

Paper 17 - Cost Audit & Operational Audit

Note: This Revisionary Test Paper is prepared without any Objective or Bit-type questions. However, the format for Question Paper remains unchanged for this paper, i.e. the Question Paper for this subject shall contain the Objective type questions as per prevalent practice. The students are strictly directed to follow the question paper structure of this paper as per the Practice Test Papers and Mock Test Papers.

1. (A) The Companies (Cost Accounting Records) Rules 2011 have not prescribed any specific formats for the cost statements. In what manner and format would the cost statements be kept under these Rules? (Taken from FAQ 1)

Answer:

As per sub rule (2) of Rule 4, the companies are required to maintain cost records on regular basis in such manner so as to make it possible to calculate per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly/quarterly/half-yearly/annual basis. The cost statements are to be prepared for every unit and every product produced, processed, manufactured or mined.

As per sub rule (3), the cost records are to be maintained in accordance with the generally accepted cost accounting principles and cost accounting standards issued by the Institute; to the extent these are found to be relevant and applicable.

These Rules have not prescribed any specific formats for the cost statement. A guidance note on the subject is under preparation by ICWAI, inter alia, containing model formats for cost records, statements, schedules etc.

(B) What does turnover mean under these Rules? Is gross turnover Inclusive of excise duty? (Taken from FAQ 1)

Answer:

As per Rule 2(p), "Turnover" means gross turnover made by the company from the sale or supply of all products or services during the financial year. It includes any turnover from job work or loan license operations but does not include any non-operational income.

The term "Turnover" defined in the Companies (Cost Accounting Records) Rules, 2011 shall exclude taxes & duties. It shall have the same meaning, wherever it appears, in all other orders/rules issued in connection with the cost accounting records and cost audit.

(C) Who can authenticate the Compliance Report as per the Companies (Cost Accounting Records) Rules 2011? (Taken from FAQ 1)

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Answer:

As per Rule 5, the Compliance Report and annexure thereto is required to be certified by a "cost accountant" as defined under Rule 2(c).

As per Rule 7, the annexure to the Compliance Report is to be duly approved by the Board of Directors.

A "cost accountant" within the definition of these Rules does not include:

- a) A member holding a part-time certificate of practice; or
- b) A member who is in full time employment whose membership fees are in arrears;
- c) A member of ICAI who has been admitted as a member through reciprocal arrangement of membership by virtue of being a member of Institute of Management Accountants USA.

(D) Companies adopt different policies relating to depreciation. What tests would you apply to satisfy yourself that they are consistent with Cost Accounting Record Rules ?

Answer:

The question mainly relates to provisions in Cost accounting rules and cost audit report rules relating to depreciation.

Cost Accounting Records Rules

- i) Adequate records shall be maintained showing the values and other particulars of fixed assets in respect of which depreciation is to be provided. These records shall inter alia, indicate the cost of each time of asset, the date of its acquisition, location and the rate of depreciation.
- ii) The basis on which depreciation is calculated and further allocated to the various departments, cost centres and to the products shall be clearly indicated in the records. Depreciation chargeable to the different departments, manufacturing units or cost centres shall not be less than the amount of depreciation chargeable in accordance with the provisions of sub section (2) of section 205 of the companies Act, 1956 as amended (Schedule XIV) and shall relate to plant and machinery and other fixed assets utilised in such departments or units or cost centres. In case the amount of depreciation charged in the cost centre is higher than the amount of depreciation chargeable under aforesaid provision of the Companies Act, the amount so charged in excess shall be indicated clearly in the records and impact of excess on the cost per unit to be stated. However, the commutative depreciation charged against individual assets shall not exceed the original cost of the respective assets. The method once adopted shall be applied consistently.

2. (A) Is there any ceiling on the number of Compliance Reports which can be authenticated by a practicing cost accountant or a cost accountant in permanent employment of the company? (Taken from FAQ 1)

Answer:

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

(B) What constitutes the cost records under Rule 2(e)? Whether the format of “Abridged Cost statement” prescribed in the Companies (Cost Audit Report) Rules, 2011 can be considered as a sample cost statement? (Taken from FAQ 1)

Answer:

Books of account and other records relating to utilization of materials, labour and other items of cost that provides data/ information to compute the cost of production, cost of sales and margin of each of the products/ activities of the company on monthly/ quarterly/ half-yearly/ annual basis are considered part of the cost records. It includes statistical, quantitative and other records which enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources. Cost records are required to be maintained on continuous basis from the basic stage of inputs to the final output.

There cannot be any exhaustive list of cost records. This would depend on the materiality of cost components in the cost of the product/activity.

The abridged cost statement can be used as a sample cost statement. This may be modified according to the need of the company.

(C) Whether product manufactured for 100% captive/ self consumption shall be covered under the Companies (Cost Accounting Records) Rules 2011? (Taken from FAQ 1)

Answer:

The test of inclusion under the Rules is whether it is a production, processing, manufacturing or mining activity resulting in a product [for definition of “product” refer to Rule 2(m)] intended for use, consumption, sale, transport, store, delivery or disposal and whether the company carrying out the activity falls within the criteria mentioned under Rule 3(1). If the company meets requirement of Rule 3(1), the activity – whether or not for captive/self consumption – will come under the ambit of these Rules.

(D) (i) In the Annexure to the Cost Audit (Report) Rules, 2011 details of production and percentage of production to installed capacity has to be given. How do you go about ascertaining:

(a) Installed Capacity

(b) Actual production.

(ii) In a Company manufacturing Electric motors, you notice that the licensed and installed capacity indicated in numbers in the Annual Audited Accounts of the Company.

Would you as Cost Auditor of the Company for the Electric Motors accept this capacity as production? If not, why? How would you present it as per requirements of Cost Audit (report) Rules. Illustrate with an example.

Answer.

(i) (a) Installed Capacity

The proper determination of installed capacity is of utmost importance and the Cost Audit (Report) Rules, 2011 has clearly brought out this in the note.

Primary source for determination of capacities is the rated capacity of the installed machines as indicated by the machinery supplier. Such capacity is expressed in terms of hourly/daily capacities. In converting this to annual capacities normal holidays, annual maintenance, shutdowns etc. are to be reckoned as well as daily working hours. The annual capacity is arrived at by multiplying rated capacity per hour/day etc. by relevant number of hours/days of working for the year. In plants where shift working is done the relevant shifts considered is also to be indicated while determining installed capacity.

Where different machines are employed, the capacity of each production machine is to be assessed. The capacity will be determined by the capacity of the key limiting factor. In this context, substantial imbalances would also be revealed.

The procedure needs to be modified where the product is not homogenous i.e. where different types/sizes of products are manufactured. In such situations, capacity has to be expressed in standard hours, occupancy hour, spindle/looms shifts etc. by which different types of production can equated.

There are situations where even this becomes difficult and simply expressed in terms of standard values at constant prices. There are also situations where capacities are flexible as company has options for in-house manufacture of parts or contracting out or where increase in men could achieve higher production.

(b) Actual Production

Actual daily production records indicating quantities produced by stages, the aggregate weekly and monthly records and the annual sum total thereof would form the basis of verifying production. The internal reporting system of production as such should be sound. These figures have to be cross-checked with stock records maintained for finished goods and components.

Production returns filed to various Govt. Authorities e.g. excise authorities also would be examined and cross-checked with the daily records, stock/records. Some companies have incentive scheme for payment to Workmen based on production and detailed records of production are maintained for this purpose. This also serves as a basis for ascertainment of production. Other cross-checks such as theoretical from input can also be used.

As in the case of capacity ascertainment, a meaningful comparison of production figures can be achieved only if production is assessed in comparable units. This unit need not necessarily be in terms of numbers and can be in terms of Standard Hours/Occupancy Hours, equated production etc.

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(b) Electric Motors come in different sizes depending on the horsepower. The mix of production of the different size also vary from year to year depending on the demand pattern. As such, capacity of production expressed in terms of numbers would be meaningless. To make it meaningful some other yardstick as Standard Production hours or equated production in terms of a single representative model e.g. 5 HP Motors should be used.

An example is given in Tabular statement:

Production Hours — 2 Shift basis 4500 Hours yearly.

Production details (HP)	Standard production hour	Numbers produced	Standard hours of production	Capacity Utilisation
1	1	100	100	(4050/4500) x 100 = 90%
2	1.5	200	300	
3	2	250	500	
5	3	600	1800	
8	4	50	200	
10	5	40	200	
12	6	50	300	
15	6.5	100	650	
			4050	

3. (A) Will the companies subject to cost audit be also required to file Compliance Report under these Rules? (Taken from FAQ 1)

Answer:

a) If all the products/ activities of a company, excluding the exempted categories, are covered under cost audit, then the company will not be required to separately file the compliance report.

(b) If one or more product(s)/ activity(s) of a company is covered under Cost Audit and there are other products covered under Companies (Cost Accounting Records) Rules 2011 but not covered under Cost Audit as per company-wise or industry specific Cost Audit Orders dated 2nd May, 2011 and 3rd May, 2011 (amended by 30th June, 2011), the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

(c) If one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products not covered under Companies (Cost Accounting Records) Rules 2011, then the company will not be required to file a Compliance Report since the product(s)/activity(s) other than product(s)/ activity(s) under Cost Audit are in the exempted category.

(B) A company with multiple product range is having cost audit for some of its products. What would be the applicability of cost audit on other products now covered under Companies (Cost Accounting Records) Rules 2011? (Taken from FAQ 1)

Answer:

The cost audit on other products now covered under the Companies (Cost Accounting Records) Rules, 2011, will not be applicable until cost audit orders are issued for its other

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products/activities. However, Compliance Report is required to be submitted for the 'company as a whole' under different product groups.

If the company's remaining products belong to the exempted categories, then Companies (Cost Accounting Records) Rules 2011 will not be applicable on such exempted category products. The requirement of the Compliance Report will be guided by clarification provided under 4.2(b) and 4.2(c) above.

(C) Is it 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? (Taken from FAQ 1)

Answer:

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

However, if any or all the products/activities of the company is also covered under Cost Audit, then for the purposes of submission of Cost Audit Report under the Companies (Cost Audit Report) Rules 2011, a consolidated cost statement for the product group(s) under cost audit is required to be prepared.

(D) P. Panda & Co., a Cost Audit firm is requested to give his observations and conclusions in his Report on:

- (i) scope and performance of internal audit if any and adequacy or otherwise.**
- (ii) adequacy or otherwise of budgetary control system, if any in vogue.**

Briefly outline the approach of auditor to fulfil these requirements.

Answer:

(i) Internal Audit:

Object and scope of Internal audit is (i) verification of the compliance of established policies (ii) verification of effective operation of established systems (iii) verification of fixed and current assets, (iv) suggest improvement in systems and controls. It is necessary to have an internal audit manual or instructions that clearly indicating the scope of verification of each operational area so that responsibilities entrusted to internal audit are clear and the scope of nature of verification is spelt out for the functional department and external Auditors. Internal audit should have a detailed programme of verification and Reporting. Internal audit is a control function that ensures that programmes, policies and procedures laid down for each operational function, procurement, accounting, production, personnel, sales etc. are carried out properly. Similarly system laid down for control of utilisation of production facilities and functions is also to be verified by internal audit.

Therefore in judging the adequacy of the internal audit of a company the Cost Auditor would look into:

- (a) qualifications and experience of the internal audit staff ;
- (b) level of the head of internal audit vis-à-vis other departmental heads;

- (c) scope of work given to internal audit as laid down in the manual. Orders etc. and its adequacy in covering all functions;
- (d) audit programme of internal audit, its coverage;
- (e) control systems and procedures in operation;
- (f) Reports emanating from the Dept. and remedial actions taken by the Management.

The Cost Auditor will examine these aspects and carry out test checks before satisfying himself of internal audit is adequate.

(ii) Budgetary control:

Budgetary control is an essential feature of cost control system. Comprehensive budgets covering each functional area is prepared and responsibility fixed on the functional heads to exercise proper control of expenditure which is to be contained within the budget. Budgets are also linked to production levels so that at different levels of operation the functional head knows his budget limits. An annual budget is broken into monthly/ weekly budgets for exercising continuous control. Budgets are normally prepared for sales of each product, for each service and also for various depts./activities production Purchases, Stores, Salaries and wages capital expenditure, comparison with budgets reporting variances and initiating remedial action is a part of the budgetary control systems.

The Cost Auditor should therefore, verify —

- (a) whether budgets for each functional area, for different levels of production/sale are prepared for the year in advance and are broken to specific period budgets;
- (b) whether a system is in operation for collecting actuals reporting variances, fixing responsibilities;
- (c) whether management takes remedial measures to correct excess expenditures etc;
- (d) whether the system is comprehensive and covers all functions and is adequate.

4. (A) Is it mandatory to submit Performance Appraisal Report to company management or can it be a NIL report? Can Form III relating to Performance Appraisal be modified or it has to be strictly followed as prescribed? (Taken from FAQ 2)

Answer:

Vide sub-rule 5 of Rule 4 of the Companies (Cost Audit Report) Rules, 2011, every cost auditor, who submits a cost audit report shall also furnish Performance Appraisal Report, duly authenticated by the cost auditor, to the Board/Audit Committee of the company in the prescribed format (Form III). There cannot be NIL report since list of the areas to be covered in the report as per Form III are relating to company's operations being audited by the cost auditor. However, the frequency of this report viz. half yearly/annual (or even quarterly) is to be decided by the Company Management.

The contents of the Performance Appraisal Report as given in Form III are "indicative". Depending on the nature of business and activity of the company, the management and the cost auditor in consultation with each other can add or delete the indicative areas to be

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covered under the Performance Appraisal Report. The intention of the law appears to assign a role to the cost auditor to provide an independent view of the performance of the company to enable the management to take corrective steps wherever necessary. The Institute is also going to bring out a Guidance Note on the subject.

(B) What is the time limit within which the central government can seek clarification from the cost auditor? (Taken from FAQ 2)

Answer:

There is no time limit within which the Central Government can seek clarification from the cost auditor. The Rules have now specified that the Company would be required to maintain the cost accounting records for the preceding eight financial years in good order. The cost auditor is required to provide reply to any clarification sought for by the Central Government from the cost auditor in writing within 30 days of the receipt of the communication addressed to him calling for such clarifications.

(C) The Information under Para 3, 4, 5 & 6 is required to be furnished for the Company as a whole. In case of companies manufacturing the same product or rendering same service at different units, should the "product group wise cost sheets" of all units be merged into one and shown as a "cost sheet of single product group" or to be shown separately for each Unit? (Taken from FAQ 2)

Answer:

The unit-wise product-wise cost statements duly certified by the cost auditor and the management are to be kept in the Company. The "product group-wise" cost statement of all the products and all units combined together will form part of the cost audit report.

(D) For how many years, does a company under these rules require to preserve the Cost details? (Taken from FAQ 2)

Answer:

In respect of companies coming under the purview of the Companies (Cost Accounting Records) Rules, 2011 and the Companies (Cost Audit Report) Rules, 2011 for the first time, cost records and cost details, statements, schedules, etc. shall be kept in good order for the next eight financial years beginning with first year of application of the said Rules.

5. (A) What are the duties of the Company under the Cost Audit Report Rules, 2011? (Taken from FAQ 2)

Answer:

Every company as specified in sub-rule (1) shall, within ninety days of the commencement of every financial year, file an application with the Central Government seeking prior approval for appointment of the cost auditor, through electronic mode, in the prescribed form, along with the prescribed fee as per the Companies (Fees on Applications) Rules, 1999, and

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requisite enclosures. However, where a company is covered under cost audit for the first time vide cost audit order dated 30th June 2011, the period of 90 days shall be counted from the date of this order.

