

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) Installed capacity is determined based on:

- (a) Manufacturers' Technical specifications
- (b) Capacities of individual or interrelated production centres
- (c) Operational constraints/ capacity of critical machine
- (d) All of the above

Answer: (d) All of the above

(ii) Example of indirect labour:

- (a) Salaries of staff in the administration and accounts department
- (b) Salaries of securities staff etc.
- (c) (a) and (b)
- (d) None of the above.

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

(iii) Distribution costs includes-

- (a) Transportation cost
- (b) Cost of warehousing saleable products
- (c) Cost of delivering the products to customers etc.
- (d) All of the above.

Answer: (d) All of the above

(iv) Material Consumed shall include materials directly identifiable for production of goods such as:

- (a) Imported materials
- (b) Cost of utilities
- (c) Amortized cost of moulds
- (d) Consumable stores and spares

Answer: (a) Imported materials

(v) Joint costs are allocated:

- (a) Based on a measure of the number of units, weight, or volume of the joint products.
- (b) Based on the values attributed to the joint products.
- (c) (a) and (b).
- (d) None of the above.

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

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

Answer: (d) All of the above

- (vii)** Para 6 of the Annexure to Cost Audit Report, 2011 deals with:

- (a) Product group details.
- (b) Quantitative information of each product group separately.
- (c) Operating ratio analysis for each product group separately.
- (d) Abridged cost statement for each product group separately.

Answer: (c) Operating ratio analysis for each product group separately.

- (viii)** Rectified Spirit is covered by

- (a) Cost Accounting Records(Chemical Industries) Rules, 2004
- (b) Cost Accounting Records(Formulations) Rules, 1988
- (c) Cost Accounting Records(Industrial Alcohol) Rules, 1997
- (d) Cost Accounting Records(Bulk Drugs) rules,1974

Answer: (c) Cost Accounting Records(Industrial Alcohol) Rules, 1997

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

- (i) Compliance Report is to be prepared for the company as a whole.**

Answer: True. The Compliance Report is to be prepared for the ‘Company as a whole’ under different product groups.

- (ii) Production, processing, manufacturing or mining involving manual operation, without the use of power is covered under these Rules.**

Answer: True. The definition of product in rule 2(m) includes manual operation as well. Therefore, any production, processing, manufacturing or mining activities-whether by use of power or not-are included for the purposes of these Rules.

- (iii) It is necessary to first prepare “unit-wise’ and “product/activity-wise” cost statements and then merge into product group-wise cost statement for the company as a whole.**

Answer: True. It is mandatory to prepare unit-wise and product/activity-wise cost statement as per the Companies (Cost accounting) Rules, 2011. For Compliance Certificate purposes, no cost statement is required to be submitted.

If any or all products/ activities of the company is also covered under Cost Audit, then a consolidated cost statement for the product group(s) under cost audit is required to be prepared.

- (iv) Value addition is to be computed based on Cost record data.**

Answer: False. Value Addition statement is to be computed based on audited financial data.

- (v) Export Benefits are to be considered as a part of other operating income.**

Answer: False. Export Benefit is to be considered as a part of sales.

- (vi) Retail Company with service tax registration is engaged in telecommunication services. Hence it is covered under Companies (Cost Accounting Records) Rules, 2011.**

Answer: False. Whether company is registered under service tax or not, is not relevant for the applicability of CARR, 2011.

(2) (a) Discuss the basis of apportionment for primary distribution of overhead. (12 Marks)

Answer:

Basis of Apportionment for Primary Distribution of Overhear

Each overhead cost is to be apportioned to all departments, both production and service departments, or other cost centres on an appropriate basis. The basis to be considered appropriate or suitable should satisfy the following conditions:

- (i) The overhead cost to be incurred should be measurable by the basis adopted.
- (ii) For achieving the above, there should be some relationship between the overhead cost and the basis.
- (iii) The basis should be practicable,
- (iv) The cost of apportionment should be reasonable.

