PAPER – 17 : COST AND MANAGEMENT AUDIT
SUGGESTED ANSWERS
SECTION – A

1. (a)

(i)	(C)
(ii)	(A)
(iii)	(B)
(iv)	(A)
(v)	(A)
(vi)	(C)
(vii)	(C)
(viii)	(A)
(ix)	(A)
(x)	(C)

1.(b)

(i)	(B)
(ii)	(A)
(iii)	(B)
(iv)	(C)
(v)	(A)

SECTION – B

2. (a)

SCOPE OF COST AUDIT:

The primary objective of 'Cost Audit' is ensuring accuracy of cost data, accumulation and exact computation of the cost of a product. However, the vast scope of Cost Audit works as a mirror of entity's performance.

The Institute of Cost and Works Accountants of India defines a cost audit as: "An audit of efficiency of minute details of expenditure….Cost audit is mainly a preventive measure, a guide for management policy and decision … and a barometer of performance".

The Institute of Cost and Management UK defined cost audits as "the verification of the correctness of cost accounts and a check on the adherence to the cost accounting plan".

In today's dynamic business world, to become competitive in every product or services of the entity is of paramount importance. Hence, the prime mover of pricing and attached quality can only be ensured through appropriate cost structure. In view of this, 'cost audit' refers to the detailed verification of the correctness of costing techniques, costing systems, and cost accounts. It is necessary to ensure that records maintained for the purpose are accurate and correct to drive entity's decision making process.

Beyond propriety, Cost Audit scope encompasses overall 'efficiency' and its improvement. The wider scope of Cost Audit can help-

a. Control over element-wise cost
b. Help in determining Sales price and margin
c. Assist Management in decision-making
d. Necessity and results from each of the activity performed
e. Setting of Standards and budgetary controls
f. Minimizing wastages, if any
g. Accuracy of inventory valuation
h. Overall efficiency improvement of the entity

Hence, Cost Audit not only to be considered as a Compliance Tool (Where the same is mandatory), the outcome is far reaching to go 'beyond compliance'.

2. (b)

Normal Price and the basis adopted to determine Normal Price:

"Normal" price means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged is the sole consideration of sale and such sale is not made to a related party. Normal price can be construed to be a price at which two unrelated and non-desperate parties would agree to a transaction and where such transaction is not clouded due to the proximity of the parties to the transaction and free from influence, though the parties may have shared interest.

In respect of related party transactions or supplies made or services rendered by a company to a company termed "related party relationship" and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of -

(i) purchase and sale of raw materials, finished good(s), rendering of service(s), process materials and rejected goods including scraps, etc. ;
(ii) utilisation of plant facilities and technical know-how;
(iii) supply of utilities and any other services;
(iv) administrative, technical, managerial or any other consultancy services;
(v) purchase and sale of capital goods including plant and machinery; and
(vi) any other payment related to the production of goods or rendering of services under reference.

These records shall also indicate the basis followed for arriving at the rates charged or paid for such goods or services so as to enable determination of the reasonableness of such rates in so far as they are in any way related to goods or services under reference.

The basis adopted to determine Normal price should be classified as under:

(i) Comparable uncontrolled price method;
(ii) Resale price method;
(iii) Cost plus method;
(iv) Profit split method;
(v) Transactional net margin method; or
(vi) Any other method, to be specified.

3. (a)

Cost Accountant as a Key Managerial Person:

Section 203 provides for the appointment of Key Managerial Person

- Managing Director or Chief Executive Officer or manager and in their absence, a whole time director;
- Company Secretary; and
- Chief Financial Officer

By virtue of qualification and experience, a Cost Accountant can become Key Managerial Person in the Company.

Cost Accountant as an Independent Director:

Section 149(4) provides that every listed public company shall have at least one third of the total number of directors as independent directors.

Rule 5 of the Companies (Appointment and Qualification of Directors) Rules, 2014 prescribes the qualification of an independent director who shall possess appropriate skills, experience and knowledge in one or more field of finance, law, management, sales, marketing, administration, research, Corporate Governance, technical operations or other disciplines related to the company's business.