Every company shall follow the procedure prescribed vide Ministry of Corporate Affairs' General Circular No. 15/2011 [File No. 52/5/CAB-2011] dated April 11, 2011.

The company and every officer thereof, including the persons referred to in sub-section (6) of section 209 of the Companies Act, 1956 shall make available to the cost auditor, such cost accounting records, cost statements, other books and documents, and Annexure to the Report, duly completed, as would be required for conducting the cost audit, and shall render necessary assistance to the cost auditor so as to enable him to complete the cost audit and submit his report within the time limit specified in rule 5, i.e., within 180 days from the close of the Company's financial year to which the report relates.

The Annexure prescribed with the cost audit report shall be approved by the Board of Directors before submitting the same to the Central Government by the cost auditor.

(B) A steel tube manufacturing company is having turnover of ₹80 crores from all its activities. The company has filed its prospectus with SEBI for a public issue of equity shares and it hopes to complete the public offering by September 2011 end. Whether cost audit will become applicable to the company even when its turnover is less than ₹100 crore? If yes, then from which financial year will cost audit become applicable? (Taken from FAQ 2)

Answer:

In the instant case, the company's equity is in the process of listing on a stock exchange in India. Hence, it meets the requirement of Rule 3(1) of the Companies (Cost Accounting Records) Rules 2011. Consequently, the said Rules are applicable to the company in place of erstwhile Cost Accounting Records (Steel Pipes & Tubes) Rules 1984.

The cost audit order No. 52/26/CAB-2010 dated 3rd May 2011 has brought under the ambit of cost audit every company engaged in 6 specific industries, which includes Steel Tubes & Pipes. Though the turnover criteria of ₹100 crores is not met by the company, the company's equity is in the process of listing on a stock exchange in India. Hence, cost audit will be applicable to the company under the order dated 3rd May 2011 on and from the financial year 2011-12.

(C) A newly constructed cement factory will be operational from end June 2011. The projected turnover for the next 2 years is ₹500 crores per annum. Whether in coming years, the company will have to get cost audit done. If yes, then under which cost audit order number. (Taken from FAQ 2)

Answer:

The company will come into commercial production in June 2011. Assuming that the turnover for the first year of operation is ₹100 crores or more, cost audit will be applicable to the company from the financial year 2011-12. In case the first year turnover is less than ₹100 crores but the company is a listed company or is in the process of getting listed, then also cost audit will be applicable from 2011-12. If both these criteria are not met during the first year of operation, the cost audit will be applicable from 2012-13.

The cost audit will have to be conducted under cost audit order No. 52/26/CAB-2010 dated 3rd May 2011 modified vide Order dated 30th June 2011.

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(D) A company has 2 wind mills. Turnover from the two wind mills is ₹2 crores. The company's total turnover is more than ₹ 100 crores. None of the products of the company is covered under cost audit at present. Whether, the company will need to get cost audit done of electricity generation activities under Cost Audit Order 52/26/CAB-2010 dated 02.05.2011? (Taken from FAQ 2)

Answer:

Applicability of cost audit is based on turnover of the total company. Hence, any activity of a company, irrespective of the turnover of the particular activity, would be covered under cost audit if that particular activity is one of the activities listed in the cost audit order Nos. 52/26/CAB-2010 dated 2nd May 2011 or 52/26/CAB-2010 dated 3rd May 2011 (modified vide Order dated 30th June 2011).

If the power generated by the 2 wind mills is sold outside but the total turnover from the sale does not exceed 2% of the total turnover of the company or ₹20 crores, whichever is lower, then the power generation would be considered as an ancillary activity of the company incidental to its main operations (i.e. products/activities that do not constitute their main line of business) and the Cost Accounting Records (Electricity Industry) Rules 2001 will not be applicable. Consequently, the company will not be required to get cost audit conducted for the electricity activity in this case.

If the power generated by the 2 wind mills is captively consumed by the company, then Cost Audit Order No. 52/26/CAB-2010 dated 2nd May 2011 will not apply. [Please refer General Circular No. 67/2011 dated 30th November 2011]. For this purpose, the term "Captive Generating Plant" shall have the same meaning as assigned in Rule 3 of the Electricity Rules, 2005, which is annexed hereto.

6. (A) A company has one 1500 KVA captive Power Plant. Turnover of the company is more than ₹100 crores.

- i) Whether Cost Accounting Records (Electricity Industry) Rules, 2001 shall be applicable to the company.**
- ii) Whether cost audit is to be conducted for electricity activities under Cost Audit Order 52/26/CAB-2010 dated 2nd May 2011:**
 - a) When the company is using the entire generated power for captive consumption;**
 - b) When the company is consuming part of the generated power for captive consumption and part is sold outside. (Taken from FAQ 2)**

Answer:

(i) In the instant case, the Cost Accounting Records (Electricity Industry) Rules, 2001 is applicable to the company for its captive power plant and the cost of generation determined is to be considered for captive consumption of power.

ii) Whether or not cost audit would be required to be conducted in case the entire generated power is used for captive consumption and where part is sold would be governed by definition of "captive generating plant" as defined in Rule 3 of Electricity Rules 2005, which has been explained in question above.

(B) Whether a cost auditor can be appointed as Internal Auditor of the company. Whether there is any restriction on the cost auditor to accept assignments from a company where he is the cost auditor? (Taken from FAQ 5)

Answer:

Refer to MCA General Circular No. 68/2011 dated 30th November 2011.

A cost auditor cannot render any services to the company whether acting individually, or through the same firm or through other group firms where he or any partner has any common interest, relating to:

- (i) design and implementation of cost accounting system; or
- (ii) the maintenance of cost accounting records, or
- (iii) act as internal auditor,

However, a cost auditor can certify the compliance report or provide any other services as may be assigned by the company, excluding the services mentioned above.

(C) What is the role of Audit Committee, where applicable, in dealing with the Cost Audit Report? Can the Annexure to a Cost Audit Report be approved by the Audit Committee and/or the Board of Directors by circular resolution? (Taken from FAQ 5)

Answer:

Refer to MCA Master Circular No. 2/2011 dated 11th November 2011.

Sub-section (6) of section 292A of the Companies Act, 1956 states that the Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half yearly and annual financial statements before submission to the Board and also ensure compliance on internal control systems. Departmental Circular No. 6/2001 dated 20.08.2001 has already clarified that the term "auditors" includes cost auditor and hence "scope of audit including observations of the auditors" occurring. In the above sub-section includes the scope of cost audit including observations of the cost auditors as well. The presence of the cost auditor in such committees will ensure overall cost management, efficiency in resource utilization, business vertical-wise performance evaluation, proper pricing of inter-unit/ inter-company transfers and valuation of inventories. Hence, the company must place the cost audit report before the Audit Committee first, which in its duty to ensure compliance of internal control system shall also discuss the suggestions made in the cost audit report for implementation, wherever cost audit has been directed under section 233B of the Companies Act, 1956.

The Audit Committee, after due consideration of the Cost Audit Report is required to submit the same for approval of the Board. Since the Board of Directors is required to approve the Annexure to the Cost Audit Report and authorize by one of the Directors and the Company Secretary (two Directors in the absence of a Company Secretary) to sign the same, the Board should also consider the Cost Audit Report in a duly convened meeting and it would not be advisable to approve the same by circular resolution.

(D) Companies covered under any of the 6 Industry/Product Specific Cost Accounting Records Rules 2011 are also subject to cost audit. Will they be required to file Compliance Report also under these Rules? (Taken from FAQ 5)

Answer:

If one or more product(s)/activity(s) of a company is covered under cost audit and there are other products that are not covered under Cost Audit as per company-wise cost audit orders issued in the past or industry specific cost audit orders dated 2nd May, 2011 and 30th June,

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2011, the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

If one or more product(s)/activity(s) of a company is covered under Cost Audit and the other product(s)/activity(s) belong to the exempted category, then the company will not be required to file a Compliance Report.

7. (A) The manufacturing process of a company generates Steel Scrap during production of its main products which may or may not be covered under cost audit. Such scrap is cleared under Chapter 72 of the Central Excise Tariff and sold in the market. Will the company be covered under cost audit for generation of scrap? (Taken from FAQ 5)

Answer:

The company is engaged in manufacture of products and coverage of its main products under cost audit would depend on whether or not such products are covered under company specific cost audit orders issued in the past or industry specific cost audit orders dated 2nd May 2011 or 30th June 2011.

The generation of steel scrap is not a production or processing or manufacturing but is incidental to manufacture of its main products. Even though steel scrap, when sold, is liable for payment of excise duty under Chapter 72, still, generation of scrap will not be covered under cost audit.

(B) Para 9 of the Companies (Cost Audit Report) Rules 2011 requires disclosure of "Cost of Production" and "Cost of Sales" at a company level. How the same would be available when all the products/ activities are not covered under cost audit? (Taken from FAQ 5)

Answer:

The Companies (Cost Accounting Records) Rules 2011 [CARR] is now applicable to all companies engaged in production, processing, manufacturing & mining. Hence, product-wise/ activity-wise cost of production and cost of sales would be available from the Cost Accounting Records of all the products/ activities, irrespective of whether these are covered under cost audit or not.

It may further be noted that in such a situation, the company would also be required to file a compliance report and for this purpose, product-wise/ activity-wise cost of production and cost of sales would be determined to prepare the reconciliation statement as required in the compliance report.

(C) A Company having turnover above ₹100 crore undertakes works contracts for pipe line execution for Drinking, Sewerage and Irrigation purpose. The required pipes for the projects, falling under Chapter 68 of CETA, are manufactured by the Company itself. A part of the production is also sold outside. Whether Cost Audit is applicable for Pipe manufacture? (Taken from FAQ 5)

Answer:

Applicability of cost audit is based on turnover of the total company. Any activity of a company, irrespective of the turnover of the particular activity, would be covered under cost audit if that particular activity is one of the activities listed in the cost audit order Nos. 52/26/CAB-2010 dated 2nd May 2011 or 30th June 2011.

Whether the company under reference will attract cost audit for its pipe manufacturing activity will now depend on whether the captive consumption is made for a product which is under cost audit. In this case it is not so and the pipe manufacturing will attract cost audit under this test.

However, if the production of pipes is an ancillary activity as defined in MCA General Circular No. 67/2011 dated 30th November 2011, then pipe manufacturing would be outside purview of cost audit.

(D) A company is engaged in construction of Roads, Bridges, Marine facilities etc. having sites in India and abroad. The company also has Joint venture projects in India and abroad. Whether Companies (Cost Accounting Records) Rules 2011 would be applicable to the company? (Taken from FAQ 5)

Answer:

As per the provisions of MCA General Circular No. 67/2011 dated 30th November 2011, all companies engaged in the construction business either as contractors or as sub-contractors, who meet with the threshold limits laid down in Rule 3 of the Companies (Cost Accounting Records) Rules, 2011 and undertake jobs with the use of own materials [whether self-manufactured/produced or procured from outside] shall be required to maintain cost records and file a compliance report with the Central Government in accordance with the provisions of the Companies (Cost Accounting Records) Rules, 2011. This includes companies engaged in the construction and/or development of residential, commercial or industrial estates i.e. development of township, residential units, commercial complex, office blocks, industrial parks [including SEZ] etc. or construction of highways, rails, roads, bridges, industrial & non-industrial structures, or other infrastructure facilities etc.

The provisions of Companies (Cost Accounting Records) Rules, 2011 would also apply for construction activities undertaken under BOT/BOOT mode, or the projects undertaken as EPC contractor or the projects undertaken abroad by a company incorporated in India.

However, if a company is engaged in the contracting or sub-contracting activities and is paid only the job work or conversion charges, then the company will not be covered under Companies (Cost Accounting Records) Rules, 2011. Such contractors or sub-contractors who are doing construction jobs without using own materials and are thus paid either the job work charges or the conversion charges only will not be covered under the Companies (Cost Accounting Records) Rules, 2011.

These Rules also do not apply to such Joint Ventures that are non-corporate entities [i.e. not companies registered under the Companies Act] or to unlisted companies having net worth less than ₹5 crore & turnover less than ₹20 crore or to a body corporate governed by any special Act.

8. (A) Whether Ready Made Garments and textile articles like sewing thread are covered under Cost Audit? (Taken from FAQ 6)

Answer:

All products including intermediate products and articles or allied products of the industries covered under cost audit orders dated 2nd May 2011, 30th June 2011 and 24th January 2012 are covered under cost audit. Products falling under Chapter references mentioned in the orders are to be considered against the respective industry as applicable.

(B) Whether automotive parts used in 4 wheeled Motor Vehicles are covered or all automotive components including automotive parts for 2/3 wheelers are also covered under the cost audit? (Taken from FAQ 6)

Answer:

Motor Vehicle is a mechanically propelled vehicle adapted for use upon roads and includes a chassis to which a body has not been attached and a trailer. Therefore, motor vehicles includes 2 or more wheelers and components for all such motor vehicles are covered under cost audit. Automotive Components falling under Chapters 84, 85 & 87 used for motor vehicles are covered under cost audit.

(C) Whether film industry like film producing companies/studios registered under Indian Companies Act covered under Companies (Cost Accounting Records) Rules, 2011? (Taken from FAQ 6)

Answer:

Companies (Cost Accounting Records) Rules, 2011 is applicable to developing, fixing, and washing exposed photographic or cinematographic film or paper to produce either a negative image or a positive image. In case a film producing company is also engaged in these activities, the same would be covered.

(D) Whether readymade garment manufacturing companies exporting garments to overseas countries are covered under CARR and cost audit? (Taken from FAQ 6)

Answer:

Readymade garment manufacturing company meeting the threshold limit will be covered under the Companies (Cost Accounting Records) Rules 2011 and are required to maintain cost accounting records. The company would also be covered under cost audit as per cost audit order dated 24th January 2012 provided it is not a 100% EOU that have been exempted from cost audit only as per MCA General Circular No. 67/2011 dated 30th November 2011. In case the company is exempted from cost audit, the company will be required to file a Compliance Report.

9. (A) A Company is manufacturing Asbestos sheets and using less than 50% of cement as an input. The product is covered under Chapter 25 of the Central Excise Tariff Act, 1985. Is Cost Audit applicable to Asbestos sheets? (Taken from FAQ 6)

Answer:

As per MCA General Circular No. 67/2011 dated 30th November 2011 the words "articles or allied products thereof" refer to such articles or allied products that are produced either wholly or predominantly [not less than 50% by weight or volume] by using the listed products as their primary inputs. In this case, Cement is the product under cost audit which is used as an input. Since Asbestos contains less than 50% of Cement, it will not be covered under cost audit as an allied product of Cement.

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(B) A Company is manufacturing Cast Iron Casting and SG Iron Castings in foundry unit which are cleared under Chapter 73 of Central Excise Tariff Act 1985. The products are treated as Iron articles and not steel articles. The predominant input for the manufacture of the same is MS Scrap, Pig Iron. Whether covered for Cost Audit under order dated 30/06/2011? (Taken from FAQ 6)

Answer:

Steel Industry referred to in cost audit order dated 30th June 2011 includes iron, pig iron, sponge iron etc. Since Cast Iron and SG Castings are iron/steel products and is cleared under Chapter 73 of Central Excise Tariff Act 1985, the same would be covered under cost audit.

(C) An Automotive Industry is manufacturing multiple products like rear-view mirror, aluminum panels etc. for motor vehicles. The finished products of the Company are covered under Chapters 70, 72, 76, 84, 85 and 87 of Central Excise Tariff Act 1985 (CETA). The inputs are glass, steel, aluminum etc. which are covered under cost audit. Whether the automotive components manufactured by the Company would be treated as products of glass, steel or aluminum, as the case may be or will the components be treated as Automotive Components and covered under cost audit order dated 24th January 2012? (Taken from FAQ 6)

Answer:

As per the cost audit order dated 24th January 2012, all automotive components, irrespective of the input material and/or the CETA Chapter under which it is cleared, are classified as automotive components and covered under cost audit from the financial year commencing on or after 1st April 2012.