The process of initial distribution to production and service departments is known as Primary Distribution. The following are the common bases for apportionment of production overheads:

1. **Direct Allocation:** Overheads exclusively pertaining to a department are charged to that department, e.g., salary of departmental manager, power when the department has separate power meter.
2. **Direct Material:** Cost of indirect materials and miscellaneous expenses if direct material cost is a dominant element in total cost, may be apportioned in the ratio of direct material cost incurred in different departments.
3. **Direct Labour/Wages:** Employer's contribution to employees provident fund or employee insurance or workmen compensation costs may be distributed in the ratio of direct labour cost of various departments. In case direct labour cost is a major element in total cost, miscellaneous expenses may also be apportioned on this basis.
4. **Number of Workers:** Supervision cost, Vanteen subsidy and other employee welfare expenses may be apportioned in the ratio of number of employees working in different departments.
5. **Direct Labour Hours:** In case production is labour intensive and no other specific appropriate base is available for apportioning an overhead cost, direct labour hour is the most suitable basis.
6. **Machine Hours:** In case production process is mechanised and no other specific appropriate base is available for apportioning a particular overhead, machine hours is the most suitable basis.
7. **Floor Area Overheads:** such as, rent, rates and taxes on building, building repair and maintenance, lighting, heating and air-conditioning may be apportioned in the ratio of effective floor area of different departments.
8. **Light Points Cost-** of lighting may be distributed on the basis of number of light points in different departments.
9. **Value of Assets:** In case depreciation is considered as fixed cost, it may be charged to different departments in the ratio of capital value of plant and machinery' in departments. Repair and maintenance of plant and machinery is also to be distributed on this basis.

10. **Value of Machines x Hours Worked'**- In case depreciation is treated as variable cost then it should be distributed in the ratio of ' Value of plant and machinery × Hours worked ' in different department. For example if department A has plant worth ₹ 10,00,000 and works for 10 hours per day and Department B has plant worth ₹ 20,00,000 and works for 8 hours daily, the ratio for distributing depreciation cost should be 10,00,000 ×10:20,00,000 × 8, Le., 10:16.
11. **Horse Power:** Cost of power is charged to different cost centres in the ratio of horse power of plant and machinery installed.
12. **Horse Power × Hours Worked:** In case different departments have worked for different number of hours, the power cost may be distributed to these departments in the ratio of horse power x hours worked'.
13. **Number of Material Requisitions:** Overhead costs on account of stores and material handling may be apportioned in the ratio of number of material requisitions by departments.
14. **Hours Worked:** Crane expenses may be charged to different departments on the basis of number of hours it had worked in different departments. In the same way supervisor's salary may be distributed in the ratio of number of hours he worked in departments, provided such information is available.
15. **Technical Estimates:** In case an appropriate basis is not available for apportioning certain overheads, the distribution is done on the basis of technical estimate regarding the share of overhead cost chargeable to different departments.

(b) As a cost accountant of a manufacturing company, how would you dealt with over and under absorption of overhead? (6 Marks)

Answer:

Treatment of Over and Under Absorption

The accounting treatment of over or under absorption depends upon the quantum of over or under absorption and the circumstances leading to it. The following are the main methods of dealing with over or under absorption:

1. Use of Supplementary Rate:

In case there is significant over or under absorption due to anticipations about overhead costs or the base not coming true, supplementary rate may be used. In this case the mismatch between anticipations and actuals arises due to normal errors in business planning and not due to abnormal factors. Computation of supplementary rates is nothing but a process of correction whereby an over absorption is brought down and under absorption is pushed up to the correct figure of actual overhead cost. Accordingly there are two types of absorption rates:

- (a) Positive supplementary rate, and
- (b) Negative supplementary rate.

Positive Supplementary Rate (in case of under absorption) =
Actual overheads - Absorbed Overheads
Actual base

Negative Supplementary Rate (in case of over absorption) =
Absorbed Overheads - Actual Overheads
Actual base

Under absorption is corrected by using positive supplementary rate, i.e., the unrecovered amount of overhead cost is added to the cost of sales, work-in-progress and unsold stock by applying supplementary rate to the base units contained in these three items of output.

Over absorption is corrected by using negative supplementary rate, i.e., the excess recovery of overhead cost is deducted from the cost of sales, work-in-progress and unsold stock by applying supplementary rate to the base units contained in these three items of output.

Supplementary rates are applied at the end of a budget period. Adjustments for over absorption are shown in the balance sheet by way of deduction in value of work-in progress and finished stock and by deducting it from the value of cost of sales in trading and profit and loss account. Simultaneously profit figure is adjusted upward by the total value of over absorption. Under absorption is adjusted in the balance sheet by an addition to the value of work-in-progress and finished stock and by adding it to the value of cost of sales in trading and profit and loss account. Simultaneously profit figure is adjusted downward by the total value of under absorption.

In case it has been decided that the values of cost of sales, work-in-progress and finished stocks are not to be affected by unanticipated changes in overhead costs and the base adopted for its absorption, supplementary rates are not used.