The Cost Accountant having expertise in most of the above fields can become independent director as stipulated in the Companies Act, 2013.

3. (b)

Process to be followed to file the reports in XBRL Format:

The following steps have to be followed in sequence:

- Mapping the individual cost elements of the company to the elements of the costing taxonomy.
- Populating the relevant data in the software/filing tool.
- Creating an XBRL instance document.
- Download XBRL validation tool
- Validating the Instance Document with the Validation Tool of MCA.
- Pre-scrutiny of the instance document.
- Use available tool to convert the Instance document to a human readable format and check correctness of data.
- Attaching the Instance Document to the e-Form and filing on MCA Portal

4. (a)

Value of Closing Stock under Average Cost Method ₹ 3,04,833

Cost of Raw materials Consumed ₹ 16,39,567

4. (b)

According to the Rule 30 of the Central Goods & Services Tax Rules, 2017, the Assessable Value of goods used for captive consumption is 110% of cost of production of such goods.

Cost of production as per CAS-4 ₹ 90,05,000

Assessable value as per Rule 30 of CGST Rules, 2017 is ₹ 99,05,500

5. (a)

Reconciliation of Profit between Cost and Financial Accounts for the year ended March 31, 2024

		₹	₹
Profit as per Financial Accounts			33,18,100
Add: Loss on Sale of Investments		45,600	
Add: Voluntary Retirement Compensation included in salary-not included in Cost Accounts		56,25,000	
Add: Donation paid		80,000	57,50,600
Less: Profit on Sale of Fixed Assets- not considered in			90,68,700
Cost Accounts		3,05,000	
Less: Receipts of insurance claim related to previous year		5,28,700	
Less: Profit from Retailing Activity		30,00,600	
Less: Interest income from inter-corporate deposit-			
-not considered in cost accounts		7,25,000	
Less: Difference in valuation of stock:			
Decrease in inventories as per cost accounts	398,15,200		
Decrease in inventories as per financial accounts	(392,06,480)	6,08,720	51,68,020
PROFIT AS PER COST ACCOUNTS			39,00,680

5. (b)

Need for Forensic Audit:

As of now, forensic auditing has emerged as a specialized field in the industry that requires a specific skill set to detect the fraud, leaving no scope for overlap, but to determine an organisation's needs, forensic auditing is significant in dealing with early warning signals of fraud.

Thus, there are a few instances on the occurrence of which an entity should direct for forensic Audit, like:

(i) Theft of business information or where business systems have been hacked.
(ii) Issues identified by Whistle-Blowers
(iii) Reconciliations resulted in unidentified material differences
(iv) Suspicious of fraud or illegal activity.
(v) Turnover has occurred and balances are showing negative results.

Forensic Audit Procedures:

Since the forensic audit is more of an investigation and collection of evidence, it is of great importance that the audit should be conducted with an attitude of professions scepticism.

However, a scientific approach involving the use of forensic audit procedures should be used to conduct the assignments. These procedures are more towards detecting possible material misstatements in the financial records that result in fraudulent activities. Besides, forensic data analysis and fraud investigation techniques, a tool named 'triangle' also are used for addressing the presence of three-element that are common to any fraud being committed:

- Incentives – a motive that drives a person to commit fraud.
- Attitude – an ability to rationalize fraudulent behaviour.
- Opportunity – that enables a person to commit fraud.

6. (a)

How Money Laundering Works:

To identify and report potential money laundering and address compliance requirements, financial institutions must have a deep understanding of how the crime works. Money laundering involves three steps:

(i) Placement
(ii) Layering and
(iii) Integration

These are a complex series of transactions that start with depositing funds, then gradually moving them into what appear to be legitimate assets.

Placement refers to how and where illegally obtained funds are placed. Money is often placed via Payments to cash based businesses; payments for false invoices; 'smurfing' which means putting small amounts of money (below the AML threshold) into bank accounts or credit cards; moving money into trusts and offshore companies that hide beneficial owners' identities; using foreign bank accounts; and aborting transactions shortly after funds are lodged with a lawyer or accountant.