(D) In planning to take up a Cost Audit of a unit what documents and information should a Cost Auditor take note of?

Answer:

In planning Cost audit work the Auditor should do preliminary groundwork to enable himself to acquaint fully with the product, industry, technology and the general economic scene. Cost Audit could then only become meaningful. The basic data and documents that he should collect and study would cover:-

- (i)** The provisions of the Cost Accounting Record Rules, 2011 in respect of the product as well as similar other products.
- (ii)** The Provision of Cost Audit Report Rules, 2011
- (iii)** Guidelines on Cost Audit issued by the Institute of Cost Accountants of India or other authorities.
- (iv)** Data on general economic environment in respect of the industry such as capacities, production, demand, prices, markets, international scenario.
- (v)** Govt. policies on tariff, price control or monitoring, licensing raw material supply if any.
- (vi)** The position of the company/unit in the industry with reference to market share, price leadership etc.
- (vii)** Organisational set up of the unit its products, processing units, selling arrangements, etc.

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- (viii) Process of manufacture — detailed study of stage-wise processes, production of utilities, technology, alternative technologies in vogue if any.
- (ix) Systems, procedures adopted for operation and control — Accounts Manual, Cost Accounting Manual, Internal Audit, Budget Manual etc.
- (x) Special accounting principles, procedures if any applicable to the specific industry.
- (xi) Details of Cost Trends
- (xii) Periodical Reports forming part of management Information system.
- (xiii) Balance Sheet and Profit & Loss Account for past years.
- (xiv) Previous Cost Audit Report if any.

10. (A) How would you treat Self manufactured packing material as per CAS 9 related to Packing Material Cost?

Answer:

Self manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.

(B) How would you compute cost of utilities generated for the purpose of inter unit transfers as per CAS 8?

Answer:

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.

(C) How would you treat repairs and maintenance costs not traceable to a cost object as per CAS 12?

Answer:

Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following two principles:

- (i) Cause and effect- Cause is the process or operation or activity and effect is the incurrence of cost.
- (ii) Benefits received-Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

(D) How will you treat an item of Direct Expenses that doesnot meet the test of materiality as per CAS 10?

Answer:

If an item of Direct Expenses does not meet the test of materiality, it can be treated as part of overheads.

11. (A) How would you treat Separation cost due to voluntary retirement, retrenchment, termination etc. as per CAS 7 related to Employee Cost?

Answer:

The separation costs related to voluntary retirement, retrenchment termination etc shall be amortized over the period benefitting from such costs. The amortized separation costs for the period shall be treated as indirect cost and assigned to cost objects in an appropriate manner.

However unamortized amount related to discontinued operations shall not be treated as employee cost.

(B) What is 'equalised transportation cost' under CAS 5?

Answer:

The term 'equalised transportation cost' has been defined as average transportation cost incurred during a specified period. The standard requires the detailed record to be maintained w.r.t collection, allocation, and apportionment of transportation cost.

(C) How would you determine the cost of material consumed in production for captive consumption as per CAS 4?

Answer:

Material Consumed shall include materials directly identified for production of goods such as :

- (i) indigenous materials
- (ii) imported materials
- (iii) bought out items
- (iv) self manufactured items
- (v) process materials and other items

Cost of material consumed shall consist of cost of material, duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement. Trade discount, rebates and other similar items will be deducted for determining the cost of materials. Cenvat credit, credit for countervailing customs duty, Sales Tax set off, VAT, duty draw back and other similar duties subsequently recovered/ recoverable by the enterprise shall also be deducted.

(D) What are the principles of measuring 'overheads' as per CAS 3?

Answer:

Principles of measuring 'overheads' are as follows:

- (i) Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited.
- (ii) Overheads other than those referred to in (i) shall be determined on the basis of cost incurred in connection therewith.

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For example, machinery spare fabricated internally or a repair job carried out internally will include cost incurred on material, employees and expenses.

(iii) Any abnormal cost where it is material and quantifiable shall not form part of the overheads.

(iv) Finance costs incurred in connection with procured or self generated resources shall not form part of overheads.

(v) Overheads shall not include imputed cost.

(vi) Overhead variances attributable to normal reasons shall be treated as part of overheads. Overhead variances attributable to abnormal reasons shall be excluded from overheads.

(vii) Any subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(viii) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the overheads.

ix) Credits / recoveries relating to the overheads, material and quantifiable, shall be deducted from the total overhead to arrive at the net overheads. Where the recovery exceeds the total overheads, the balance recovery shall be treated as other income.

(x) Any change in the cost accounting principles applied for the measurement of the overheads shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an entity.

12. (A) What do you understand by the term 'collection of overheads' as per CAS 3?

Answer:

Collection of overheads means the pooling of indirect items of expenses from books of account and supportive/ corroborative records in logical groups having regards to their nature and purpose.

Overheads are collected on the basis of pre-planned groupings, called cost pools. Homogeneity of the cost components in respect of their behaviour and character is to be considered in developing the cost pool. Variable and fixed overheads should be collected in separate cost pools under a cost centre. A great degree of homogeneity in the cost pools are to be maintained to make the apportionment of overheads more rational and scientific. A cost pool for maintenance expenses will help in apportioning them to different cost centres which use the maintenance service.

(B) What is the value of Goods used for captive consumption as per CAS 4?

Answer:

According to the Central Excise Valuation (Determination of Price of Excisable Goods) Rules 2000, the assessable value of goods used for captive consumption is 110% w.e.f. 05-08-2003 of cost of production of such goods, and as may be prescribed by the Government from time to time.

(C) What do you understand by the term 'service cost centre' as per CAS 13?

Answer:

The cost centre which provides services to Production, Operation or other Service Cost Centre but not directly engaged in manufacturing process or operation is a service cost centre. A service cost centre renders services to other cost centres / other units and in some cases to outside parties.

Examples of service cost centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, welfare services, safety, transport, Component, Tool stores, Pollution Control, Computer Cell, dispensary, school, crèche, township, Security etc.

(D) How are 'inward' and 'outward' transportation cost treated as per CAS 5?

Answer:

Inward transportation costs shall form the part of the cost of procurement of materials which are to be identified for proper allocation/ apportionment to the materials / products.

Outward transportation cost shall form the part of the cost of sale and shall be allocated / apportioned to the materials and goods on a suitable basis.

Explanation:

Outward transportation cost of a product from factory to depot or any location of sale shall be included in the cost of sale of the goods available for sale.

13. (A) How would you treat the forex component of imported packing material as per CAS 9?

Answer:

The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.

(B) How would you treat overtime premium as per CAS 7 related to Employee Cost?

Answer:

Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and specific circumstances requiring such overtime.

(C) How would you assign administrative overheads as per CAS 11?

Answer:

Assignment of administrative overheads to the cost objects shall be based on either of the following two principles:

(i) *Cause and Effect* – Cause is the process or operation or activity and effect is the incurrence of cost.

(ii) *Benefits received*– Overheads are to be apportioned to various cost objects in proportion to the benefits received by them.

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The costs of shared services should be assigned to user activities on the basis of actual usage. General management costs should be assigned on rational basis.

(D) How would you determine the cost of utilities generated for inter company transfers as per CAS 8?

Answer:

Cost of Utilities generated for the inter company transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.

14. (A) "Risk of material misstatement at the assertion level consists of two components" – explain.

Answer:

The risk of material misstatement at the assertion level consists of two components as follows:

- "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related cost heads, items of cost and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cost heads consisting of amounts derived from cost estimates that are subject to significant measurement uncertainty pose greater risks than do cost heads consisting of relatively routine, factual data.
- External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a cause changes to a manufacturing process rendering the existing classification of variable and fixed costs inappropriate and cause product contribution to be misstated.. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of cost heads, items of cost, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, external market constraints may cause normal capacity as an unreliable basis for determining unit costs.
- "Control risk" is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's Cost Statements. Some control risk will always exist because of the inherent limitations of internal control.
- Inherent risk and control risk are the entity's risks; they exist independently of the audit of the Cost Statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. When the auditor's assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. The CAAS AND GACAAPs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risk of material misstatement." Although the CAAS AND GACAAPs ordinarily describe a combined assessment of the risk of material misstatement, the auditor may make separate or combined assessments of inherent and control risk

depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

- "Detection risk" is the risk that the cost auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of cost heads, items of cost, or disclosure and because of other factors. Such other factors include the possibility that a cost auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, and supervision and review of the audit work performed.
- Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.

(B) What are the objectives and functions of the Cost Audit and Assurance Standards?

Answer:

The following are the objectives and functions of the Cost Audit and Assurance Standards Board:

- a) To identify areas in which Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services need to be developed.
- b) To develop Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services so that they may be issued under the authority of the Council of the Institute.
- c) To develop Guidance Notes on issues arising out of any Standard or on auditing issues pertaining to any specific industry or on generic issues so that they may be issued under the authority of the Council of the Institute.
- d) To formulate and issue Technical Guides, Practice Manuals and other Papers under its own authority for guidance of Cost Accountants in the cases felt appropriate by the Board.
- e) To review the existing Standards, Guidance Notes, Technical Guides, Practice Manuals and other Papers to assess their relevance in the changed conditions and to undertake their revision, if necessary.
- f) To provide Interpretations or formulate General Clarifications, where necessary, on issues arising from the Standards.

(C) Explain the statement with the help of Cost Audit and Assurance Standard (CAAS) – 101 “Cost Auditor includes audit partner”

Answer:

As per CAAS - 101 “Audit partner” means the partner or other person in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

(D) What are the matters that are relevant in formulating audit strategy and drawing up the audit plan?

Answer:

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

- a. The cost reporting framework generally prescribed by the Cost Audit Report Rules on which the cost information to be audited has been prepared, including need for reconciliation with financial reporting framework.
- b. The specific requirements of industry specific cost accounting record rules.
- c. Industry regulators' requirement as to how costs will be handled.
- d. Unique features of an industry that influence audit requirements e.g. definition of product in the newspaper industry.
- e. Reliance that can be placed on the work of financial auditors, other cost auditors appointed by the entity and internal auditors for example their attendance in annual stocktaking
- f. State of IT implementation, whether the entity is using an ERP system or internally developed systems and the reliance that can be placed on them.
- g. Statutory timelines for cost reporting which can be modified by managements for early completion.
- h. Timelines for Board/ audit committee meetings which can set the time limits for completion of audit work.
- i. Resources required and available in terms of manpower, equipment and others and the assignment of these to specific parts of the work.

15. (A) “The Cost Audit report contains significant information which would help to assess and improve operational efficiency of a concern:

Discuss the statement with reference to the matters to be reported by a Cost Auditor in his report.

Answer:

- (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.

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- (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 regards the following matters for improvements in performance of the company under audit with reference to :-

- (a) Rectification of general imbalance in production facilities;
- (b) Fuller utilisation of installed capacity;
- (c) Concentration on areas offering scope for cost reduction, increased productivity and key limiting factors causing production bottlenecks; and
- (d) 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.

(B) (i) Under the Companies Act, 1956 before the appointment of a cost auditor is made by the Board of Directors of a company a written certificate is to be obtained by the board from the proposed auditor to the effect that the appointment, if made, will be in accordance with the provisions of Section 224(1B) of the Act. Discuss the provisions of Section 224 (1B)

(ii) "A person referred to in sub-section (3) or sub-section (4) of section 226 of the Companies Act, 1956 shall not be appointed for conducting the audit of the cost accounts of a company". Please examine and discuss this provisions.

Answer.

(i) Section 224 (1B)

No Company or its Board of directors shall appoint or re-appoint any person (who is in full-time employment elsewhere) or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies.

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Provided that in the case of a firm of auditors, "specified number of companies" shall be construed as the number of Companies specified for every partner of the firm who is not in full-time employment elsewhere.

Provided further that where any partner of the firm is also a partner of any other firm or firms of auditors, the number of companies which may be taken into account, by all the firms together, in relation to such partner shall not exceed the specified number in the aggregate.

Provided also that where any partner of a firm of auditors is also holding office, in his individual capacity, as the auditor of one or more companies, the number of companies which may be taken into account in his case shall not exceed the specified number in the aggregate.

Explanation I: For the purpose of sub-section (1B) "specified number" means,

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

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

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

(ii) (a) Section 226 (3) :

None of the following persons shall be qualified for appointment as auditor of a company —

(a) a body corporate;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment of an officer or employee of the company;

(d) a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees.

Explanation : Reference in this sub-section to an officer or employee shall be constructed as not including references to an auditor.

(b) Section 226 (4) :

A person shall also not be qualified for appointed as auditor of a company if he is, by virtue of sub-section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(C) Mr. Jalan, a practicing cost accountant, doing Cost Audit of M/s. ABC Ltd since last three years. During the year M/s. ABC Ltd requested him to develop his Cost Accounting System. Can Mr. Jalan accept the proposal and do Cost Audit for the same period. Suggest

Answer:

No. After the Cost Auditor has accepted the appointment for a company, there may be changes in his position in relation to the company that impede his arm's length relationship with the company. It may happen that an assignment subsequently handled by him for the client, for example, design and implementation of Cost Accounting System may disqualify him from continuing as Cost Auditor for the company.

(D) While doing Cost Audit, the Cost Auditor should hold professional skepticism. Explain

Answer:

As per Cost Audit and Assurance Standard on Overall Objectives of the Independent Cost Auditor and Conduct of an audit in Accordance with Standards on Auditing (CAAS) – 103, an attitude of professional skepticism means the cost auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and be alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. An attitude of professionalism is necessary throughout the cost audit process for the auditor to reduce the risk of overlooking unusual circumstances, of over generalizing when drawing conclusions from cost audit observations, and of using faulty assumptions in determining the nature, timing and extent of the cost audit procedures and evaluating the results thereof. When making inquiries and performing other cost audit procedures, the cost auditor is not satisfied with less – than - persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the cost auditor's opinion.

16. (A) What is the Qualification of Cost Auditors?

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 (1-B) 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).

(B) Explain Disqualification of Cost Auditors.

Disqualifications of a Cost Auditor

The disqualifications of a person for being appointed or re-appointed for conducting the cost audit are detailed in sub-Sections (a), (b) and (c) Section 233 (5) of the Companies Act, 1956 detailed as under:

- (a) The sub-Section (5)(a) provides that a person referred to in sub-Section (3) or sub-Section (4) of the Section 226 shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company.
- (b) The sub-Section 5(b) provides that a person appointed under Section 224 as an auditor of a company shall not be appointed or re-appointed for conducting the audit of the cost accounts of that company.
- (c) The sub-Section (5)(c) provides that if a person, appointed for conducting the audit of cost accounts of a company, becomes after his appointment, to any of the disqualifications specified in clause 5(a) or 5(b) above, he shall on and from the date on which he becomes disqualified, shall cease to conduct the audit of the cost accounts of the company.

Section 226 of the Companies Act, 1956 provides for the qualifications and disqualifications of the auditors. Reading of sub-Section (3) of Section 226 implies that the following persons cannot be appointed or reappointed as cost auditor of a company –

- (a) a body corporate;
- (b) an officer or employee of the company;
- (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;
- (d) a person who is indebted to the company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;
- (e) a person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. (Explanation: "security" means an instrument which carries voting rights);

The sub-Section (4) of Section 226 provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-Section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so

disqualified if the body corporate were a company. In other words, if a person is disqualified under any of the aforesaid classes from being appointed as an auditor of any company or body corporate, he cannot be appointed as auditor of its holding company, subsidiary or 'co-subsiary'; and

A person, who is in full time employment elsewhere [Section 224(1B)]. If an auditor becomes disqualified after his appointment, under any of the above provisions he shall be deemed to have vacated his office.

