Paper-17 - Cost Audit & Operational Audit

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

Working Notes should form part of the answer.

"Wherever necessary, suitable assumptions should be made and indicated in answer by the candidates."

SECTION I (50 Marks)

(Cost Audit)

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

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

(i) For calculation of Capital Employed, average is considered for —

(a) Current year and previous year
(b) Current year and previous 2 years.
(c) Current year only.
(d) Previous 5 years.

Answer: (c) Current year only.

(ii) Para 9 of the Annexure to the Cost Audit Report Rules deals with —

(a) Capital employed
(b) Installed capacity and actual production
(c) Wages and salaries
(d) Financial Position and Ratio Analysis.

Answer: (d) Financial Position and Ratio Analysis.

(iii) CAS 9 deals with —

(a) Packing Material Cost
(b) Indirect Material Cost
(c) Direct Material Cost
(d) None of the above.

Answer: (a) Packing Material Cost

(iv) Copy of Cost Audit Report need not be submitted to —

(a) Company Law Board
(b) Board of Directors of the Company
(c) Members at Annual General Meeting of the Company.
(d) Income Tax Officer along with the Income tax Return.

Answer: (c) Members at Annual General Meeting of the Company.

(v) As per Rule 7 of the Companies (Cost Accounting Records) Rules, 2011, the Annexure to the

Compliance Report is to be duly approved by the -

a. Secretary
b. Cost Accountant
c. Board of Directors
d. None of the above

Answer: c. Board of Directors

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

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

Answer: a. CAS -5

(vii) Form A XBRL is used for filing -

a. Cost Audit Report of a Company
b. Annual Report of a Company
c. Compliance Report of a Company
d. Annual Accounts of a Company

Answer: c. Compliance Report of a Company

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

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

Answer: a. Every rupee invested gives optimum returns

(b) State whether following statements are "True" or "False". Reasons or justification is needed for the answer. [6×1=6]

(i) Every company required to maintain Cost Records under Section 209(1)(d) of the Companies Act is required to get such records audited under Section 233(B) of the Companies Act.

Answer: False. The Cost Accounting Records Rules, 2011 is applicable to companies whose net worth as on the last date of the immediately preceding financial year exceeds five crore of rupees or the aggregate value of the turnover made by the company from sale or supply of all products or activity during the immediately preceding financial year exceeds twenty crore of rupees or the company's equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) The Cost Auditor is not a member of the Audit Committee of the Company.

Answer: False. A Cost Auditor of a company can be the member of the Audit committee of the company in which he is not appointed as cost auditor of the company.

(iii) Under Para 11 of the Annexure to Cost Audit Report, the Cost Auditor gives Reconciliation of only 2 years.

Answer: False — The Cost Auditor gives Reconciliation of only the Current Year.

(iv) Cost Auditor has a statutory right to visit the Branch of the company.

Answer: False.

(v) CAS 6 deals with the principles and methods of classification, measurement and assignment of material cost, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.

Answer: The statement is True.

(vi) As per CAS 10, Credits/ recoveries relating to the Direct Expenses, material and quantifiable, shall not be considered to arrive at the net Direct Expenses.

Answer: False — Credits/ recoveries relating to the Direct Expenses, material and quantifiable, shall be deducted to arrive at the net Direct Expenses.

2(a) What are the benefits of cost information as per the expert committee of India? (6 Marks)

Answer:

The Expert committee formed by the Government of India to study the Cost Audit scenario in the country, highlighted the following benefits of cost information:

(i) Cost Information enables the organization to structure the cost, understand it and use it for communicating with the stakeholders.

(ii) Costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively operational processes transform input into output. It contributes to the data input on economy level parameters like resources efficiency, waste management, resources allocation policies etc.

(iii) Costing includes product, process, and resource-related information covering the functions of the organization and its value chain. Costing information can be used to appraise actual performance in the context of implemented strategies.