2. Carry Over of Overheads:

In the following circumstances over and under absorption of overheads may be transferred to Overhead Reserve Account and carried forward to the next year in the hope that an over absorption in the current period will be more or less neutralised by under absorption in the next period:

- (a) In case of seasonal industries over absorption of one season may be carried forward to the next season for neutralisation over a period of one year.
- (b) In case of cyclical businesses over absorption of one year may be carried forward to the next year in the hope that over and under absorption will neutralised each other over a period of one business cycle.
- (c) In case of new projects, under absorption of initial years may be carried forward in the hope of neutralization later when the project gets well established.

The criticism against this method is that overheads of a particular period are not charged to that period entirely. Such carry over of overheads adversely affects inter-temporal comparisons which may hinder managerial planning and control.

3. Transfer to Costing Profit and Loss Account:

In the following two cases the amount of over or under absorption of overheads should be credited or debited to Costing Profit and Loss Account:

- (i) In case over or under absorption is of relatively very small value, it may be totally unnecessary to adjust value of cost of sales, work-in-progress and finished stock by such insignificant amount.
- (ii) In case over or under absorption arises due to abnormal factors, e.g., heavy machine breakdown, fire, strikes, lock outs, acute depression resulting in low output and capacity utilisation, etc., it should be transferred to Costing Profit & Loss A/c.

The reasons are : (a) the basic costing principle is that cost of output must not be affected by abnormal gains and losses ; (b) Charging under absorption to output under these circumstances will be wrong from the point of view of business policy and strategy ; and (c) it will also distort cost comparisons and cost control.

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

- (i) Research and Development Cost;**
- (ii) Packing Expenses;**
- (iii) Fringe Benefits;**
- (iv) Expenses on Removal and Re-erection of Machinery;**
- (v) Training Costs.**

(3×5=15 Marks)

Answer:

(i) Research and Development Cost:

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

Treatment in Cost Accounts

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

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

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

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

(ii) Packing Expenses:

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

Cost Accounts they are treated as follows:

- (i) It is treated as a direct material cost in the case of those products which cannot be sold without the use of a packing. For example Ink-pot; Bread; Paste etc.
- (ii) It may be treated as distribution overhead if packing expenses are incurred, to facilitate the transportation of finished products.
- (iii) It may be treated as advertisement cost and included in selling overheads if it is incurred for advertisement to make the product attractive.

(iii) Fringe Benefits:

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

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

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

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

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

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

(v) Training Costs:

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

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

(b) Any change in the cost accounting principles applied for the determination of the cost should be made only if it is required by law or for compliance with the requirements of a cost accounting standard or generally accepted cost accounting principles or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.

Comments.

(3 Marks)

Answer:

Principles applied for determining the employee cost should be followed consistently. For example profit sharing bonus paid to employees was required to be separately disclosed in the cost audit Proforma, after "Total Cost of Sales" under previous Cost Audit Report Rules 1996. This principle was being followed consistently but due to change in the principle with the notification of Cost Audit Report Rules, 2011 bonus is now part of the employee cost and no separate disclosure is required. Thus change in cost accounting principle / law for determining the cost can be made when required by any law as illustrated above or for compliance with cost accounting standards or it results in appropriate presentation of cost statement.

(4)(a) TPO 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 blanked rate based on machine hours. The budgeted production overheads of the factory are ₹10,08,000 and budgeted machine hours are 96,000.

For the period first six month of the financial year 2007-2008, following information were extracted from the books:

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Actual production overheads	₹6,79,000
Amount included in the production overheads:	
Paid as per court's order	₹45,000
Expenses of previous year booked in current year	₹10,000
Paid workers for strike period under an award	₹42,000
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 respects)	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 $\frac{1}{4}$ of the under-absorption was to defective production policies and the balance was attributable to increase in costs. You are required:

- (i) to determine the amount of under absorption of production overheads for the period,
- (ii) to show the accounting treatment of under-absorption of production overheads, and
- (iii) to apportion the unabsorbed overheads over the items. (15 Marks)

Solution:

- (i) Amount of under absorption of production overheads during the period of first six months of the year 2007 – 2008:

	Amount (₹)	
Total production overheads actually incurred during the period		6,79,000
Less: Amount paid to worker as per court order	45,000	
Expenses of previous Year booked in the current year	10,000	
Wages paid for the strike period under an award	42,000	
Obsolete material written off	18,000	(1,15,000)
		5,64,000
Less: Production overheads absorbed as per machine (48,000 hours * ₹10.5) hour rate		5,04,000
Amount of under absorbed production overheads		60,000

$$\text{Budgeted machine hours rate} = \frac{\text{₹10,08,000}}{96,000 \text{ hours}} = \text{₹10.50 per hour}$$