(C) What procedure is required to be followed by a company in respect of appointment of cost auditor?

Answer:

The Company is required to e-file its application with the Central Government on www.mca.gov.in portal, in the prescribed Form 23C within ninety (90) days from the date of commencement of each financial year, along with the prescribed fee as per the Companies (Fees on Application) Rules, 1999 as amended from time to time and other documents as per existing practice i.e.

- (i) certified copy of the Board Resolution proposing appointment of cost auditor; and
- (ii) copy of the certificate obtained from the cost auditor regarding compliance of section 224(1-B) of the Companies Act, 1956.

(D) What will happen if Central Government doesn't give its approval within 30 days of submission/ re-submission of the application?

Answer:

After filing the online application by the Company, the same shall be deemed to be approved by the Central Government, unless contrary is heard within thirty (30) days from the date of filing such application.

However, if within thirty (30) days from the date of filing such application, the Central Government directs the Company to re-submit the said application with such additional information or explanation, as may be specified in that direction, the period of thirty days for deemed approval of the Central Government will be counted from the date of re-submission of Form 23C by the Company.

17. (A) Who can be appointed as a cost auditor?

Answer:

A Cost Accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under sub-section (1) of section 6 of that Act and including a Firm of Cost Accountants can be appointed by a Company as cost auditor. However, the cost accountant or partners of a firm of cost accountant should be in whole-time practice and not holding any other employment.

(B) Who is competent authority in companies to appoint cost auditor?

Answer:

As per provisions of section 233B(2), the Board of Directors of a Company can appoint a cost auditor after obtaining prior approval of the Central Government.

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Under the revised procedure, the first point of reference will be the Audit Committee to ensure that the cost auditor is free from any disqualification as specified under section 233B (5) read with section 224 and sub-section (3) or sub-section (4) of section 226 of the Companies Act, 1956. The Audit Committee should also ensure that the cost auditor is independent and is at arm's length relationship with the company. After ascertaining the eligibility, the Audit Committee will recommend to the Board of Directors for appointment of the Cost Auditor.

In those companies where constitution of an Audit Committee is not required by law, the functions of the "Audit Committee" as per the procedure will be discharged by the "Board of Directors".

(C) Is a cost auditor required to give any certificate in respect to his independence and arm's length relationship with the appointing company? (Taken from FAQ 1A)

Answer:

Yes, the cost auditor will be required to give a separate certificate to the audit committee in respect to his/its independence and arm's length relationship with the company.

(D) (i) In the sulphuric acid industry, heat is generated by burning of sulphur. How will you deal with this in cost ?

(ii) In industries that have own captive thermal generation of power using steam, the exhaust steam from the power turbine is used in process. How would you determine the value of steam used in power generation and in process ?

Answer.

(i) Sulphuric acid manufacturing process is exo-thermic, i.e. giving out heat because of burning sulphur. This heat can be valued on the basis of the thermal value of the heat generated as equated to say, furnace oil. If the heat is directly used for producing steam then based on the quantity of steam produced, the heat can be valued and credited to acid manufacture.

(ii) In thermal power generation by exhaust type power turbines, steam is used only as a force to rotate the vanes of the turbine. After rotating the blades, steam has no role to play in power generation and so comes out as exhaust steam. However while being fed to the turbine the steam is high pressure super-heated and dry. When it comes out as exhaust there is a fall in its temperature, pressure and dryness. This is determined by the enthalpic value of steam fed and steam coming out as exhaust. This fall in enthalpic value as a percentage can be used to value the steam cost for power generation and the balance as the process steam.

18. (A) How many cost audits can be allotted in the name of one practicing cost accountant? (Taken from FAQ 1A)

Answer:

Section 224 (1B) stipulates "On and from the financial year next following the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), no company or its Board of directors shall appoint or reappoint any person who is in full-time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies:

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Provided that in the case of a firm of auditors, "specified number of companies" shall be construed as the number of companies specified for every partner of the firm who is not in fulltime employment elsewhere:

Provided further that where any partner of the firm is also a partner of any other firm or firms of auditors, the number of companies which may be taken into account, by all the firms together, in relation to such partner shall not exceed the specified number, in the aggregate:

Provided also that where any partner of a firm of auditors is also holding office, in his individual capacity, as the auditor of one or more companies, the number of companies which may be taken into account in his case shall not exceed the specified number, in the aggregate.

Provided also that the provisions of this sub-section shall not apply, on and after commencement of the Companies (Amendment) Act, 2000, to a private company.

Explanation I: For the purposes of sub-sections (1B) and (1C), "specified number" means, -

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

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

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

(B) What will happen if Central Government doesn't give its approval within 30 days of submission/ re-submission of the application? (Taken from FAQ 1A)

Answer:

After filing the online application by the Company, the same shall be deemed to be approved by the Central Government, unless contrary is heard within thirty (30) days from the date of filing such application.

However, if within thirty (30) days from the date of filing such application, the Central Government directs the Company to re-submit the said application with such additional information or explanation, as may be specified in that direction, the period of thirty days for deemed approval of the Central Government will be counted from the date of re-submission of Form 23C by the Company.

(C) What is the obligation of the cost auditor after receipt of formal appointment letter? (Taken from FAQ 1A)

Answer:

The Cost Auditor is required to inform the Central Government within thirty days of receipt of formal letter of appointment from the Company. Such intimation is required to be done in prescribed e-Form 23 D along with a copy of such appointment.

Click here to download e-Form 23 D:

<http://www.mca.gov.in/MCA21/dca/downloaddeforms/eformTemplates/1101-Form23D.zip>

Click here to download instruction for filling up Form 23D:

http://www.mca.gov.in/MCA21/dca/downloaddeforms/eformTemplates/1101-Form23_help.zip

(D) What disclosures are required to be made by a Company in respect of cost audit in its Annual Report? (Taken from FAQ 1A)

Answer:

The Company is required to disclose full particulars of the cost auditor along with the due date and actual date of filing of the Cost Audit Report by the cost auditor, in its Annual Report for each relevant financial year. Since the notification has made effective from April 1, 2011, companies under cost audit are required to furnish the details in its Annual Report from the financial year 2010-11.

Since the cost audit report of a particular financial year may not have been submitted before publication of the Annual Report, relevant details of due and actual date of filing for the last financial year and the due date of filing for the current year may be published in the Annual Report.

(E) What are the penal provisions for non-compliance of any of the provisions of the Act regarding cost audit? (Taken from FAQ 1A)

Answer:

Non compliance by Companies

If a Company contravenes any provision of this circular, the company 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-section (2) of Section 642 read with sub-section (5) and (7) of Section 209 and sub-section (11) of Section 233B of Companies Act, 1956.

Relevant provisions of Section 209 of the Companies Act, 1956 are as follows:

Sub- section (5) of Section 209 provides that if any of the persons referred to in sub-section (6) fails to take all reasonable steps to secure compliance by the company with the requirements of this section, or has by his own willful act been the cause of any default by the company thereunder, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both:

Provided that in any proceedings against a person in respect of an offence under this section consisting of a failure to take reasonable steps to secure compliance by the company with the requirements of this section, it shall be a defense to prove that a competent and reliable person was charged with the duty of seeing that those requirements were complied with and was in a position to discharge that duty:

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed willfully. Sub- section (6) of Section 209 provides that the persons referred to in sub-section (5) are the following, namely:—

where the company has a managing director or manager, such managing director or manager and all officers and other employees of the company; and

where the company has neither a managing director nor manager, every director of the company;

Sub- section (7) of Section 209 provides that if any person, not being a person referred to in sub-section (6), having been charged by the managing director, manager or Board of directors, as the case may be, with the duty of seeing that the requirements of this section are

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complied with makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both.

Relevant provision of Section 642 of the Companies Act 1956 is as under:

Sub-section (2) of Section 642 provides that any rule made under sub-section (1) may provide that a contravention thereof shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first during which such contravention continues.

Non compliance by Cost Auditor

If default is made by the cost auditor in complying with the aforesaid provisions, he shall be punishable with fine, which may extend to five thousand rupees.

19. (A) (i) In the sulphuric acid industry, heat is generated by burning of sulphur. How will you deal with this in cost ?

(ii) In industries that have own captive thermal generation of power using steam, the exhaust steam from the power turbine is used in process. How would you determine the value of steam used in power generation and in process ?

Answer.

(i) Sulphuric acid manufacturing process is exo-thermic, i.e. giving out heat because of burning sulphur. This heat can be valued on the basis of the thermal value of the heat generated as equated to say, furnace oil. If the heat is directly used for producing steam then based on the quantity of steam produced, the heat can be valued and credited to acid manufacture.

(ii) In thermal power generation by exhaust type power turbines, steam is used only as a force to rotate the vanes of the turbine. After rotating the blades, steam has no role to play in power generation and so comes out as exhaust steam. However while being fed to the turbine the steam is high pressure super-heated and dry. When it comes out as exhaust there is a fall in its temperature, pressure and dryness. This is determined by the enthalpic value of steam fed and steam coming out as exhaust. This fall in enthalpic value as a percentage can be used to value the steam cost for power generation and the balance as the process steam.

(B) State whether the following companies are covered by cost accounting records rules with reasons for your conclusions:

(i) A small scale industrial unit manufacturing formulations, which are subject to statutory price control order under Drugs price Control order.

(ii) A construction company, which runs a mini cement plant to manufacture cements for its own use.

(iii) A company which manufactures cotton yarn.

Answer.

(i) SSI units are exempted only if DPCO order is not APPLICABLE to them. Therefore the unit referred to in the question is covered by the cost accounting records rules.

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- (ii) The test for applicability of the cost accounting records rules is the manufacture of the product that is covered by the relevant rules. Hence the construction company in the given case is covered by the Cost Accounting Records Rules.
- (iii) Cost Accounting records (Cotton textile) Rules applicable to spinning weaving and even processing companies. therefore it is applicable to the case referred to in the question.

(C) Write Short notes on Social objectives of cost audit.

Answer.

The main purpose of introduction of Cost Accounting Records Rules is to monitor utilisation of resources. Cost Audit would therefore aim at effectiveness of such monitoring.

Hence the social objectives of cost audit can be identified as :

- (a) Better utilisation of resources to ensure productivity and as better supply of end products to help the nation and the common man.
- (b) Review the pricing policy of the companies cost audited to ensure consumer protection against undue profiteering, creating artificial shortages.
- (c) Review the existing system of internal monitoring of cost behavior to ensure minimum time lag between the occurrence of any event and corrective action taken thereon. This would help to curb sickness in industry which could affect the society as such sickness would have an impact on the economic well being of the employees, suppliers, customers and financial institutions which finance the companies.
- (d) Develop cost awareness which would sharpen the competitiveness of Indian industry and help it in international business, particularly at a time when our foreign exchange reserves are under considerable pressure.

(D) Could the following persons be appointed as cost auditor of a company ? briefly explain your conclusions.

- (i) **A cost accountant in practice and holding part-time employment with that company.**
- (ii) **A firm of cost accountants, who are presently acting as internal auditors of that company.**
- (iii) **A firm of cost accountants, one of whose partners is a director of that company.**
- (iv) **A firm of cost accountants, who were retained in the previous year as consultants to install a costing system in that company.**

Answer.

- (i) Under section 233B(5) a person referred to in section 226(3) shall not be appointed as a cost auditor. Section 226(3)(b) disqualifies an officer of the company from being appointed as an auditor of the company. Hence any cost accountant having part-time employment with a company cannot be appointed as a cost auditor under section 233B.

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- (ii) Under a circular issued by the Company Law Board any one who is acting as internal auditor of the company cannot be appointed as cost auditor or financial auditor of the company.
- (iii) Under section 233B(5) a person referred to in section 226(3) shall not be appointed as a cost auditor. Section 226(3)(c) disqualifies a person who is a partner or an officer of the company from being appointed as an auditor of the company. Since a director is an officer of the company, partners or the director cannot act as auditor of that company. Therefore such a firm cannot be appointed as cost auditors.
- (iv) Rendering professional services as consultants is not being in employment of the company. Further the facts of the case indicate that the consultancy assignment was in an earlier year. Therefore at the time of appointed as cost auditors the firm suffers from no disability and can be appointed as cost auditors of the company.

20. (A) Comment on whether the following practices would in your opinion, be acceptable in your capacity as cost auditor.

- (i) **A sugar Mill has treated both seasonal and non-seasonal wages of direct labour as part of labour cost while arriving at the cost of sugar produced.**
- (ii) **A company which has till last year valued chlorine at realisable value, on the ground that it was a by-product of caustic soda, has decided to change the system in the current year and apports cost on the basis of atomic weight on the ground that it is a joint product.**
- (iii) **Records of receipts and issues of bamboo and wood are maintained at 'green weight' and the moisture content is adjusted only at the year end.**
- (iv) **Alumina issued for manufacture of aluminum is valued at a cost which includes a notional value for loss on transport and moisture during the year.**

Answer.

- (i) Classification of labour costs as direct and indirect is based on the type of work carried on by the individual and whether such job can be treated as direct to production or whether it is to be treated as a supporting facilities. The distinction between seasonal and off season wages is based on the period for which the factory works in the light of availability of inputs. Hence both direct and indirect labour costs have the elements of seasonal and off season wages. Hence the company is right in treating both seasonal and off season wages of direct workers as direct labour.
- (ii) Technologically chlorine and caustic soda are joint products, as both the products are produced simultaneously. Therefore decision to treat chlorine as a by-product is an economic decision which may be dictated by the market environment. So change in the system per se is not wrong.

The cost auditor should however make specific mention to the impact on unit cost due to change of basis in valuation in para 5, so that comparison with the previous year figures is made in the proper perspective.

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- (iii) The relevant records rules required maintenance of records both in green weight and air dry weight and monthly reconciliation of the two. Hence there is a deviation from prescribed records rules.
- (iv) The procedure adopted by the company is correct, as it ensures even charge during the year avoiding periodic fluctuations in matching cost with revenue. The procedure adopted is analogous to apportioning service costs during the year on the basis of budgeted rate. However, at the year end such accrued charge should be brought to actuals.
- (B) Comment, as a cost auditor, on the following procedures adopted by the companies:**
- (i) **A company, which manufactures cables and conductors, has charged only a portion of the administrative overheads to cost of production and the balance to cost of sales of its products.**
- (ii) **A company manufacturing rayon uses sulphuric acid, which is manufactured in its own plant, as an input. The cost of that input is evaluated at cost of manufacture of that acid plus excise duty payable thereon.**

Answer.

- (i) It is a requirement of the relevant Cost Accounting Records that administrative overheads should be partly charged to cost of production and the balance to cost of sales. Hence, the present treatment is correct. However, reasonableness of apportionment of administrative overhead has to be verified by the Cost Auditor. In such verification the consistency of the basis adopted has to be examined.
- (ii) The Cost Accounting Records Rules require that the inputs generated by the company have to be evaluated at actual cost. Since excise duty is an element of such cost, it is correct to evaluate cost of sulphuric acid by including excise duty payable on such acid. In this connection the rules relating to CENVAT and the procedure adopted by the company to account for such CENVAT has to be duly considered.

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

Answer.

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

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March covers two partial seasons, the number of days, cane crushed, etc. of two partial seasons must be aggregated to give capacity utilisation and recovery for one year.

(D) Describe the information to be collected before starting Cost Audit for the first time in a Company?

Answer.

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

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

21. (A) What are the features of a good Internal Control System?