(iv) Good practice in costing should support a range of both regular and non-routine decisions when designing products and services to

- meet customer expectations and profitability targets;
- assist in continuous improvements in resources utilisation; and
- guide product mix and investment decisions.

(v) Working from a common data source (or a single set of sources) also helps to ensure that output reports for different audiences are reconcilable with each other.

(vi) Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation.

(b) List out the records to be maintained by companies to which Cost Accounting Record Rules, 2011 is applicable? (9 Marks)

Answer:

An illustrative list of Cost Records can be as follows:

1. **Production**
   a. Raw Material consumption register/report;
   b. Production report;
   c. Rejections/wastages/scrap report;
   d. Report on stoppage of machines with reasons;
   e. Idle time report with reasons;
   f. Machine utilization report;
   g. By-Product & Joint Products.
2. **Work-in-Progress and Finished Goods**
   a. Process stock register- cost centre-wise and product wise;
   b. Finished goods stock register- product-wise.
   c. Daily Stock Accounts (DSA) maintained under Central Excise Law
3. **Raw Materials and Stores Accounting**
   a. Goods received register;
   b. Bin cards;
   c. Materials/stores ledgers.
   d. Packing Materials
4. **Employee Cost**
   a. Attendance registers/ sheets;
   b. Wages/salary sheets;
   c. Leave and gratuity payments.
5. **Repairs and Maintenance**
   a. Works order register / card showing material and spares consumed and labour utilized;
   b. Procedure followed for routine maintenance;
   c. Details major breakdowns & Repairs;
   d. Details of Abnormal Repairs & Reconditioning activities.
6. **Utilities (Water, Steam, Power, DM Water, Air, Effluent Treatment etc.)**
   a. Records of input and output;
   b. Record of cost centre-wise allocation of outputs.
7. **Overheads**
   a. Details such as production hours, labour hours, machine hours to facilitate distribution of overheads;
   b. Overheads Keys.
8. **Cost Accounts**
   a. Overheads analysis register;
   b. Cost centre-wise assets register;
   c. Product ledger;
   d. Annexures and proformae as per rules, if any;
   e. Reconciliation of profit/loss as per cost records and financial records. The Reconciliation Statement between cost accounts and financial accounts can also be treated as a Costing Profit & Loss Account. This statement shall normally start with the margin arrived at as per cost accounts and all other items of expenses not considered for determination of cost or incomes not considered for arriving at the margin as per cost accounts would get reflected.
9. **Sales**
   a. Product-wise Sales analysis
   b. Stock Transfer

c. Marketing/ Market Research Cost

(c) How many Compliance Report a cost accountant in full-time practice can authenticate?

(3 Marks)

Answer:

Ceiling on a cost accountant in full-time practice on number of Compliance Report that he can authenticate:

There is no ceiling on the number of Compliance Reports that can be authenticated by a cost accountant in full-time practice.

A cost accountant working as permanent employee can authenticate the Compliance Report of the company where he is employed provided his membership dues are not in arrears. He cannot authenticate Compliance Report of any other company even under the same group.

(3)(a) As a cost auditor of a company, how would you deal with the following expenses -

(i) Separation costs related to voluntary retirement, retrenchment, termination etc. should be amortized over the period benefitting from such costs;

(ii) Subsidy, Grant, Incentive or any such payment received or receivable with respect to any Employee cost. (6 Marks)

Answer:

(i) These benefits are amortized over the period benefitting from such additional cost resulting in reduction of current employee cost. Lump sum payments under the above schemes are generally amortized over a period of 5 years. Earlier costs related to voluntary retirement, retrenchment/termination compensation were treated as a part of non-cost items. As per cost accounting standard on employee cost, it should be amortized over the period benefitting from such costs. If this amount is charged off in the financial profit & loss account during the year of incurrence, the difference in the amount charged in cost accounts and the amount carried forward during the years of benefit would be reflected as a reconciliation item in the statement of reconciliation between cost accounts and financial accounts.