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(ii) Accounting treatment of under absorbed production overheads:

As, one fourth of the under absorbed overheads were due to defective production policies, this being abnormal, hence should be debited to profit and loss account

Amount to be distributed = $(60,000 * \frac{3}{4}) = ₹45,000$

Supplementary rate = $\frac{₹45,000}{30,000 \text{ hours}} = ₹1.50 \text{ per unit}$

(iii) Apportionment of under absorbed production overheads over WIP, finished goods and cost of sales:

	Equivalent completed units	Amount (in ₹)
Work-in- progress (16,000units×50%×1.50)	8,000	12,000
Finished goods(4,000 units×1.50)	4,000	6,000
Cost of sales (18,000 units×1.50)	18,000	27,000
Total	30,000	45,000

(b) State the time limit within which Compliance Report should be submitted to the Central Government. Is there any penalty for contravention of these provisions? (3 Marks)

Answer:

Time limit for submission of Compliance Report, – Every company shall submit the compliance report referred to in rule 5 to the Central Government within a period of one hundred and eighty days from the close of the company's financial year to which the compliance report relates.

Penalties, – (1) If default is made by the Cost Accountant in complying with the provisions of these rules, he shall be punishable with fine, which may extend to five thousand rupees.

(2) For contravention of these rules, -

- the company shall be punishable as provided under sub-section (2) of section 642 of the Act; and
- every officer thereof who is in default, including the persons referred to in sub-section (6) of section 209 of the Act, shall be punishable as provided under sub-sections (5) and (7) of section 209 of Companies Act, 1956.

SECTION II (50 Marks)
(Operational Audit)

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

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

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

(ii) Pareto distribution is technique used in inventory control.

(iii) Section 292 A of the Companies Amendment Act ,2000 provides for constitution of Audit Committees.

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

(v) Excisable goods must come out of production process.

(vi) Margin of Dumping means the difference between normal value and export price of goods.

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

(i) Dumping is an 'illegal' practice.

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

(ii) Assurance engagements involve three separate parties.

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

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

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

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

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

(v) GATT and its agreement are permanent.

Answer: False. GATT was ad hoc and provisional

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

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

(6)(a) What are the areas need to be examined by the management auditor of the company to evaluate the adequacy of Budgetary Control System? (6 Marks)

Answer:

Adequacy of budgetary control system

While determining the adequacy or otherwise of the budgetary control system of an organisation, it is essential that management auditor should evaluate its coverage and effectiveness i.e., whether the system in operation covers all functions rather than an accounting exercise. For this purpose, he should examine whether the system contributes towards accomplishing the basic task of planning, coordinating and controlling the activities of the organisation in relation to the product under management audit. The management auditor should examine and appraise the following points :-

(a) In the area of planning:

1. Where it covers all interrelated functions like production, sales, purchasing and finance.
2. Whether it determines the linkage between budget centres and responsibility centres.
3. Whether it establishes definite goals and limits for these function well in advance. The system must answer the questions such as "what they are expected to operate?" What will be the financial requirement for the functional areas? What would be the potential problems in the key areas?
4. Whether there are imbalances in the fixation of performance levels of functional budgets in relation to sales budgets.
5. Whether budget monitoring cell exists for operating the system in right perspective.

(b) In the area of coordination :

1. Whether the budget monitoring committee holds its meeting regularly with a view to ensure performance evaluation.
2. Whether it helps to prevent waste that results in duplicate or cross purpose activities.
3. Whether it reveals timelines in the process of preparation and approval of all functional budgets and master budget.

(c) In the area of control:

1. Whether system exists for measuring, comparing and quantifying the results of all functional areas.
2. Whether the budget incorporates a degree of flexibility with a provision of its periodical review.
3. Whether the variance reports are issued in time and appropriate corrective action is taken on these variances.

(b) Prepare the checklist of Purchasing Function.

(12 Marks)

Answer:

(i) Purchasing Function Checks

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

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

(7)(a) Write short notes on objectives of Operational Auditing.

(10 Marks)

Answer:

The general objectives of Operational Audit are -

1. Appraisal of Controls:

- (a) Internal controls provide the essential tools / measures to ensure proper performance in each functional or organizational area for accomplishing the desired organizational objective.
- (b) If controls are well designed and faithfully adhered to, the organisation can function smoothly and achieve its objectives. But if controls are weak, the organisation will fail to operate effectively even though it is well equipped and well manned.