Layering refers to separating criminal funds from their source. It involves converting the illicit proceeds into another form and creating complex layers of financial transactions to disguise the funds' origin and ownership. Criminals do this to obfuscate the trail of their illicit funds. So, it will be hard for AML investigators to trace the transactions.

Integration refers to the re-entry of the laundered funds into the economy in what appears to be normal, legitimate business of personal transactions. This is sometimes done by investing in real estate or luxury assets. It allows launderers and criminals to increase their wealth.

The offense of Money Laundering:

Money-Laundering has been defined in the Prevention of Money Laundering Act,2002 under Section 3, wherein a person shall be guilty of the offences of money-laundering, if such person is found to have directly or indirectly:

- Attempted to indulge or
- Knowingly assisted or
- Knowingly is a party or

Is involved in one or more of the following processes or activities connected with proceeds of crime, namely:

- Concealment; or
- Possession; or
- Acquisition; or
- Use; or
- Projecting as untainted property; or
- Claiming as untainted property.

Section 2(u) of PMLA defines "Proceeds of Crime" as any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offense or the value of any such property, or where such property is taken or held outside the country, then the property equivalent in value held within the country or abroad.

"Proceeds of Crime" include property not only derived or obtained from a scheduled offense, but also any property which may directly or indirectly be derived or obtained as a result of any criminal activity relatable to the scheduled offense.

The Schedule to PMLA lists all offenses which have been defined as scheduled offenses. As per Section 2(1) (y) of PMLA, Scheduled Offence means:

- The offenses specified under Part A of the Schedule; or
- The offenses specified under Part B of the Schedule, if the total value involved in such offenses is one crore rupees or more; or
- The offences are specified under Part C of the Schedule

An offense of money laundering cannot exist independently. It is evident that money laundering comprises a predicate offense well and is usually the result of the commission of a predicate offense is the sine qua non for the existence of an offense under PMLA that the money in question is 'proceeds of crime' derived from the commission of a predicate offense. In the absence of a predicate offense, there can be no offense of money laundering.

6. (b)

Top Objectives of having a Management Audit are:

(i) Clearly defined prime objectives of the organisation

(ii) Ensuring a clear, lean and thin Organisational reporting structure. The setting of a well-defined organisational structure with clear-cut lines of reporting.

(iii) Goal setting process aligned with business objectivity

(iv) Process benchmarking for improving effectiveness. Challenge existing rules and regulations to work out on effectiveness level.

(v) Suggesting improvement measures for giving an impetus to business performance in the forthcoming months/periods.

(vi) Suggesting ways to restructure the organisation and ensure high-quality service at all quarters.

(vii) More effective resource utilization planning.

(viii) Incorporating management information systems to reach production and work efficiency goals.

(ix) Identification of weak points or managerial inefficiencies with respect to core functional areas of the business, namely finance, sales and production.

7. (a)

Information Systems Audit Approaches:

There are three approaches for conducting Information Systems Audit viz. Auditing around the computer, Auditing through the computer and Auditing with the computer.

Auditing around the computer:

Under this approach, the emphasis is on checking the correctness of the output data/documents concerning the input of a process without going into the details of the processing involved. This approach is preferred, where auditors themselves do not have the desired level of technical skills to adopt the other approaches. This is also preferred, when high reliance is placed on the users rather than the computer controls to safeguard the assets, maintain data integrity and attain effectiveness and efficiency objectives. The focus is on procedural controls rather than computer controls. This approach can be used in the following circumstances:

When an application system is simple, logic is straightforward, and a clear audit trail exists, this approach can be adopted. The process generates the audit trails such as the generation of exception reports along with the main reports. Such systems have very low inherent risk i.e. they are unlikely to be susceptible to material errors or irregularities or to be associated with significant ineffectiveness or inefficiencies in operations. Input transactions in such systems are in batch mode and control is maintained using traditional methods like the separation of duties and management supervision. Further, the task environment in such systems is relatively constant and the system itself is rarely modified.

