provide for complimentary allocation of duties.

4. Suitable personnel:
   (A) Competent and honest persons alone should be employed in the organization so that the system operates effectively.
   (B) The qualification, experience and personal characteristics of the personnel involved are important in establishing and maintaining a system of internal control.

5. Internal Audit System
   (A) The Management may establish an internal Audit Department and delegate some of its supervisory functions like review of internal control.
   (B) Internal Audit constitutes a separate component of internal control system undertaken by specially assigned staff with the objective of determining whether internal controls are well designed and operating properly.