(ii) Subsidy, grant or incentives are provided for specific purpose. For example, generation of employment in specified areas, subsidy, grant or incentives are given by government to attract setting up units in those areas. Any subsidy, grant received / receivable relating to employee cost shall be reduced from the employee cost.

(b) Bengal Electronics Ltd. is engaged in the manufacture of colour television sets having its factories at Kolkata and Gujarat. At Kolkata the company manufactures picture tubes which are stock transferred to Gujarat factory where it is consumed to produce television sets. Determine the Excise duty liability of captively consumed picture tubes from the following information: - Direct material cost (per unit) ₹ 800; Direct Labour ₹ 100; Indirect Labour ₹ 50; Direct Expenses ₹ 100; Indirect Expenses ₹ 50; Administrative Overheads ₹ 50; Selling and Distribution Overheads ₹ 100. Additional Information: - (1) Profit Margin as per the Annual Report of the company for 2012-13 was 12% before Income Tax. (2) Material Cost includes Excise Duty paid ₹ 73 (3) Excise Duty Rate applicable is 12%, plus education cess of 2% and SHEC @ 1%. (9 Marks)

Solution:

Cost of production is required to be computed as per CAS-4. Material cost is required to be exclusive of CENVAT credit available.

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

Particulars	Amount (₹)
Material Consumed (Net of Excise duty)(800 – 73)	727
Direct Wages and Salaries	100
Direct Expenses	100
Works Overheads (50+50)	100
Quality Control Cost	--
Research and Development Cost	--
Administrative Overheads (relating to production capacity)	50
Less: Sale of Scrap	--
Cost of Production	1,077
Add: 10% Profit margin on cost of production (i.e. 1,077 x 10%)	108
Assessable Value as per Rule 8 of the valuation rules	1,185

Note - (1) Indirect labour and indirect expenses have been included in Works Overhead.

(2) In absence of any information, it is presumed that administrative overheads pertain to production activity.

(3) Actual profit margin earned is not relevant for excise valuation.

(c) What are the requisite qualifications required for appointment as a cost Auditor of the company? (3 Marks)

Answer:

Qualification of Cost Auditors:

Section 233(B) of the Companies Act, 1956 provides that the Central Government may, if it considers necessary, direct that the audit of cost accounts kept by a company for a specified product or activity under Section 209(1)(d) shall be conducted by an auditor who shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959. In other words, the Sec. 233B(1), in so far as it relates to qualifications of cost auditor provides that a person holding certificate of practice from the Institute of Cost Accountants of India only can be appointed as a cost auditor. The cost auditor may be an individual cost accountant or a firm of cost accountants with at least two partners. A firm of cost accountants can be constituted with the previous approval of the Central Government/Institute as required under the regulation 113 of the Cost and Works Accountants Act, 1959 as amended from time to time and in which all the partners are cost accountants holding certificate of practice issued by the Institute of Cost

Accountants of India. Section 224(1B) of the Companies Act, 1956 further provides that a person can be appointed as a cost auditor only if he is not in full time employment elsewhere.

A proviso to Section 233B(1) lays down that if the Central Government is of opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act, 1959 are not available for conducting the audit of the cost accounts of companies generally, the Government may, by notification in the Official Gazette, direct that, for such period as may be specified in the said notification, such Chartered Accountant within the meaning of the Chartered Accountants Act, 1949, as possesses the prescribed qualifications, may also conduct the audit of the cost accounts of companies. It may be clarified here that the Central Government has not so far issued any notification under the above proviso.

However, it is only in the background of the aforesaid proviso that Section 233B (5)(b) provides that a person appointed under Section 224 as an auditor of the company (financial auditor) shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company (cost auditor of the same company).