Answer:

A good Internal Control System should possess the following features -

- i. Proper Organisation 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, authorisation of transactions, execution of transactions and record keeping should be based on the organisation structure.
- ii. Scheme of authorisation and procedures: A good Internal Control System should define proper authorizations and procedures. *The* scheme of authorisation should ensure that -
 - (a) Every transaction is duly authorised 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.
- iii. Internal Check:
 - (a) Accounting Procedures should be designed in such a manner that no single person is authorised 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.
- iv. Suitable Personnel:
 - (a) Competent and honest persons alone should be employed in the organisation 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.
- v. 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.

(B) What is the role of Management with regard to Internal Control?

The responsibility of Management with regard to Internal Control can be summarized as under -

- i. Creation of system: Management is responsible for maintaining an adequate accounting system incorporating various Internal Controls to the extent appropriate to the size and nature of the business. The Management is vested with the responsibility of carrying on the business, safeguarding its assets and recording the transactions in the books of account and other records.
- ii. Review of System: The system installed should be reviewed by the Management to

ascertain whether -

- (a) The prescribed Management policies are being properly interpreted by the employees and are faithfully implemented,
- (b) The prescribed procedures need a revision due to changed circumstances or whether they have become obsolete or cumbersome, and
- (c) Effective corrective measures are taken promptly when the system appears to break down.

iii. Internal Audit: It is desirable that the Management also installs an Internal Audit System as an independent function to check, amongst other things, the actual operation of the Internal Control System and report any deviations or non-compliances.

(C) "Operating auditing is an extension of internal audit in operational areas, but with different approach". Examine this statement in the light of the objectives of operational audit.

Answer.

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 have 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.

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(D) Draft a brief questionnaire to enable your management audit team to evaluate the following aspects of a large company.

- (i) Corporate culture**
- (ii) Personnel Development**
- (iii) Corporate Planning**

Answer.

(i) Corporate culture :

- (1) What is the importance given to quality assurance in the company.
- (2) How are the complaints from customers dealt with ?
- (3) What steps are taken by the company to help suppliers to improve the quality of their supplies ?
- (4) What are the social responsibilities of the company in its perception ?
- (5) What are the steps taken by the company to discharge such responsibilities.

(ii) Personnel development :

- (1) What are the opportunities given by the company to help the personnel to update their skills ?
- (2) Does the company have a succession plan in the organisation ?
- (3) Are the personnel encouraged to give their views on various matters, for e.g. through suggestion schemes ?
- (4) Is there an effective mechanism to evaluate objectively the suggestions offered ?
- (5) What are the avenues available for promotion in the organisation ?
- (6) What are the training programmes conducted in the organisation ?

(iii) Corporate Planning:

- (1) How often new products, process and similar improvements introduced ?
- (2) What is the mechanism existing to identify national and international developments in the company's business ?
- (3) How are such developments disseminated within the organisation ?
- (4) How much capital is being invested in improving information technology, R & D and such other similar functions ?
- (5) How are the new markets planned and developed ?

22. (A) Outline the Internal Control aspects in relation to Fixed Assets.

Answer:

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

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

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

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

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

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

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

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

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

(B) What are the internal control aspects relating to Investments?

(a) Dealings in Investments: Responsible persons should authorise purchases and sales of investments. These are to be evidenced by proper documents. Those responsible for authorisation should not be in charge of cash or the custody of documents of title.

(b) Investment Register: A detailed investment register should be maintained and all dealings in investments should be immediately recorded therein. This register should be periodically agreed with the investment control account. Documents of title should be physically verified.

(c) Accounting for accretions: Arrangements should be made for checking contract notes against authorised purchase or sales instructions to ensure that charges are correctly calculated. Share transfer formalities should be initiated to ensure that share certificates are duly received or delivered. Bonuses, Rights, Capital Repayments and Dividends or Interests received should be properly accounted for.

(d) Custody: Property documents, share certificates and other documents of title should be under the authority and control of at least two responsible persons, with the object of

protecting them against loss and irregularities. Access to or withdrawals of such documents should be permitted only on the authority of such persons acting jointly.

(C) What aspects would you, as a management auditor, look into in relation to the following areas of a multi-core company ?

- (i) Organisational structure**
- (ii) Industrial relations**
- (iii) Corporate culture**

Answer:

(i) Organisational structure

Organisational structure is influenced by a number of factors like

- a) The product divisions
- b) Number of units, i.e. factories, offices, branches etc.
- c) Major markets for the products of the organisation like exports, government etc.

Hence, the above factors have to be studied as the first step before identifying the direction of management audit.

Another important aspect is to decide on the balance to be struck between centralisation and decentralisation. Centralisation has the advantage of encouraging specialisation and ensuring uniformity of approach. Such specialisation helps in optimum utilisation of resources, particularly human resources, computer facilities and the like. Decentralisation provides certain flexibility and often results in saving of time.

Additionally, effectiveness areas of different levels of management have to be examined. Such examination should duly consider line-staff relationship, space of control, overlapping of the areas between factories and levels of the organisation.

(ii) Industrial Relations

The main aim of industrial relations is to ensure that the employees of different levels feel that they are part of the organisation and that they can look forward to their future with confidence in the given environment. Therefore, the first aspect to be looked into is the morale of the employees. Such moral is strengthened by providing positive support and sufficient opportunities for their growth in the organisation and a mechanism and a mechanism to smoothen any irritants that they may feel. The latter aspect is normally taken care of by grievance procedures, which should ensure that the employees have adequate and reasonable opportunity to sort out their real or fancied grievances.

Welfare and other facilities, suitable to the needs of the employees would be one other area. In that broad spectrum, opportunities provided for cultural, social, sports and similar activities may be included.

Training would play an important role in providing avenues for growth of the employees. Similarly, encouragement need to be given to those employees who demonstrate their initiative to develop themselves in the areas which would be in consonance with the activities of the organisation.

Involvement of members of senior management in the above activities would also help to increase the morale.

Hence the management auditor should aim at assessing the effectiveness of personnel practices in achieving the above objectives and identifying such additional inputs as may be required.

(iii) Corporate Culture

The test of a sound corporate culture may be stated as the keenness of an organisation to be leader in the field and the steps taken towards the end. It also presupposes certain values which are acceptable to the society of which the corporation is a part. Hence, the aspects that may be examined by a management auditor may be identified as :

- Innovation
- Human resources development
- Succession planning
- Social commitment
- Developing new Technologies and products

Some of the above aspects may be inter linked and even occasionally overlapping.

(D) Today's customer is more demanding than the customer of yesterday. In view of this, how would you evaluate, as a management auditor, the performance of :

(i) Quality control department

(ii) Customer Services department

Answer.

(i) Quality Control Department

The main objective of quality control function is to ensure that the products delivered to the customers measure up to laid down standards of quality.

The other objectives of the quality control functions are :

- a) to identify the defect at the earlier stage, so that further costs are not incurred on the defective work
- b) to monitor to the production and related functions the causes of the defects like poor quality of material, poor workmanship, defective tooling, poor upkeep of the machines etc.

The performance of quality control function could therefore be best assessed by an analysis of customers complaints. Such complaints, if studied over a period of time, would indicate whether they are on the rise or reasonably contained.

Such study would also indicate the adequacy of tests which the quality control under takes to pass the final product. One of the popular methods to improve the effectiveness of the function is to have an internal quality audit. Such audit is manned by persons who have sufficient in quality control. Those audit personnel test check the operations of quality control to assess whether all requisite tests are conducted in the prescribed manner.

Equally important is the monitoring of the causes of defects detected by the quality control function. For illustration, if most of the defects are due to poor workmanship, it may indicate the necessity for more specific and clear instructions to them or even industrial relation conflicts. It would be upon the management to decide on the corrective action in any of the above cases.

The above aspects would form a reasonable approach to evaluate the performance of a quality control department.

(ii) Customer Services Department

The main objective of customer services department is to ensure that the customer's requirements and demands are promptly attended to and satisfied to the extent feasible. Such services may include after sales service, depending on the product of the company.

The evaluation of the performance of such department should therefore attempt to assess the performance in the following areas.

➤ **Warranty**

In many cases the manufacturer gives a warranty for a specified period of time. The customer should be satisfied that such warranty is adhered to in letter and spirit. Occasionally one may have to refuse the requests of the customers, as such requests may be beyond the scope of warranty. In those cases, the rejection of requests should be worded courteously.

➤ **Grievance Procedures**

There should be a well laid down system to attend to any grievance of the customer. Such grievance may relate to delay in attending to the customer's requests relating to delivery letters etc. and not necessarily to the quality of the product. Generally the customer desires prompt reply to his letters.

➤ **Customer Education**

The customers service department should constantly attempt to educate the customers on the upkeep of the products and their use. The brochures of such education should be in simple language, attractively printed and taken into consideration the likely problems that the customer may face.

➤ **Monitoring**

The complaints of the customers must be analysed in detail to obtain adequate information, which could be fed back to production, design, packing etc. For illustration, an area-wise analysis may indicate that the packing adopted by the company is not satisfactory in cases where the goods are delivered over long distances.

23. (A) What are the objectives of Management Audit?

Answer:

Management audit is carried out to –

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

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

- (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.

(B) What are the pre-condition for initiating Management Audit?

Answer:

Pre -conditions for Management Audit

- (a) Overall Objectives: The objectives of the enterprise should be clearly perceived, identified and stated in specific terms.
- (b) Operational Plans: The overall objectives of the organisation are to be analysed into quantifiable, detailed targets and plans for various segments like production, sales, etc.
- (c) Management Hierarchy: An organisational structure should be created, with specific targets and objectives for each function, and also their reporting responsibilities.
- (d) Performance Measurement: There should be a mechanism for measuring the performance of each functional area or responsibility centre. Performance expressed in quantitative terms facilitates comparison with objectives and targets. MIS: A suitable Management Information System (MIS) should provide timely and adequate information to the Management Auditor on various efficiency aspects.
- (e) Attitude: There should be co-ordination between the Management Auditor and various department heads. A motivation system may be adopted, e.g. incentives for best performance.

(C) What aspects should know by the Management Auditor before commencing Audit?

Answer:

Different aspects should know by the Management Auditor before commencing his Audit

- i. Aims or Purpose for which the organization has been created. Profit motive should be properly balanced with said objects like creation of employment opportunities, development of backward areas, etc.
- ii. Management Structure including delegation of authority, planning and budgeting.
- iii. Internal Control, system of work, methods and procedures together with authority & sanction procedures,
- iv. MIS Reports, decision -making process, reports required for proper Management and the reports actually received.
- v. Personnel Policy and Personnel Management including requirements, training, welfare incentives and disincentives.
- vi. Purchase Aspects like Materials Management including sources of important Raw Materials, receipt of materials of the required quality and quantity, storage, supervision and safe custody, insurance and procedure for issue of materials.
- vii. Production Aspects, e.g. nature of production technology, production planning, factory layout, design and installed capacity.
- viii. Sales Aspects, e.g. Sales Management and Sales Planning, including advertisement policy.
- ix. Accounts and Finance matters, Financial Management of the organization, books and records including Cast Accounting Records, Cost Accounting System and financial accounting policies.

(D) What is SWOT analysis in Corporate planning ? Describe its importance in any industry you are familiar with.

Answer.

SWOT analysis is an examination of the strengths, weaknesses, opportunities and threats of a company. A detailed review of these enables the company to draw up a Corporate Plan for the future growth. Even in cases of losing companies, such an analysis is necessary in drawing up plans for the rehabilitation of the company. For example, the following were noticed in connection with a company that is engaged in manufacturing a paint chemical and is currently losing. A SWOT analysis of the company and its business environment identified the following :

Strengths:

- i) The company is a pioneer in the manufacture of the pigment chemical
- ii) It has its captive facilities for getting the basic raw materials
- iii) The technology used by the company is reasonably current
- iv) Its production has been well established and a steady 55% capacity utilisation is maintaining.
- v) The company is in a monopolistic position till date as there are no competitors.

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- vi) The quality of the company's product has been acknowledged as the best.
- vii) Ruling price is quite attractive.
- viii) Variable costs are quite low at 32% leaving significant contribution.

Weaknesses :

- i) Lack of proper and efficient management
- ii) No control on costs
- iii) Heavy loan burden and consequential high interest cost (about 22% of selling price)
- iv) This is a Government Company and so suffers from all handicaps common to them
- v) No proper marketing organisation & policies.

Opportunities :

- i) There is scope for export
- ii) Scope for developing other applications for the company's product.

Threats :

- i) market survey indicates a couple of more units likely to be commissioned in the next two years.
- ii) Liberalisation of inputs and reduction in import duties are progressively forcing the company to face competition from foreign manufacturers.

A good corporate plan will have to be based on the above building upon the strengths, correcting the weakness, exploiting the opportunities, and evolving appropriate strategies to face the threats. Such a plan will aim at :

- (i) By proper planning and control the variable cost must be brought down. All inputs of chemicals, power, fuel, stores, spares etc. require close review and standardisation at significantly lower levels.
- (ii) Revamping the management structure.
- (iii) Introducing a responsibility based budgeting system and controlling the operations through budgets.
- (iv) Introducing an effective marketing function with necessary supporting functions and policies.
- (v) Drawing up a scheme for capital restructuring, funding the interest arrears and requesting for concessions to the extent possible etc. so that the interest burden is reduced.
- (vi) Giving more autonomy to the company by freeing it from the shackles of Govt.
- (vii) Having greater interaction with the customers to wear them away from importing.
- (viii) Exploring export market seriously.
- (ix) Setting up a product application development cell that can develop other uses for the product and the commercially exploiting them.

(E) Prepare a check-list to carry out a management audit of the Human Resources Development (HRD) function in a large Company.

Answer.

The check-list must cover the following :—

- (i) What is the degree of importance assigned to human resources development in the company in comparison with production marketing etc. ?
- (ii) Does the company have an organisation manual or position guides describing each job ?
- (iii) Does the company prepare a Manpower budget ?
- (iv) Whether the responsibilities of the people in HRD clearly delineated.
- (v) Does the organisation have a regular performance appraisal programme ?
- (vi) Is there career progression plan in the company ?
- (vii) Is there a schedule of formal comprehensive training programmes covering all classes of employees to train them in new techniques and to improve their efficiency and personality ?
- (viii) How are the training programmes organised – In-house or nomination to outside course ?
- (ix) How much are the training programmes company oriented as compared to new techniques oriented ?
- (x) Is there a system adopted for evaluating the utility of the training programmes ?
- (xi) What is the remuneration policy pursued by the company ?
- (xii) Are pay scales or remuneration packages fixed scientifically by job evaluation or region-cum-industry or industry leader studies ?
- (xiii) What is the promotion & recruitment policy?
- (xiv) What is the rate of absenteeism ?
- (xv) What is the rate of turnover ?
- (xvi) Are these induction and orientation programmes for new entrants ?
- (xvii) Are proper individual employee records continuously maintained ?
- (xviii) Are these suggestion plans with adequate records to motivate people ?
- (xix) What are the facilities provided by the company for social needs of the employees like health care, children's education, marriage, holiday, housing, recreation etc. ?

24. (A) Bring out the need for Management Audit.

Answer:

Need for Management Audit -

The importance for Management Audit may be understood from the following points -

- i. Management Index: Management Audit serves as a tool to improve Management performance. It recognizes facts and information about Management, presented after

an appropriate examination, verification and evaluation, by professionally qualified and competent people.