- (c) The purpose of operational Audit is to determine whether the controls are - (i) adequate, and (ii) effective in accomplishing Management's objectives or plans or operations.
- (d) The Operational Auditor reviews internal controls and reports to ascertain whether they bring the performance, qualitatively and quantitatively to the notice of the Management, also within the organisation's policies and plans are being carried out.

2. Evaluation of performance: In the area of performance appraisal, the Operational Auditor is basically concerned with -

- (a) Analysing the technical efficiency of the operations,
- (b) Accumulating information and evidence to measure the effectiveness, efficiency and economy of operations, and
- (c) Comparing actual performance with applicable standards, procedures, rules, policies and plans.

Performance Evaluation is generally based on - (i) Productivity, (ii) Personnel, (iii) Workload, (iv) Cost and (v) Quality.

3. Appraisal of Management objectives and plans:

- (a) This objective is based on the fact that everything in an organization is the product of basic plans and objectives set by the Management. Hence, the basic thing that should be evaluated is Management policies, plans and objectives.
- (b) The aim of operational Auditing is to appraise operations and controls and adherence to prescribed and laid-down policies and not to go into the question of appropriateness of plans and objectives. But, the Operational Auditor may look into aspects like -
- Clarity of objectives,
 - Proper communication of objectives to the personnel responsible for implementation,
 - Feedback from personnel i.e. whether they have understood the objectives in the same sense as meant by the Management, and
 - Apparent conflict in the objectives and its effect on operations.

4. Appraisal of Organisation Structure:

- (a) Organisational structure, an essential element of internal control design, provides the line of relationships and delegation of authority and tasks.
- (b) The Operational Auditor should consider the following in evaluating the organisation structure -
- Conformity with Management objectives,
 - Proper match between responsibility and authority,
 - Clear definition of Scalar Line of Authority from top to bottom, and
 - Possibility of defective delegation, overlapping or duplication of work.

(b) "Management Audit can be potent tool for managerial control and reduction of cost". Do you agree with the above statement? Briefly comment on the potential of management audit as a tool for managerial control and reduction of costs. (8 Marks)

Answer :

"Management audit may be more specifically defined as being an investigation of a business from the highest level downwards in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with outside world and the most efficient organization and smooth running internally."

Management Audit is the total examination of transaction of an organization, or parts of it, and includes checks on the effectiveness of managers, their compliances with company on professional standard, the reliability of management data, the quality of performance of duties and recommendations for improvement. In this context, the distinction between administration and management should be recognized. Administration is concerned with the structure of the organization and the mechanism of its operations, whereas management relates to the leadership and direction of the people, the way in which they are controlled to exercise their functions within the administrative framework. The question of audit arises only because of the ownership of many companies is widely spread between a large number of shareholders, and the running of the organization lies with people holding comparatively a small portion of the equity. This dichotomy of dispersed ownership and entrenched management necessitates and examination to be done of the Management function itself by an independent authority. In this context management audit undertakes examination of the effectiveness of management in controlling the total activities of the organization in the accomplishment of the organization objectives. Since a number of audits is conducted in various area, audit responsibility lies in avoiding any overlapping and selecting such areas not covered by an audit already, e.g., if internal audit examines adherence to procedures, management audit should examine the effectiveness of such procedures.

Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management. A working director is included as a manager for purposes of management audit. It is normally presumed to be a non routine investigation into a performance of a manager or group of managers. But in a number of organizations management audit is now a regular feature to examine and improve managerial effectiveness. It attempts to look into all aspects of the management performance. Management audit does not concentrate on financial matters alone as in the case of financial audit. It looks into the efficiency and effectiveness of performance in an organization.

In a developing country like India, management audit through CAG, public accounts committee and parliamentary committee on public undertakings, has helped the Government in identifying improper or wasteful use of funds, checking extravagant organization practices and curbing ineffective use of physical resources. Indian financial Institutions, banks and Board for Industrial Finance and Reconstruction (BIFR) have found management audit (called concurrent audit) useful in monitoring sick industrial units and to help the units in their rehabilitation.

Thus, it can be said that Management Audit can be a potential tool for managerial control & reduction of cost.

(8) Write Short Notes on:

- (i) Energy Conservation**
- (ii) SWOT Analysis**
- (iii) Qualities and function of a Management Auditor**
- (iv) Management Audit Programme /MAP**
- (v) Management Frauds**
- (vi) Audit Committee**

(6×3=18 Marks)

Answer:

(i) Energy Conservation

Energy Conservation refers to optimum use of energy or getting the maximum production for every unit of energy conservation, which means improving its productivity and its optimum use.