(4) (a) State the duties & liabilities of a Cost Auditor of the Company? (8 Marks)

Answer:

Duties of the Cost Auditor

The duties of the cost auditor are also similar to those of the (financial) auditor of the company has under sub-Section (1) of Section 227 (Section 223B(4)).The duties of the cost auditor *inter-alia* include:

(a) To ensure that the proper books of accounts as required by Cost Accounting Records Rules have been kept by the company so far as it appears from the examination of those books and proper returns for the purpose of his audit have been received from branches not visited by him;

(b) To ensure that the Cost Audit Report and the detailed cost statements are in the form prescribed by the Cost Audit Report Rules by following sound professional practices i.e. the report should be based on verified data and observations may be framed after the company has been afforded an opportunity to comment on them;

(c) The underline assumptions and basis for allocation and absorption of indirect expenses are reasonable and are as per the established accounting principles;

(d) If the auditor is not satisfied in any of the aforesaid matters, he may give a qualified report along with the reasons for the same;

(e) Sending the Report to the Cost Audit Branch within 180 days from the end of the financial year with one copy to the company;

(f) Sending his replies to any clarification, that may be sought by the Cost Audit Branch on his report. Sending such replies within 30 days from the date of receipt of communication calling for such clarification.

Penal Provisions for Cost Auditor:

Rule 8 of the Cost Audit Report Rules, 2011 provides the following penal provisions –

Where default is made by the Cost Auditor in complying with the provisions of Rule 4 or Rule 5 of the Cost Audit Report Rules, 2011, he shall be punishable with fine, which may extend to five thousand rupees.

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

	Cutting Department	**Welding Department**	**Total**
Actual Usage in 2002-03 (Machine hours)	**60,000**	**40,000**	**1,00,000**
Practical capacity for each department (Machine hours)	**90,000**	**60,000**	**1,50,000**

Required:

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

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

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

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

Solution:

(a) Working notes:

1. Fixed practical capacity cost per machine hour:

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

2. Budgeted rate per machine hour (using practical capacity):

   = Fixed practical capacity cost per machine hour + Budgeted variable cost per machine hour

   = ₹6 + ₹4 = ₹10

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

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

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

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

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

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

(iv) Comments:

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

SECTION II (50 Marks)
(Operational Audit)
Answer Question No. 5 (carrying 14 marks) which is compulsory and answer any two (carrying 18 marks each) from the rest in this Section.

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

(1) FSN analysis is technique used in inventory control. (investment/inventory)

(2) operational audit is also termed as micro level management audit. (operational/ organizational).

(3) The Companies Amendment Act,2000 had introduced a new Section 292A regarding constitution of audit committees.(managing/audit)

(4) The quorum for Audit Committee meeting shall be two members or 1/3rd members of Audit Committee which ever is greater. (1/3rd, 2/3rd)

(5) Responsibility cannot be delegated. (Authority, Responsibility)

(6) VAT law specifically excludes all importers, export and interstate transactions which are covered by CST Act. (excludes/includes)

(7) Excisable goods must come out of production process. (production/sales)

(8) SALVAGE is considered as credit by insurer against what is owed under the policy for an insured loss. (credit/debit).

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

(i) Audit of Human Resource Development is outside the scope of Management Audit.
(ii) Management Audit imposes barriers in executive decision making.
(iii) Management Audit Report is presented to the management.
(iv) The efforts which are directed towards humanizing and harmonizing the jobs and their content are collectively knows as "Job Enlargement".
(v) Consumerism is a movement protecting the interest of the consumers.
(vi) Principles of Management Audit remain valid irrespective of the nature of an enterprise.

Answer :

(i) **False –** The scope of management audit extends over all the functions of an organization viz. management, personnel, administration etc. So the audit of human resource development is not outside the scope of management audit.
(ii) **False –** Management Audit does not impose barriers in executive decision making, it appraise the management performance at all the levels and helps to spotlight the decision or activities, that are not in conformity with organisational objectives.

(iii) True - Management Audit Report is to be submitted to the Management of the concern.
(iv) False – The efforts, which are directed towards humanizing and harmonizing the job and their content are collectively known as "Job Enrichment" and not "Job Enlargement".
(v) True – The statement is true.
(vi) True – Irrespective of the nature of an enterprise, the principles of Management Audit will remain valid.