- ii. Efficiency Analysis: Management Audit focuses on a comprehensive and constructive examination of the organizational structure, its components i.e. divisions, departments, ventures, plans, policies, its financial control system, its method of operation, its appropriate use of human, physical and financial resources.
- iii. Detecting Managerial Deficiencies: Management Audit is required for detecting and overcoming current managerial deficiencies (and resulting operational problems) in ongoing operations. If certain Managers are ineffective in their present positions, appropriate corrective action should be taken.
- iv. Forward Looking: Management Audit represents a positive, forward-looking approach that evaluates -
 - (a) how well Management accomplishes its stated organizational objectives,
 - (b) how effective Management is in planning, organizing, directing, and controlling the organisation's activities, and
 - (c) how appropriate Management's decisions are for reaching the stated organisation objectives.
- v. System Flow: A Management Audit Questionnaire helps to evaluate managerial performance. This questionnaire helps in understanding the flow of systems, procedures and method of work within the organisation.
- vi. Current Control and Pre-control: Managerial problems and related operational difficulties can be spotted immediately in Management Audit, unlike a Financial Audit. Periodic Management Audits pinpoint problems as they develop from a small scale.
- vii. Business Re-Engineering: Management Audit helps ailing industries to identify their problems & overcome them. Management Audit is more relevant in the case of Industries which face problems like - (a) High volume of Stocks and Stores, (b) Machine Breakdowns, (c) Operational Failures, and (d) Under-utilisation of capacities, etc.

(B) Explain the Scope of Management Audit.

Answer:

Scope of Management Audit

- i. Objectives: The Auditor should reach to the root of Management efficiency. This consists of the functions of Top Management, which lay down objectives and policies, provide means and procedures of implementation and control and which actually engage in direction and control on a continuous basis.
- ii. Effectiveness: Management Audit encompasses the relevance and effectiveness of the aims, duties, and decisions Management at various levels.
- iii. Efficiency: The Management Auditor should review the efficiency in Management decisions and functions. He has to judge whether - (a) Management is doing the correct things, and (b) Management is doing those things correctly.

(C) How would you evaluate management performance in the following functional areas ?

- (i) Production, and**
- (ii) Project implementation.**

Answer.

i) Production

- (a)** Is there an effective production planning & control system ? How does this operate ? How good is the coordination with marketing, materials, maintenance etc. ?
- (b)** How good is production capacity utilisation ? What steps are continuously taken to improve this ?
- (c)** Material input-output and balance
- (d)** Plant down time and attempts to minimise this
- (e)** Are these needs to frequently interrupt and change production schedules ?
- (f)** How are waste, scrap, rejects etc controlled ?
- (g)** Is there a good preventive maintenance system in vogue ?
- (h)** Are these continuous efforts to Improve process efficiencies, productivity etc. innovatively ?
- (i)** Is the material handling system proper ?
- (j)** Are there regular steps being taken for improvement in energy consumption ?

ii) Project Implementation

- (a)** Is the method adopted by the company for project management good, and standardised and not ad-hoc ?
- (b)** How are projects cleared for implementation ?
- (c)** Are individual activities making up a project clearly identified with time and cost budget for each ?
- (d)** Are modern techniques like PERT-CPM employed for scheduling of activities ?
- (e)** Is there a system to report on a short term basis the actual time and cost spent activity-wise ?
- (f)** Are there method to recognise the scope for and benefits from speeding up specific activities by spending more resources (crashing) ?
- (g)** Is the critical time received and updated ?
- (h)** Is there proper coordination between Project funds mobilisation and application budgets ?
- (i)** Are contracts for equipments etc placed after detailed consideration of all aspects like delivery, performance etc ?
- (j)** Is everybody involved in the project work in unison to ensure completion of the project within time and cost budgets ?

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(D) In recent times there is so much discussion about effective material procurement system in organisations. Enumerate 10 points for carrying out a Management Audit of material procurement function in a company.

Answer.

Management Audit of the procurement function must cover the following inter alia.

- (i) Organisation of the purchase department.
- (ii) Preparation of Material Requirement Plan integrated with the production Plan.
- (iii) Continuous vendor development and sourcing
- (iv) Differential inventory policies for imported, indigenous, own production, Critical, insurance etc. items.
- (v) Long-term ordering and short-phasing of deliveries
- (vi) Good system of vendor rating
- (vii) Clearly defined procedures and authority for placement of purchase orders
- (viii) Procedures for floating tenders, negotiation etc.
- (ix) Authority for price approvals and modifications
- (x) Good system of flow up of deliveries
- (xi) Follow-up on rejected materials
- (xii) Ensuring quality in supplies by providing deterrents.

25. Distinguish the following –

- (A) **Financial Audit and Management Audit**
- (B) **Cost Audit and Management Audit**
- (C) **Management Audit and Internal Audit**

Answer:

(A) Distinguish between Financial Audit and Management Audit.

Aspects	Financial Audit	Management Audit
Legal Requirement	It is compulsory in the case of enterprises like Companies, Trusts, Societies, etc.	There is no legal compulsion as regards Management Audit. It is voluntary.
Periodicity	Financial Audits are conducted annually.	Management Audits are conducted once in 2 or 3 years.
Time Period Covered	It covers business transactions of the past financial year.	There is no limitation as to the period to be covered.
Scope	To express an opinion on the true and fair view of the Financial Statements.	To express an opinion on performance of the Management during a particular period, and to suggest remedial measures, if required.

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Audit Focus	It is concerned with financial aspects of business transactions, for the year under audit.	It is concerned with review of the past performance, to ascertain whether it is in tune with the objectives, policies and procedures of the enterprise.
Reporting Authority	The Statutory Auditor reports to the Owners, i.e. Shareholders in case of a Company.	The Management Auditor reports to the Management.

(B) Distinguish between Cost Audit and Management Audit

Aspects	Cost Audit	Management Audit
Legal Requirement	Cost Audit is compulsory for Companies engaged in production, processing, manufacture or mining, and covered u/s 209(1)(d) of the Companies Act.	There is no legal compulsion as regards Management Audit. It is Voluntary.
Qualification of Auditor	It shall be done by an Auditor who shall be a cost accountant within the meaning of the Cost and Works Accounts Act, 1959.	It may be done by any independent person. However, professional Accountants are more suitable on account of their knowledge.
Focus	It involves verification of Cost Records, to determine internal efficiency of the Enterprise.	It involves a review of the past performance of the enterprise to ascertain whether it is in tune with the objectives, policies, etc.
Time period	Financial Year of the enterprise.	May be longer than the entity's financial year.
Reporting Authority	Cost Auditor reports to the Central Government, with a copy to the Company.	The Management Auditor reports to the Management.
Contents of Report	These are governed by the Companies Cost Audit (Report) Rules, notified by Central Government.	The contents of the Report are based on the Management Auditor's findings. There is no specific format for the same.
Time Limit for reporting	Cost Audit Report should be submitted within the prescribed time.	There is no rigid timeframe as regards submission of Management Audit Report.

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(C) Distinguish between Management Audit and Internal Audit

Aspects	Management Audit	Internal Audit
Definition	Management Audit is - (a) the systematic independent appraisal activity, (b) within an organisation, (c) for a review of the Management's efficiency, (d) in its decision-making function.	Function of internal control with the objective of determining whether other internal controls are well designed and properly operated.
Relationship to Internal Control	It is not a part of Internal Control. It is over and above the regular internal control system.	This operates as a part of Internal Control System.
Objectives	It is concerned with appraising - <ul style="list-style-type: none"> • Management's accomplishment of organizational objectives, • Management functions of planning, organizing, directing, and controlling, and • Adequacy of Management's decisions and action in moving towards its objectives. 	<ul style="list-style-type: none"> • To determine whether internal controls are well designed and properly operated, and • To assist all members of Management in the objective of discharging of their responsibilities by reviewing activities and procedures.
Function	Constructive Function, i.e. to provide suggestions for improvement.	Protective Function, i.e. to safeguard the assets of the Enterprise.
Areas	All aspects of managerial decision-making are analysed, to see whether they are in tune with Management policies, objectives and goals.	The traditional field of Internal Auditors is restricted to financial accounting and internal control.
Aspect	Qualitative aspects of decision-making are analysed.	Internal Audit Function focuses more on quantitative aspects when compared to Management Audit.

26. (A) Explain the needs and objectives of Operational Audit?

Answer:

Need for Operational Audit

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

- i. 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.

ii.. 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.

- iii. 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.
- iv. 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.
- v. 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.
- vi. 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.
- vii. Shortcomings 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.
- viii. 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.
- ix. 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.

Objectives of Operational Auditing

The general objectives of Operational Audit are -

- i. 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) 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.
 - (c) 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.
- ii. 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.
 - (d) Performance Evaluation is generally based on - (i) Productivity, (ii) Personnel, (iii) Workload, (iv) Cost, & (v) Quality.
- iii. Appraisal of Management objectives and plans:
 - (a) Every Activity in an organization is the product of basic plans and objectives set by the Management. Hence, Management policies, plans and objectives should be evaluated properly.
 - (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.
- iv. 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) Evaluation of the personnel function of an organisation by the management auditor is by no means an easy task. In your view what are the areas to be covered and points to be kept in mind while assessing the personnel function of an organisation.

Answer.

(i) Areas are to be covered :—

- (a)** Procedure for recruitment, promotion, transfers and training.
- (b)** Absenteeism and sickness; action taken to reduce them.
- (c)** Method for wage payment and incentives.
- (d)** Labour turnover; methods adopted to analyse and action taken to reduce high rate of labour turnover.
- (e)** Accidents; preventive measures for safety.
- (f)** Welfare measures.
- (g)** Productivity of labour.
- (h)** Discipline and morale.

(ii) Points to be kept in mind while assessing the personnel functions :—

- a.** It is rather difficult to quantify the influence or effects of the human factors and its contribution to the success or failure of the organisation.
- b.** It is also difficult to develop a yardstick for the measurement of the performance of a large group of workers in a big organisation.
- c.** The workers are influenced by the fellow workers and the industrial background.
- d.** Understanding the human behaviour is again a hard task and the pattern of behaviour will vary from man to man. It is necessary for the organisation to motivate them in a proper way to bring them together towards a common goal.
- e.** The management auditor should assess whether the supervisors and managers possess leadership qualities and dynamic ideas to motivate their personnel.
- f.** The personnel function is a very important function because in the absence of a well organised personnel function, the company will not be able to utilise other resources in an optimum manner. Human resource is the most important asset to any organisation.
- g.** There are other factors which may bring down the output in spite of best attention being paid by the personnel function.
- h.** It is difficult to measure the impact of the training and development programmes on the ability of the works to improve productivity or increase production.

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(C) A Company whose performance and profitability has been excellent often finds itself short of cash funds. You are appointed as a Management Auditor to look into the problem. Indicate your plan of approach stating the aspects you will cover and why?

Answer.

The profit recorded in the accounts are the net result of cash and credit operation. Thus although profits are recorded in terms of the transactions the receipt and disbursements of cash and the matching of inflows and outflows could alone result in a smooth functioning of the financial operations. The cash crunch results from uneven in-flow and out-flow of funds.

The approach to rectification of this problem would be the examination of the Cash Budgeting in Vogue.

- Detailed estimates of Cash receipts.
- Detailed estimates of cash disbursements,
- Time lag available for payment to creditors,
- Time lag afforded to customers,

The Budgeting of Cash in-flows and out-flows is dynamic and has to be done not only on an annual basis but also on daily, weekly basis as cash receipts and disbursements take place all the time.

The analysis of payments and receipts should identify.

- i)** regular payments at pre-determined intervals viz, daily, weekly etc.
- ii)** annual one time payments.
- iii)** payments for revenue and capital expenditure.

The time lag available viz, the credit periods due also need to be considered in determining the exact occurrence of such payment.

Similarly while budgeting the receipts, which are mainly from sales, the pattern of sales, credit period allowed. Allowance for default etc. are to be taken note of.

Having determined the in-flows and out-flows, arrangements have to be made for funds for meeting the demand for demand for cash as and when it occurs through Working Capital loans to the extent necessary.

The Management Audit would see whether a system of such budgeting exist which ensures —

- (i)** whether sufficient cash is available for revenue and Capital expenditure.
- (ii)** shows when and to what extent finance is needed.
- (iii)** when surplus funds are available and to what extent this can be profitably invested.

The cash shortages could occur due to various reasons such as :—

- (i)** Large and long credits allowed to customers.
- (ii)** Defaults in payments by customers.
- (iii)** Inefficient credit collection.
- (iv)** Lack of proper credit policy.
- (v)** Seasonal nature of sales which brings in uneven flow of funds.
- (vi)** Substantial advances to raw material suppliers.
- (vii)** Improper phasing of purchases resulting in sudden pressure on cash resources.
- (viii)** Overstocking of inventories.
- (ix)** Diversion of funds to capital expenditure.
- (x)** Inadequate working capital in relation to volume of operations.

The Management audit should cover each of these areas and examine them with reference to the practices. The findings of the Auditor would enable him to formulate his

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recommendations in regard to each of these aspects as to the existing practice, the trade practice and the suggested solution.

In brief, the study would be a comprehensive review of the Cash inflow-outflow position and suggestion to make this balanced to avoid liquidity problems.

(D) Distinguish the followings –

(i) Operational Audit and Internal Audit

(ii) Financial Audit and Operational Audit

(iii) Operational Audit and Management Audit

Answer:

(i) Distinguish between Operational Audit and Internal Audit.

Particulars	Operational Audit	Internal Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	Function of internal control with the objective of determining whether other internal controls are well designed and in place.
Link with Internal Control	This is not a part of Internal Control. This is over and above the regular internal control system.	This operates as a part of Internal Control System.
Objectives	<ol style="list-style-type: none"> 1. Appraisal of controls. 2. Evaluation of performance. 3. Appraisal of objectives and plans. 4. Appraisal of organizational structure. 	<ol style="list-style-type: none"> 1. To determine whether internal controls are well designed and properly operated, and 2. To assist all members of Management in the objective discharge of their responsibilities by reviewing activities and procedures.
Function	Constructive Function, i.e. to provide suggestions for improvement.	Protective Function, i.e. to safeguard the assets of the enterprise.
Areas	All aspects of operations are analysed to see whether they are in tune with Management Policies, Objectives and Goals.	The traditional field of internal Auditors is restricted to financial accounting and internal control.
Aspect	<p>Qualitative Aspects are analysed. For example in Cash Management, the Operational Auditor would analyse -</p> <ol style="list-style-type: none"> 1. Whether quantum of cash in hand is related to requirement of cash? 2. Whether surplus cash is promptly invested in short-term securities for maximizing return? 3. Whether maximum possible protection has been given to cash? 	<ol style="list-style-type: none"> 1. The Internal Audit Function is said to focus more on quantitative aspects when compared to Operational Audit. 2. Internal Auditors view and examine internal controls in financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not found. 3. They check the accounting books and records to see whether the internal checks work properly and the resulting accounting data are reliable.

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(ii) Distinguish between Financial Audit and Operational Audit.

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

(iii) Distinguish between Operational Audit and Management Audit.

Particulars	Operational Audit	Management Audit
Definition	Review and appraisal of operations of an organisation carried on by a competent independent person.	The Audit of the Management focuses on evaluating Managers' ability to manage.
Areas Covered	Operational Areas where standards and actual performance defined and expressed in quantitative terms are considered.	It is concerned with appraising - <ul style="list-style-type: none"> • Management's accomplishment of organizational objectives, • Management functions of planning, organizing, directing, and controlling, and • Adequacy of Management's decisions and action in moving towards its objectives.
Focus	Focus is on efficiency and economy in operations.	Focus is on effectiveness of Management decisions and actions.
Standards	Expectations or standards are expressed in quantitative terms, for comparison of actual therewith.	Standards are not defined in quantitative or monetary terms.
Evaluation	It is objective in nature, since standards are quantifiable.	Evaluation is comparatively subjective, since standards are not defined in monetary terms.
Technical Background	Operational Auditor should have a strong technical and operational background.	Management Auditor should have conceptual background. Technical Background is desirable, but not compulsory.