1. Identifying the variable and fixed element of energy.
2. Identifying the cost centres which consumes 80% of each type of energy.
3. Comparative energy efficiency of similar machine.
4. Relationship between setup time and energy consumed.
5. Investment and time required for alternative energy sources.
6. Investment justification in case of under taking new projects for alternate sources.
7. Input-output study of energy.

(ii) SWOT Analysis

SWOT analysis refers to the identification of a company's Strength, Weakness, Opportunities and Threats. While the first two are internal to the organization, the other two are external environment.

The following is an indicative list of questions for which answers must be obtained to make an objective SWOT analysis as follows:

1. Strength/ Weakness:
 - a. Financial
 - b. Marketing
 - c. Personnel
2. Opportunities / Threats
 - a. Power requirement and availability
 - b. International competition
 - c. Product obsolescence
 - d. Export potential
 - e. Opportunities available in the country
 - f. Government policy regarding the industry

(iii) Qualities and function of a Management Auditor

Qualities :

The most important and essential qualities for a Management Auditor are :

1. Ability to grasp the business problems.
2. General understanding of the motive, purpose and objectives of the organization to be audited.
3. Knowledge about the basic management principles and practices.
4. Sufficient knowledge about Engineering, Statistical techniques, Cost and Management Accountancy, Production planning and control.
5. General understanding of various laws like Company Law, Customs, Central Excise, Income Tax, MRTP, FEMA etc.
6. Ability to prepare reports for different levels of management.
7. Ability to move and get along with all people at different levels.

8. Effective communicator with ability to elicit information.

Functions of a Management Auditor :

1. He should ensure that all pertinent information needed for planning reaches the higher management.
2. He should ensure that the decisions are based on the objectives of the management.
3. He should focus maximum attention of functions/ operations, which are profit making/ revenue yielding.
4. He should keep abreast with the developments taking place in Information Technology and introduce latest methods of information and communication systems – consistent with cost benefit studies needed to improve the systems.
5. The implication of changes in the budgetary proposals should be projected by him adequately both in respect of direct taxation.
6. Assist the management in achieving the most efficient and effective administration.

(iv) Management Audit Programme /MAP

Management audit programme is an essential prerequisite to conducting the audit. It is a plan of action drawn in advance of taking up the audit, and to help the auditor to cover the entire area of his function thoroughly.

He should lay down for himself a proper procedure to be followed to complete the work in time, giving thorough coverage to all aspects.

An efficient management audit programme shall comprise the following:

- (i) Review of the organizational objectives and plans
- (ii) Study of the policies and practices of the management
- (iii) A critical review of the organizational structure
- (iv) Study of the systems and procedures
- (v) Evaluation of operations
- (vi) Study of the efficiency of the use of physical resources available
- (vii) Exercise of proper management control
- (viii) Maintain suitable monitoring system through management information system (MIS)
- (ix) Check on adherence to the statutory obligation and
- (x) Above all, review the efficiency of manpower handling, which ultimately results in the organization's success.

An audit programme is laying down the path in its required details before conducting such audit.

A management auditor shall shrewdly assess weak and risk areas in the organization and deal with such areas in more detail. He has to lay down a programme by making a list of such weak and risk areas and follow them up in his audit.

(v) Management Frauds

Fraud is an intentional misrepresentation of facts. In general, it is seen that top executives like Managing Directors, Directors, General Managers and other such executives occupying the positions in an organization are found to commit Management Frauds. These frauds are the deception practiced by these managers so as to show their performance better than what actually they are.

The manager / top executives for their personal benefit may commit of their fiduciary position and having easy access to the assets and greater power to control accounting and financial statement preparation, the managers/ top executives have better opportunities to defraud the company and others. Such frauds may take the form of misappropriation of assets and manipulation of records.

(vi) Audit Committee

Audit Committee is set up by the company and their details are as follows :

- a. The audit committee shall have minimum three members.
- b. The chairman of the committee shall be an independent director.
- c. The chairman of the committee shall be present at Annual General Meeting to answer share holder's queries.
- d. The company secretary shall act as the secretary of the committee.
- e. The audit committee shall meet at least thrice a year.
- f. The audit committee shall have powers as follows :
 1. To investigate any activity.
 2. To seek information from an employee.
 3. To obtain outside legal or other professional advise.