6. (a) What are the limitations in implementation of an effective internal control system of a company? (12 Marks)

Answer:

Limitations of internal control

An important ingredient in development of an effective internal control system aimed at the achievement of management's objectives is to ensure that the organization has adequate relevant policies accompanied by effective monitoring and reporting mechanism. Moreover, while establishing the management objectives, the management must take into consideration the cost of attempting to achieve them. In other words, the cost of achieving objectives must be less than the anticipated benefits to be derived by achieving the objectives. One extreme is to achieve objectives "*As quickly as possible*" implying zero controls, while other extreme of achieving of objectives with "*No errors*" implies strong internal controls covering all aspects of objective. Controls must therefore be practical, useful, achievable, and compatible with both operating and control goals and there is always a trade-off between cost and benefit. Since all controls cost resources in terms of money, personnel, equipment, and time, internal controls always imply a trade-off between the anticipated cost and benefit envisaged. (Is it worth to spend rupees ten thousand to prevent a possible loss of rupees five thousand?).
For example, those risks that have a low probability and low cost should simply be *ignored.* But for those with high probability and high costs, control activities need to be implemented to *prevent* the risk from occurring. For example, a disaster may have a low probability but it has a high cost, therefore management should employ *insurance and/or backup plan* as an appropriate control activity. This model requires management to identify what needs protecting, what the risks are for those assets, and the level of cost impact and probability for each risk. Therefore, the organization must do a comprehensive risk assessment before actually designing an internal control system, i.e., identify the risks to which it is subjected to and the corresponding amount of loss if that risk comes true. In other words, any Internal Control System must ensure that all anticipated risks are taken care up to the point of cost benefit analysis i.e., cost of effecting control or managing a risk does not exceed the estimated amount of losses, if that risk actually happens or comes true. However, this condition may not be strictly applicable to those controls, which are aimed at ensuring compliance with applicable laws and regulations.

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

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

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

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

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

(a) to safeguard assets and control transactions; and

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

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

Answer:

Internal audit involves five areas of operations:

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

5. ***Accomplishing of established objectives and goals for operations:*** Internal auditor should review operation or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.

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

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

Answer:

Internal Audit Documentation (SIA 3):

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

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

iii. All significant matters which require exercise of judgment, together with internal auditor's conclusion thereon should be included in the internal audit documentation. Documentation prepared by internal auditor should enable reviewer to understand:

   - the nature, timing and extent of audit procedures performed to comply with SIAs and applicable legal and regulatory requirements;
   - the results of audit procedures and audit evidence obtained;
   - significant matters arising during the audit and conclusions reached thereon; and
   - terms and conditions of an internal audit engagement/requirements of internal audit charter, scope of work, reporting requirements, any other special conditions, affecting the internal audit.

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

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

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

(b) Explain the objects of Management Audit? (6 Marks)

Answer:

Objects of Management Audit

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

(i) to ensure optimum utilization on all the resource employed, including money, materials, machines, men and methods;

(ii) to highlight efficiencies in objectives, policies, procedures and planning;

(iii) to suggest improvement in methods of operations;

(iv) to highlight weak links in organizational structure and in internal control systems, and suggest necessary improvements;

(v) to help management by providing health indicators and help prevent sickness or help cure in case of sickness; and

(vi) to anticipate problems and suggest remedies to solve them in time.

(c) Explain the need for capacity determination of an organisation in India. (6 Marks)

Answer:

Need for Capacity Determination

The need for determining "production capacity" in respect of industrial organisation in India arises from the following reasons :-

(i) To meet the requirement under Section 211 of the Companies Act, 1956, that prescribes the form and contents of the balance sheet as well as profit and loss account (Part II of the Schedule VI of the Companies Act).

(ii) For purpose of Cost Audit Report under section 233 – B of the Companies Act, 1956 where a cost audit has been ordered by Government.

(iii) For internal management purpose, to be used:

 (a) in planning, scheduling and controlling production, and

 (b) in planning expansion of capacity and correction of imbalances.