This approach may be used when an application system uses a generalized package that is well tested and used by many users as its software platform. If the package has been provided by a reputed vendor, has received widespread use, and appears error-free, the auditors may decide to adopt this approach. Auditors should ensure that the organisation has not modified the package and adequate controls exist over the source code and documentation to prevent unauthorized modification of the package.

When high reliance is placed on the users rather than the computer controls to safeguard the assets maintain data integrity and attain effectiveness and efficiency objectives, this approach can be adopted.

Auditing around the computer is a simple approach. It does not provide any information about the system's ability to cope with the changes. Systems can be designed and programs can be written in certain ways to inhibit their degradation when user requirements change. Further, this method cannot be used for complex systems. Otherwise, the auditors might fail to understand some aspects of a system that could have a significant effect on the audit approach.

Auditing through the Computer:

Auditing through the computer requires a fair knowledge of the operating system, hardware being used, and certain technical expertise in systems development. Under this approach, the computer programs and the data constitute the target of IS audit. Compliance and substantive tests are performed on the computer system, its software (both operating system and application system) and the data. The IS auditors can test the application system effectively using this approach. The IS auditors can use a computer to test logic and controls existing within the system and also records produced by the system. The approach increases the IS auditor's confidence in the reliability and applicability of the evidence/information collected and evaluated. This approach is time-consuming, as it needs an understanding of the internal working of an application system. It also needs some technical expertise.

Auditing with the Computer:

Under this approach, the computer system and its programs are used as tools in the audit process. The objective is to perform substantive tests using the computers and their programs. The data from the auditee's computer system are retrieved in an independent environment. Audit interrogation and the query are carried out on such data, using special programs designed for the purpose. This method is used where:

(a) Application system consists of a large volume of inputs, producing a large volume of outputs and where the direct examination of the inputs/outputs is difficult.

(b) Logic of the system is complex

(c) There are substantial gaps in the visible trails.

7. (b)

Productive Efficiency:

Productive Efficiency, also known as production efficiency, is the economic concept of producing the largest possible output from the available resources. Productivity enhancement and/or efficiency improvement are positives for growth and profitability.

How Productive Efficiency Works:

Productive efficiency often comes into play when a production process relies on scarce resources. In microeconomics, this could involve two industries competing for the same raw materials and ending up limited by similar externalities.

As an example, consider the production of most rechargeable batteries, which require a steady supply of the mineral lithium and cobalt. When companies allocate these minerals toward the maximum production efficiency of car batteries, they reduce the available resources for other types of batteries that rely on the same core materials. If the car battery manufacturing process has reached its maximum productive efficiency, there will be higher marginal costs for any additional unit produced. In competitive companies may be able to evade and situations by improving workflows, technical efficiency, and exploiting economies of scale. In the short run, they bump up against the limits of production efficiency.

Productive vs Allocative Efficiency: What is the Difference?

Productive efficiency and allocative efficiency measure common characteristics, but the two terms are not synonyms.

Productive efficiency represents the maximum output of a product given scarce resources. The production of any additional units results in opportunity costs-one which is the reduced output of another product. This metric focuses entirely on monetary costs and resources.

Allocative efficiency measures the distribution of goods and services. Allocative efficiency is state of market equilibrium where both producer and consumer benefit. Specifically, it means the marginal cost of production for each unit sold will equal the marginal benefit to the customer buying that good. To have true allocative efficiency, both producers and buyers must benefit from the overall condition of the market. On a macroeconomic level, this applies to entire societies such that producers benefit in an open market and consumers pay reasonable prices for an enhanced quality of life.

Both efficiencies are limited by externalities. A corporation or small business can do a great deal to improve its productive efficiency levels and reduce inefficiency. This includes ramping up its level of production, performing preventive maintenance on equipment, reducing factory downtime, tracking key performance indicators (KPIs), reimaging production lines, and incentivizing higher productivity levels among its workforce. However, even when a company streamlines and optimizes in every possible way, it can still be hampered by the production of another product that taps into its same supply chain.