(E) Give brief notes on -

(i) Operational Audit of Research and Development Activities

(ii) Operational Audit of Marketing Function

Answer:

(i) Operational Audit of Research and Development Activities

Need for R and D Activities

The rapid strides in technological progress and increasing danger of obsolescence today prompt every company, regardless of size, to discover and utilise the concepts and procedures to survive. The following guidelines will help to gauge whether research will keep the organization abreast of the technological changes and face the market with confidence:

- (i) A budget should be set for research and development and a definite sum should be set aside every year for this purpose.
- (ii) The extent of research and development necessary to keep the company young should be decided.
- (iii) The research concepts should be broad in spectrum and be within the capabilities of the organisation.
- (iv) The research projects should be selected on the basis of decisions taken as a team rather than being on one man's decisions.
- (v) A definite goal should be set.
- (vi) A pilot scheme should be set and tested before a full scale commitment is made.

Evaluation of R and D Activities

In evaluating the R and D activities of the management the following factors should be considered:

- (i) There should be a duly approved budget for R and D activity based on a detailed report of each project.
- (ii) The actual expenditure incurred on each project should be collected in a systematic manner and be compared with the budget authorization. Similarly, physical progress should be monitored.
- (iii) There should be a system of authorization of various R and D projects within the scope of the budget.
- (iv) There should be control on material requisition and consumption.
- (v) The recruitment of R and D personnel should be based on merit and competence.
- (vi) As and when a project is completed and found to be successful, suitable decisions for commercialization should be taken.
- (vii) As soon as a project is found to have failed, further expenditure on it should be stopped forthwith.
- (viii) All R and D projects should be well coordinated and be within the overall objectives of the company.
- (ix) The laboratory and library should be well-equipped. A team of experts should decide on

the additions to equipment and library.

- (x) Investigation into the causes of failure of projects made immediately after the failure will lead to the organization taking corrective steps for the future.

(ii) Operational Audit of Marketing Function

Scope of Marketing Function

The concept of the marketing function embraces the following activities, each of which will form a separate field for management audit investigation:

- (i) Sales analysis, market research and product design activities are used for discovering the customers needs.
- (ii) Sales promotion, sales training and selling activities are used for getting in touch with customers, both potential and regular, to secure orders.
- (iii) Customer service is provided to help the customer to derive the benefit for which they purchase the products.
- (iv) Trade and industry research and allied studies, to understand the economic trends, customer patterns and competitor's actions/ activities.
- (v) Sales management to effectively utilise the marketing resources.

The various marketing activities can be further analysed into:

- (i) Strategic or planning activities involving sales analysis, sales forecasting, market research etc.
- (ii) Tactical or creative activities such as advertising, sales promotion, sales management, customer services, etc.

The analyses of sales should be made on the following basis with comparative data relating to the previous period to assess the sales potential of the company:

- (i) Product mix analysis giving information relating to product mix on customer class/ group wise or territory wise.
- (ii) Sales by territory or customer class wise.
- (iii) Profit or contribution earned salesman wise, territory wise, customer group wise, and product group wise.
- (iv) Variances from sales forecast and analysed by product mix, territory and salesmen.

Besides the above data, the sales staff should be provided with such information as product specification and uses, discounts which they can offer, inventory position, etc. to enable them to increase the sales. The management auditor should see that the above information is used to the maximum advantage of the company.

Sales forecast is an important activity which should be looked into by the management auditor because it forms the basis for production planning, purchasing and inventory control. Every forecast includes certain assumptions which should be stated explicitly. The management auditor should understand the assumptions underlying the forecasts and test them for validity and relevance. There are several methods of forecasting sales like, for example, trend analysis, correlation analysis, etc., and the management auditor should see that the company is able to make use of the computers for properly assessing the sales forecasts.

A review of the marketing plans in use may reveal that the company has lost economies due to failure to manage marketing and sales effort on an integrated basis. If the company has a marketing plan, it has to be seen whether its implementation has been controlled and review of the performance is made periodically.

Market research consists of information on customers, sales prospects, competitor's activities, product specifications and sales activities. The management auditor examining the market research activities should see that the company is able to achieve cost effectiveness.

Trade journals, companies' annual reports, circulars from trade associations etc. provide information about products, competition, sales potential, etc. The management auditor should see how far these documents are used by the company to their best advantage.

Companies spend huge sums of money on advertising and sales promotion. It is necessary to evaluate how effective are these programmes. The management auditor's investigation in this direction will be somewhat as under:

- (i) Who are the final consumers?
- (ii) What are the segments in markets to which the products are catered?
- (iii) What is the relation between the budget allocation and sales achieved?
- (iv) Is the advertising directed towards that class of customers for whom the product is intended?
- (v) What priorities are assigned for sales promotion?
- (vi) Does the advertisement appeal to the customers?
- (vii) Is the budget allocation to the different channels of advertisement adequate and commensurate with the benefits?

Based on the above information, the management auditor is expected to evaluate the effectiveness of the advertisement programme.

The sales management is responsible for managing the sales and marketing activities. The skill with which the resources are used by the sales management is important. In reviewing the performance of the sales department the management auditor should ensure that the sales management uses the systems concept and computer technology to solve the problems. Moreover, the programme for recruitment and training of salesmen will bring about an increase in turnover. The management auditor should evaluate the performance of each salesman and the sales department as a whole in terms of the actual achievement of sales as compared to the budget and past performance. A customer service cell is introduced to attend to the complaints received from the customers. Although the management auditor may not be able to quantify the services rendered by this section, a scrutiny of the complaints will give him an idea of the nature of the complains say, about the product quality, product life, packaging problems, defects, etc. and efforts can then be directed to see whether corrective action is taken to improve the product performance and marketability of the goods to ensure enhanced sales.

27. (A) Why Management audit is resorted to even though we have Financial Audit, Internal Audit and Cost Audit. State the salient features of Management audit.

Answer.

Financial Audit involves verification and attestation of financial data shown in books of accounts as supported by vouchers and supporting documents. It deals with the checking and verification of past records. It is compulsory according to the statute. This is performed by a chartered accountant in practice to depict a true and fair view of the financial aspect of company. The financial audit may be taken as a sort of protective tool available to the shareholders for safeguarding their interest.

Cost Audit is concerned with review, examination, and appraisal of accounting records so as to ensure inter alia true and correct cost of production.

Therefore, Cost Audit is product oriented. Cost Audit is not applicable to all but covers only limited industries for which an order is required to be issued by the Govt. of India. Company Law Board. Cost Auditor needs professional qualifications as prescribed under the Act and Regulations. A perusal of the Cost Audit (Report) Rules could show that cost auditor is required not only to certify about the correctness of cost of product processing, manufacturing or mining activities as the case may be, and marketing of the product under reference as exhibited in the record maintained for the purchase, but he is expected also to make observation as regards improvement of the efficiency of the concern under audit and as regards the drawbacks that may come to his notice in the course of his audit. It would thus, be seen that the constructive feature is a distinct specialty of cost audit. The prominence of constructive aspect in cost audit has made it quite distinct from financial audit.

Management Audit is entirely different from the above two types of audits. It is concerned with appraisal of total performance of management of the company. management Audit is the neither compulsory under any statute or law but is purely voluntary and terms of reference and scope are determined by the management. This can be undertaken internally by Management themselves or externally by Management Consultants. No qualification is prescribed for a Management Auditor. The area and scope of Management Audit is very wide and comprehensive. It is a tool in the hands of Top Management.

Salient Features

Cost audit does not normally cover the operational areas and management functions. Management audit covers up the deficiency and aims at better efficiency in business operations and management functions. The Managements auditor reviews the existing plans, procedures, practices, etc. and offer constructive suggestions for improvements. It is mainly constructive in approach.

Internal Control and Internal Audit are the techniques used for successful management control and management Audit. They have limited area and scope as compared to overall review of the total Management function.

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(B) A public limited company is heading towards sickness probably due to mismanagement. In order to study the working of the Company and advise. Board of Directors appoint you as a Management Auditor to prepare a suitable report and a questionnaire for investigation. You are required to state how you will study the working of the Company and prepare questionnaire for the purpose of submission of report to the Board of Directors.

Answer.

(i) General Study the following :

- a. Study the latest Financial accounts of the enterprise to analyse the present state of affairs.
- b. Go through the previous 4 to 5 years position to know how the position has been deteriorating.
- c. Study the profitability ratios, current ratios, inventory turnover ratios, to give the trend analysis.
- d. Interview some of the top officials, to find out first hand information regarding the possible causes for changing situation.
- e. Financial management by diversion of Funds using working capital funds to meet capital expenditure, longer period of credit allowed to customers, blocking previous working capital inventory consisting of slow moving items etc. in other words a continuous irregularity in cash credit dealings.
- f. Higher rates of rejection of goods manufactured by the company due to poor supervision poor quality of raw materials and non availability of suitable labour.
- g. Poor Sales organisation, promotion and excessive dependence on one of few customers.
- h. Poor equity base and decline in profitability due to lack of control over costs & overheads.
- i. Non availability of power as per requirement.
- j. Inadequate accounting and preparation of financial statement.
- k. Poor industrial relations.
- l. Lack of proper management information system (MIS).
- m. A poor system of internal audit.
- n. Study the situation of industrial relations prevailing in last 4-5 year and find out whether these are healthy or otherwise.

(ii) Board of Directors :

- a. Names of Directors.
- b. Qualifications, industrial experience & past attainments.
- c. Whether a person holds directorship in other companies ? If so how Many ? Which ?
- d. Who is the Managing Director ? Chairman ?

(iii) Board Meeting :

- a. How long after they meet ?
- b. Do they consider various problems according to the agenda ?
- c. How is the relationship amongst Directors ?
- d. Are any sub-committees appointed to resolve special problems ?

(iv) Problem before the Board of Directors

- a. How is the trusteeship agreement taken by the Board ?
- b. Performance of the Board in respect of the following functions ?
 - Long range planning.
 - Laying down policies i.e. production, sales, inventory, finance, personnel.

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- Approving budgets and budget review.
 - Review of progress and performance if any ?
 - Review of variations.
 - Compliance with statutory requirements.
- c. Do the Nominee Directors assist in evolving healthy practices ?
- d. Appraisal of present Managers and evaluation from the point of view of present sickness.
- e. Is it necessary to appointed a sub-committee for considering the present Sickness ? Can the executive head be co-opted /

(C) As a Management Auditor of a Company, draft a model questionnaire for evaluation of production management.

Answer.

The main objective of production management is to turn out finished goods of requisite quality by making an optimum use of men, machine, materials and services. The management auditor can evaluate these functions by asking the following questions.

- (i)** Is there an adequate system of production planning ? Are production schedules drawn up to optimise various factors like plant capacity, raw materials, skilled labours, availability of funds, machine hours, and availability of power ?
- (ii)** Is there a close co-ordination with sales dept., to ensure acceptability of the finished products by customers. How effective is the quality control on production. How are the customer complains regarding manufacturing defects, etc. dealt with ?
- (iii)** Is the Production design properly worked out ? Is there a constant review of the production design to improve the cost benefit ratio ?
- (iv)** Are the inputs and outputs of each process or department linked up periodically ? Are the actual-output ratios, conform with standard ratio. ?
- (v)** What is the system of reviewing delays in production ?
- (vi)** What is the frequency of accidents ? Are safety measures adequate ?
- (vii)** Is there a system of incentives linked up with the output of various production units ? Have the incentive system been designed on the basis of scientific studies ?
- (viii)** How effective is control over idle time.
- (ix)** Is each production process reviewed periodically to explore the possibility of having more efficient production method ?
- (x)** Are the performances of service departments appraised periodically ? Have standard efficiency factors been worked out ? Are they compared with actual efficiency ratios ?
- (xi)** How effective is the management information regarding production function as a whole.

28. A) In XYZ LTD, F a junior accountant was given additional responsibility of making recoveries from the debtors. On one occasion, when an insurance claim of ₹85,000 was received, he credited the same to the account of a debtor and misappropriated the cash which he had recovered from the said debtor. Pinpoint weaknesses in the internal control system which led to this situation.

Answer:

Following two essential features of internal control are relevant here:

- (i) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end and
- (ii) Segregation of accounting and custodial functions.

Weakness in internal control system in the instant case:

- i) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.
- ii) It also appears that system for issuing receipts for amount received - whether cash or cheque is also lacking.
- iii) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system.

B) Elaborate the principles of internal check system that should be followed with regard to cash payments.

Answer:

The principles to be followed are enumerated below:

- i) Making all payments through cheques except petty cash payments.
- ii) Segregating duties: The employee in charge of receipts should not be involved in making payments.
- iii) All payments should be duly authorized. Payments above ₹20000 should be tendered through crossed cheque.
- iv) The unused cheques should be under proper custody.
- i) The vouchers supporting payments should be stamped as 'paid' so that they are not presented twice.
- ii) Statement of dues received from creditors should be verified with invoices and ledger accounts before authorizing payments. Confirmation of accounts should be made with creditors.
- iii) Monthly or periodic payments should be always be made on fixed dates.
- iv) Bank reconciliation statements should be made atleast bimonthly to locate the difference between cash and bank book if any. The statement should be prepared by an independent person not in charge of receipts or payments.

C) How would you audit 'Inventory Control and Management' as an Internal Auditor?

Answer:

The Internal Auditor should ensure the following as regards 'Inventory Control and Management':

- (i) Has the inventory been classified for proper control? Is A, B, C system of inventory classification followed?
- (ii) How the inventory levels – maximum, minimum, reorder, economic order quantity fixed?
- (iii) Is material budget prepared in advance to regulate purchase?
- (iv) Study the opening/closing stocks of the last few years.
- (v) Study the procurement of materials for the last 2/3 years and see whether the same compares favourably with production.
- (vi) Is there any regular system to assess slow-moving/non-moving stores items for early disposal in cases considered necessary?
- (vii) Who is the person to declare some material as surplus? Who authorizes its disposal?
- (viii) Review whether value analysis, PERT etc. are applied for better management of stores.
- (ix) Work out inventory ratios to judge the reasonableness of inventory build up
 - (a) working capital to store inventory
 - (b) Current assets to store inventory
 - (c) Inventory turnover.

Some General Aspects:-

(i) Sometimes used materials are returned to stores. In such cases procedure for recording would be the same as followed in case of unused materials except that these may or may not be priced. Usually separate stores ledger / bin cards are opened. See whether the procedure in this regard has been observed.

(ii) Review whether any study has been made in regard to mechanization in stores receipt/issue, store accounting.

(iii) Review whether proper numerical accounts have been kept in respect to stand by spares.

(iv) See whether there are any Material Receiving Report pending disposal – recording valuation in stores ledger/bin card, accounting the accounts records etc.

(v) Review the mode of valuation of closing stock.

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- (vi) How soon the stores schedule is prepared for annual accounts purpose ?
- (vii) Are the stores materials adequately covered by insurance against loss from fire and other risks ?
- (viii) Is there proper coordination between –
- (a) Central Purchase Department
 - (b) Local Purchase Department
 - (c) Stores Department
 - (d) Stock – verification Department
- (ix) In case there are number of factories producing same / similar products make comparative study regarding –
- (a) Surplus materials
 - (b) Obsolete/slow-moving materials.
 - (c) Finished/work-in-progress stock
 - (d) Opening/closing stock of raw material, etc.

Apart from the above O and M study may be carried out for standardization of forms, modification of work flow for improvement in efficiency in various directions etc.

Question 29.(A)

Write short note on - Probable format of environmental statement

Answer

Probable format of "Environmental Statement": The following are the main aspects which may be covered in the probable format of Environmental Statement :

- a. Name and address of the owner/occupier of the industry, operation or process.
- b. Date of last environmental audit report submitted.
- c. Consumption of water and other raw materials during current and previous year.
- d. Pollution generated in air and water alongwith the output and the types of pollutants and the deviation from standards.
- e. Generation of hazardous waste in current year and previous year from processes.