(iv) For assessment of capacities for national level planning.

(v) For fixing the price of product(s) after ascertaining the capacity costs and per unit incidence thereof, and

(vi) For determination of allotment of scarce raw-materials in the form of quotas, import licenses, etc.

8. (a) You have been appointed to carry out Management-cum-Operational Audit of a Public Limited Company. State whether the use of Quantitative ratios is more effective than the use of Financial Ratios to gain real insight into the Financial Statements. (10 Marks)

Answer:

Meaning: Ratio indicates the relationship between two or more inter-related variables. Ratio Analysis is an Audit tool to - (a) assess the reliability and validity of financial statements, and (b) obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

1. **Advantages:** Ratio analysis has the following advantages -

   (a) Most suitable for handling/ auditing large volume of transactions.

   (b) Ideal for Firms using mechanized accounting systems where all transactions cannot be checked.

   (c) Brings out abnormal deviations & unexpected variations, which normal routine checking may not reveal.

   (d) Highlight on the underlying problems and distortions.

2 **Superiority of Quantitative Ratios:** In a Management-cum-operational Audit, the objectives are - (a) to verify compliance with the controls, and (b) to suggest measures to improve operational environment and thus increase overall productivity. For this purpose, quantitative ratios and reconciliations can be used more effectively than financial ratios. Quantitative Ratios offer the following relative advantages.

3. **Not affected by price:** Quantitative ratios and reconciliations remain unaffected by changes in price whereas financial ratios keep changing with the variations in the price level.

4. **Basic Relationships:** Quantitative Ratios reflect certain basic relationships and change only if there is a change in the methods of operation, technology, degree of automation, product mix, etc.

5. **Trend Analysis:** A comparison of quantitative ratios over the years can reveal pertinent and leading indications of the real state of affairs.

6. **Better reading of financial statements:** The Auditor can have better insight into Financial Statements through the underlying quantitative data.

7. **Illustrations:** The nature of quantitative ratios and reconciliations that an Auditor can work out in a particular Audit would depend upon the actual circumstances of the case. Some examples are -

   (a) Input-Output ratios for materials,

   (b) Production Loss and Rejections,

   (c) Quantitative ratios in services like man-hours per customer or man- hours per application processed.

8. **Aspects to be considered:** The Auditor must keep the following in mind, while using quantitative data -

   (a) **Relevance:** The Auditor should analyse and use such data mainly as an evidence to support the figures in the statements under Audit.

   (b) **Quantity Relationships:** The Auditor should try to correlate vital relationships between physical quantities. He should establish the cause and effect relationship between activities. The sequence of activities and their predecessor-successor relationships may be used to work out activity ratios.

(c) **Monetary Relationships:** The Auditor may try to link a physical quantity with its corresponding monetary figure through an estimated average rate. For example, if Raw material constitutes about 65% of the total price of the product, the material consumption as shown in the financial statements would be about 65% of the sales value.

(b) Bring out the need for Operational audit. (8 Marks)

Answer:

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 -
   (a) Departmental manager's routine performance report,
   (b) Internal Audit reports,
   (c) Periodic Special Investigation, and
   (d) Survey.

   These sources create communication gaps on activities, which do not come under the direct observation of managers. Hence, Operational Audit is required.
3. **Little time for 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, one cannot rule out 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. **Lack of Managerial Expertise:** Departmental Managers and their aides generally transmit information required for analysis. But an Independent Operational Audit Team will be able to evaluate the operations analytically.
6. **Shortcomings of Regular Reports:** The information transmitted by managers may be subjective, manipulated and biased. Performance Reports contained in the annual accounts and routine reports prepared by the operating departments have their own limitations.
7. **Shortcomings of Internal Audit Reports:** 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.
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 for certain undesirable happenings. These basically attempt to carry out a post-mortem rather

to give a signal for dangers and forthcoming disasters. Operational Audit is required to ensure day-to-day control of activities.

9. **Environment 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.