8. (a)

Adequacy of Internal Controls

As per SA 200 read with SA 315, the auditor should obtain an understanding of the accounting system sufficient to identify and understand major classes of transactions, manner of initiation of transactions, significant accounting records, supporting documents and specific accounts in the financial statements and the accounting and financial reporting process. Accounting control comprises the plan of an organisation and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial controls. Internal control so far as financial and accounting aspects are concerned, aims at the following:

(i) Providing the flow of work through various stages.

(ii) There should be proper segregation of personnel duties so that no single person can be in a position to handle whole of the work from its beginning to its end.

(iii) Adequate documentation should be made at each stage of work.

(iv) The transactions are recorded with appropriate amounts and in timely manner and that too as per the applicable accounting policies and practices.

(v) The assets should be properly safeguarded.
(vi) The access to the assets should be restricted to only authorised persons.
(vii) Existence of organisational chart would help in fixing responsibilities.
(viii) Building up of a system to locate the deviations and departures from the prescribed procedures and to detect the frauds and errors automatically without mush loss of time.
(ix) Standardized records and formats should be evolved. It would ensure availability of right information at right time.
(x) There should be an efficient Management Information System.
(xi) Minimization of loss and wastages.
(xii) Employees should be encouraged to do good work and comply with the procedures. Special attention should be given to the disgruntled employees.
(xiii) Adequate cut off procedures should be formulated so that the transactions of one period can be separated from the transactions of other period.

8. (b)

AUDIT OF SELF-HELP GROUPS:

Self Help Group (SHG) Movement in India has been recognized as an effective strategy for mobilization and empowerment of rural people, particularly poor women and other marginalized groups. In India, Self HelpGroupsorSHGsrepresentauniqueapproachtofinancialintermediation.Theapproachcombinesaccessto low-cost financial services involving a process of self-management, with an objective of social and economic development for the women SHG members. Formations of SHGs are facilitated by the Government or by NGOs. SHGs are linked not only to banks but also to wider development programs, SHGs are seen to confer many benefits, both economic and social.

As expert accounting professionals are hardly available at Gram Panchayat level, the need of the hour is "Community Audit" and it is necessary to develop sufficient number of "Community Auditors" for the sake of financial transparency.

The Institute of Cost Accountants of India and WBSRLM have entered into an MOU to enable the undertaking of various collaborative activities for establishing a "Community Audit" system for Self Help Groups in West Bengal by developing a sufficient number of qualities "Community Auditors" for meeting the audit needs of SHGs in the state.

Applying the Field Balance Sheet Approach to Audit:

1. **Background Review**:
During a background review, a preliminary examination of the group-level records, including the cash book, is conducted. The auditor also does a general review of the group-level records and member passbooks to verify/ cross-check data entries for their accuracy and correct posting.

2. **Prepare Field Balance Sheet**:
The auditor prepares the Field Balance Sheet for the group, as on the audit date, based on the SHG's internal records, and then cross-checks the correctness of balance sheet items. The primary objective is to ascertain the retained earnings of the SHG.

Sl. No.	Assets	Amount ₹	Sl. No.	Liabilities	Amount ₹
1	Cash in Hand		1	Voluntary Savings	
2	Cash at Bank		2	External loan Outstanding	
3	Loan Outstanding with Members		3	Equity:	
4	Fixed Deposit		a	Compulsory Saving	
5	Fixed Asset		b	Retained Earning	
	Total			Total	

3. **Private Meetings with Members:**
   The auditor conducts private interviews with 25% of the total members to triangulate information collected from the background review, as well as from the Field Balance Sheet, and to ascertain the decision-making pattern in the group.
4. **Meeting with the SHG Group:**
   If serious issues are raised during the course of the audit, the auditor will meet with the entire group for further discussion.
5. **Reporting:**
   Once the auditing is complete, the auditor summarizes any weak practices that put savings at risk or make records unreliable, and recommends any better methods. The auditor submits the Field Balance Sheet, along with a summary report to the MFI/bank, to all group members and adds relevant comments to enable decision-making regarding the provision of credit.