- f. Quantity of solid waste generated during current year and previous year and from recycling or reutilisation of waste, etc.
- g. Disposal practice for different type of waste.
- h. Practice in operation for conservation of natural resources.
- i. Additional investment proposal for environmental protection including abatement of pollution.

Question 29(B)

What are the key functions of an Energy Auditor?

Answer

Key functions of Energy Auditor

Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:

- (i) Quantification of energy costs and quantities
- (ii) To correlate trends of production or activity to energy cost.
- (iii) To devise energy database formats to depict to correct picture – By product, department or consumer.

Question 29(C)

A limited company having turnover of approximately Rs.50 crore uses a tailor made accounting software package. In the said package, all transactions are recorded, processed and the final accounts generated from the system. The management tells you that in view of the voluminous nature of day books, there is no need to print them and that audit can be conducted on the computer itself. The management further assures you that any 'query based reports' as required can be generated and printed. As a statutory auditor of the company, enumerate the procedures you would adopt to conduct the audit.

Answer

A key feature of the accounting software package used by the company definitely involves the absence of a clear audit trail. In other words, transactions cannot be easily traced or co-related from the individual supporting documents of those transactions. Moreover, the management does not wish to print the daybooks in view of the voluminous nature since it may involve extensive costs. This has naturally led to extensive dependence by management upon the "exception reporting" principle.

From the auditor's point of view, it must also be conceded, the exception reports in the form of 'query-based reports' which isolate the above data provide him with the very material that he requires for most of his verification work. The only problem which it raises, and it is a serious one, is that he cannot simply assume that the programmes which produce the exception reports are reliable in respect of the following factors:

- (i) operating accurately;
- (ii) printing out all the exceptions which exist; and
- (iii) bound by programmed control parameters which meet the company's genuine internal control requirements.

In view of the above, whether management relies upon exception reports, it effectively eliminated the audit trail between input and output and the auditor is forced to test the invisible processes which purport to embody the controls, and produce the output such as it is. These tests, which invariably involve the use by the auditor of the computer itself, are known as tests through the machine. In the 'through the machine' approach, the auditor starts by proving the accuracy of the input data, and then thoroughly examines (by applying tests) the processing procedures with a view to establishing the following that:

- (i) all input is actually entered into the computer.
- (ii) neither the computer nor the operators can cause undetected irregularities in the final reports.
- (iii) the programmes appear, on the evidence of rejection and exception routines, to be functioning correctly.
- (iv) all operator intervention during processing is logged and scrutinised by the DP manager.

The auditor in such circumstances will have to first evaluate the existing controls. For the same, he has to do the following:

- (i) Evaluate the internal control system especially the controls and checks existing for recording the transactions, i.e., he has to verify at what level transactions can be entered into the system and what checks are available to prevent any unauthorised data entry and for rectifying errors/omissions in the transactions entered.

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(ii) Evaluate at what level there is authority given for modification of transactions already entered. Is there any authority given only to a senior employee to carry out modifications? Or is it that once transactions are entered and validated no further modifications are possible thereto.

(iii) Whether there is a provision in the software for carrying out an on line audit of transactions, i.e. whether there a separate module in the package, where a separate password given to the auditor and once he has seen and approved a particular transaction/set of transactions, the same would be locked and no modifications would be possible by anyone (including the senior most employee) in the company.

(iv) Whether there are proper procedures for backup of data on a regular basis and whether the said procedures are being strictly followed.

(v) In case of any loss of data whether there is a clear defined recovery procedure to minimise the loss of data due to power failures or any human errors.

(vi) The auditor may introduce some dummy data into the system and see the results obtained.

After the auditor has evaluated the above procedures, he has to prepare an audit plan depending on the results obtained from his earlier evaluation. Since the daybooks are not being printed, the plan can contain procedures wherein data is verified directly on the computer from the vouchers/invoices, etc. The audit plan will also require a lot of analytical procedures to be performed. Depending on the importance of various expense heads and other important account heads, the auditor will also obtain various reports from the system depending on various queries that he would have to identify. Some illustrative reports can be:

(i) To check whether proper classification is done for revenue/capital - a report can be obtained of all purchases (not being raw materials or other routine purchases) exceeding Rs. one lakh.

(ii) To check whether all freight outward bills are accounted for a report containing a month-wise co-relation between goods despatched and freight amount paid. The same can be further co-related with the freight rates obtained from the bills.

Once the auditor has performed the above procedures, he would be able to form an opinion whether reliance can be placed on the accounting systems and the data recorded. If the auditor finds that reliance cannot be placed on the systems he can inform the management about the fact and also that the daybooks, etc., will need to be printed to allow him to conduct the audit. The finalisation procedures to be followed even under this system would remain more or less similar to other accounting systems. The auditor can obtain reports of depreciation on fixed assets, inventory valuation and using the normal procedures find out whether reliance can be placed on them, e.g., if while valuing stocks the system is using the LIFO method, the same would not be acceptable and will need to be modified. Similarly depreciation calculations will have to be verified on a random basis to find out its reliability.

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Question No 30

State the relevance of Cost Information in Anti-dumping Duty

Answer:

Costing Information for imposing anti dumping duty

- (1) Description of the cost accounting system used by the company to record the production costs of the product concerned.
- (2) Company's use of standard or budgeted costs.
- (3) An explanation for allocation method used as well as for any significant or unusual cost-variances that occurred during investigation period.
- (4) A list of direct and indirect cost centres.
- (5) Method used to allocate cost among the company's organizational units.
- (6) Description of Cost Accounting system to value the cost of sales and raw materials, WIP and finished goods inventories for the audited financial statements.
- (7) A list of all costs which are valued and treated differently for cost and financial accounting purposes and the reasons treating them differently.
- (8) Information regarding cost of production/trading.

Anti-dumping Application Proforma:

The following is an outline of application proforma under Anti-dumping laws in India:-

Part	Deals with
I	Imported Product Information
II	Indian Industry Profile
III	Evidence of Dumping <ol style="list-style-type: none"> 1. Estimates of Normal Value 2. Estimates of Export Price 3. Estimates of Dumping Margin
IV	Evidence of Injury
IVA	Injury Information on Domestic Industry
IVB	Country wise landed value
V	Evidence of Casual link
VI	Costing Information Format "A" – Statement of Raw Materials and Packing Materials Consumption and Reconciliation Format "B" – Statement of Raw Material Consumption Format "CI" – Statement of Cost of Production Format "CII" – Allocation and Apportionment of Expenditure Format "D" – Statement of Consumption of Utilities Format "E" – Statement of Sales Relations Format "F" – Certificate

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Cost Accounting Standards (CASs) - relevance and application in the light of Anti-dumping Laws in India

The following are the Cost Accounting Standards issued by the Institute of Cost Accountants of India. Effective application of CASs brings about uniformity in the principles of measurement and valuation of goods.

CAS	Deals with
1	Classification of Cost
2	Capacity Determination
3	Overheads
4	Cost of Production for Captive consumption
5	Average (Equalized) cost of transportation
6	Material Cost
7	Employee Cost
8	Cost of Utilities
9	Packing Material Cost
10	Direct Expenses
11	Administrative Overheads
12	Repairs and Maintenance
13	Cost of Service Cost Centre
14	Pollution Control Cost
15	Selling and Distribution Overheads
16	Depreciation and Amortization
17	Interest and Financing Charges
18	Research and Development Costs
19	Joint Costs

“Cost Records means books of accounts relating to utilization of material, labour and other items of cost as applicable to the production, processing, manufacturing and mining activities of the company”. It has also been clarified that such conformance to GACAP and CAS are to be followed to the extent these are found to be relevant and applicable and the variations, if any, are required to be indicated and explained.

The basic purpose of maintenance of these cost records is to enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in

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utilization of resources. These records shall also provide necessary data which is required to be furnished under these rules.

Companies (Cost Audit Report) Rules, 2011 - relevance and application in the light of Anti-dumping Laws in India

The following states the relevance of respective Para prescribed Cost Audit Reports and Cost Accounting Standards which may be used as reference for making an authentic assessment under Anti-dumping laws in India. Since the Cost Accounting Records are to be maintained by companies satisfying the prescribed parameters, a reference to the Cost Compliance Report or the Cost Audit Report may be an important tool for the stakeholders in ascertainment of injury margin. Further, application of generally accepted cost accounting principles and cost accounting standards, would bring about a uniformity/standardization in the principles followed in measurement and valuation of cost.

Anti-dumping Application Proforma	Reference to Para prescribed under Cost Audit Report Rules, 2011		Reference to relevant Cost Accounting Standards
Format A - Statement of Raw Materials and Packing Materials Consumption and Reconciliation	Para 5 : Abridged Cost Statement	Item No.1 & 2 Raw Material Consumption and Process Materials	CAS 6 – Material Cost
		Item No.16 and 23 – Primary Packing Cost Material and Secondary Packing Cost	CAS 9 – Packing Material Cost
Format B – Statement of Raw Material Consumption	Para 5 : Abridged Cost Statement – Item Nos.1 & 2		CAS – 6 – Material Cost
Format CI – Statement of Cost of Production (to be certified by a Cost Accountant in Practice)	Para 5 : Abridged Cost Statement – Item No. 21 – Cost of Production		CAS 2 – Capacity Determination CAS 6 – Material Cost CAS 7 – Employee Cost CAS 8 – Cost of Utilities CAS 9 – Packing Material Cost

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		CAS 10 – Direct Expenses CAS 12 – Repairs & Maintenance
Format CII – Allocation and Apportionment of Expenditure	Para 2 : Cost Accounting Policy	CAS 1 – Classification of Cost CAS 2 – Capacity Determination CAS 3 - Overheads
Format D – Statement of Consumption of Utilities	Para 5: Abridged Cost Statement – Item No.3 – Utilities	CAS 8 – Cost of Utilities

However, for the purpose of ascertaining the Normal Value, Non-injurious price or to determine price undercutting or price underselling, application of the specific Cost Accounting Standards in all relevant situations may be made which would be a safeguard for the stakeholders.

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Example: FORMAT "CI" - STATEMENT OF COST OF PRODUCTION

Name of the Company: XYZ Limited

Installed Capacity	1,00,000 units							
Production in Installed	65,000 units							
Capacity Utilization (%)	65%							
Production in Investigation Period	56,000 units							
Capacity Utilisation in Investigation period	56%							
Sales (quantity)	61,000 units				51,000 units			
Particulars	Previous Accounting Year				Investigating Period			
	Qty	Rate (₹)	Value (₹)	Cost per unit	Qty	Rate (₹)	Value (₹)	Cost per
Manufacturing Expenses:								
Raw Materials (specify the major raw materials) (MT)	10,000	100.00	10,00,000	15.38	8,000	120.00	9,60,000	17.14
Utilities								
Administrative Expenses								
Variable			1,30,000	2.00			1,12,000	2.00
Selling & Distribution Expenses								
Variable			61,000	1.00			56,000	1.00
Financial Expenses								
Variable			1,30,000	0.70			35,700	0.70
Less: Miscellaneous Income (from product concerned) –			(25,000)				(20,000)	
Total Cost to make and sell			18,34,000	28.22			16,47,700	29.42
Selling Price				35.00				32.00
Profit/Loss				6.78				2.58

Note: This Statement of Cost of Production is to be authenticated by a Cost Accountant in Practice

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Example: One of the major reasons for this decrease in the quantity of sales is identified to be import of like/similar goods by a foreign company to India. The selling price of such goods, in Indian market, as fixed by the foreign counterpart is ₹ 23, while the same goods are normally sold at that foreign country for Rs.35. Landed Value of Imports ₹ 25. XYZ Ltd. being deceived requested the competent authority to have a review. Ascertain the injury margin and suggest the measure suitable to safeguard the Indian Industry.

Solution:

Particulars	Amount (₹)
Price of the "Product under Consideration (PUC) or "Article under Investigation" from the Exporting Country / Export Price	23.00
Normal Value of such product, when sold in the domestic market of the exporting country	35.00
Dumping Margin or Margin of Dumping (DM) = 35.00 – 25.00	10.00
Non Injurious Price (NIP) – this is the constructed sale price of the domestic industry which will give a reasonable return on investment and if the domestic industry is able to sale its product at that price, it will not claim any injury	30.00 (say)
Landed Value of Imports (including all the expenses incurred during the course of importation upto the port including the non-creditable duties of customs	25.00
Injury Margin (IM) = Non Injurious Price (-) Landed Value of Imports = 30.00 (-) 25.00	5.00

Thus, for XYZ Ltd. the Injury Margin is ascertained at Rs.5 per unit. Accordingly, the Authorities shall cause to initiate necessary proceedings to levy additional duty of customs (under the aegis of Anti-dumping Laws) to safeguard the domestic industry.

Example : Following is the relevant extract from the Trial Balance of ABC Ltd. for the year ended 31.3.2013.

Particulars	Amount (₹)	Particulars	Amount (₹)
Raw Materials	5,00,000	Sales	21,60,000
Consumable Stores and Spares (Other Inputs)	3,00,000		
Utilities (Power, Fuel, Steam, Water, etc)	1,80,000		
Direct Labour	4,00,000		
Manufacturing Overheads	1,50,000		
Research & Development	60,000		

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Administrative Overheads	90,000		
Selling & Distribution Cost	50,000		
Depreciation	30,000		
Financial expenses	10,000		
Other Miscellaneous Expenses	12,000		

Company deals with two products for which necessary information is furnished:

Particulars of Expenses	Product X1	Product X2
Raw Materials (Ratio of utilization)	60%	40%
Consumable Stores and Spares (Other Inputs)	in proportion to raw materials	
Utilities (Power, Fuel, Steam, Water, etc)	in proportion to raw materials	
Direct Labour	2,45,000	1,55,000
Manufacturing Overheads	30%	35%
Research & Development	35%	40%
Administrative Overheads	30%	40%
Selling & Distribution Cost	35%	50%
Depreciation	45%	55%
Financial expenses	50%	30%
Other Miscellaneous Expenses	25%	25%

Prepare Statement showing Allocation and Apportionment of Expenditure for assessment under Anti-dumping laws in India for Product A, which is the Product under Investigation.

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Solution:

Format CII

Statement Showing Allocation and Apportionment of Expenditure for Product X1

Sl. No.	Particulars of expenses	Total applicable to product under investigation	Share applicable to product under investigation	Share not allocation/apportionment	Basis
1	Raw Materials (Ratio of utilization)	3,00,000	3,00,000	NIL	Actual Ratio
2	Consumable Stores and Spares (Other Inputs)	1,80,000	1,80,000	NIL	Raw Material Ratio
3	Utilities (Power, Fuel, Steam, Water, etc)	1,08,000	1,02,000	6,000	CAS 8
4	Direct Labour	2,45,000	2,41,000	4,000	CAS – 7 (Actual)
5	Manufacturing Overheads	45,000	38,000	7,000	Cost Driver
6	Research & Development	21,000	15,000	6,000	Wrong Basis
7	Administrative Overheads	27,000	24,000	3,000	CAS - 11
8	Selling & Distribution Cost	17,500	16,000	1,500	CAS -15
9	Depreciation	13,500	11,500	2,000	CAS-16, Value of Asset
10	Financial expenses	5,000	5,000	NIL	CAS-17, Actual utilization of borrowed funds
11	Other Miscellaneous Expenses	3,000	3,000	NIL	Actual
12	Total Expenditure Total of (1) to (11)	9,65,000	9,35,500	29,500	
13	Sales	10,95,000	10,95,000	NIL	

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14	Other Income (Sale of Scrap of Product X1)	3,000	3,000	NIL	
15	Total Income (13+14)	10,98,000	10,98,000	NIL	
16	Profit/Loss	1,33,000	1,33,000		

Note:

This statement is to be certified by a Practicing Cost Accountant.