

PAPER - 17: COST AND MANAGEMENT AUDIT

SUGGESTED ANSWERS

SECTION-A

1. (a)

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

1. (b)

- (xi) A
- (xii) C
- (xiii) D
- (xiv) B
- (xv) C

SECTION - B

2 (a):

The main purpose of Cost Audit:

- To make systematic and independent verification of a company's cost records.
- It is to ensure accuracy, prevent fraud, and assess efficiency.
- It keeps a vigil on compliance with cost accounting principles and procedures and other legislations.
- It verifies cost accounts, statements, and data, provides reliable information for management decision-making.
- It helps identify areas for cost reduction viz. wastage of material or labor, and optimization of opportunities.
- It constructs management policies regarding pricing, production, resource allocation and promoting better corporate governance through various operational disclosures to the directors.
- Verification of the cost of each “Cost unit” and “Cost Centre” to ensure that these have been properly ascertained.
- Determination of inventory valuation.
- Advising management, based on inter-unit/inter-firm comparison of cost records, as regards the areas of performance improvement.

2 (b):

Particulars relating to the Items of Costs to be included in the Books of Accounts in respect of Repairs and Maintenance:

- a) Proper records showing the expenditure incurred by the workshop, tool room and on repairs and maintenance in the various cost centres or departments shall be maintained under different heads.
- b) Repairs and maintenance cost shall be the aggregate of direct and indirect cost relating to repairs and maintenance activity. Direct cost shall include the cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other identifiable resources consumed in such activity. Indirect cost shall include the cost of resources common to various repairs and maintenance activities such as manpower, equipment usage and other costs allocable to such activities.
- c) Cost of in-house repairs and maintenance activity shall include cost of materials, consumable stores, manpower, equipment usage, utilities, and other resources used in such activity.
- d) Cost of repairs and maintenance activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.
- e) Cost of repairs and maintenance jobs carried out by contractor at its premises shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited. This cost shall also include the cost of other resources provided to the contractors.
- f) Cost of repairs and maintenance jobs carried out by outside contractors shall include charges made by the contractor and cost of own materials, consumable stores, spares, manpower, equipment usage, utilities other costs used in such jobs.
- g) Each type of repairs and maintenance shall be treated as a distinct activity, if material and identifiable.
- h) Cost of repairs and maintenance activity shall be measured for each major asset category separately.
- i) Cost of spares replaced which do not enhance the future economic benefits from the existing asset beyond previously assessed standard of performance shall be included under repairs and maintenance cost.
- j) The cost of major overhaul shall be amortised on a rational basis.
- k) Finance costs incurred in connection with the repairs and maintenance activities shall not form part of repairs and maintenance costs.
- l) Repairs and maintenance costs shall not include imputed costs.
- m) Price variances related to repairs and maintenance, where standard costs are in use, shall be treated as part of repairs and maintenance cost. The portion of usage variances attributable to normal reasons shall be treated as part of repairs and maintenance cost. Usage variances attributable to abnormal reasons shall be excluded from repairs and maintenance cost.
- n) Subsidy or grant or incentive and any such payment received or receivable with respect to repairs and maintenance activity shall be reduced from cost of the cost object in the financial year when such subsidy grant or incentive and any such payment is recognised as income.

- o) Any repairs and maintenance cost resulting from some abnormal circumstances, e.g., major fire, explosions, flood and similar events, if material and quantifiable, shall not form part of the repairs and maintenance.
- p) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the repairs and maintenance cost.
- q) Credits or recoveries relating to the repairs and maintenance activity, material and quantifiable, shall be deducted to arrive at the net repairs and maintenance cost.
- r) Any change in the cost accounting principles applied for the measurement of the repairs and maintenance cost shall be made only if, it is required by law, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.
- s) Repairs and maintenance costs shall be traced to a cost object to the extent economically feasible.
- t) Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following the principles of:
 - (1) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost and
 - (2) Benefits received - overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.
- u) if the repairs and maintenance cost (including the share of the cost of reciprocal exchange of services) shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects.

3. (a):

Steps to be taken by the cost auditor before accepting appointment:

- As per Section 148(3) of the Companies Act 2013, read with Rule 6 of the Companies (Cost Records & Audit) Rules 2014, cost audit shall be conducted by a Cost Accountant who shall be appointed by the Board.
- The category of companies specified in rule 3 and the thresholds limits laid down in rule 4, shall within one hundred and eighty days of the commencement of every financial year, appoint a cost auditor.
- Provided that before such appointment is made, the written consent of the cost auditor to such appointment, and a certificate from him or it, as provided in sub-rule (1A), shall be obtained.
- The cost auditor appointed under sub-rule (1) shall submit a certificate that—
 - (a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act;
 - (b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Act, so far as may be applicable;
 - (c) the proposed appointment is within the limits laid down by or under the authority of the Act; and
 - (d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

3. (b):

In planning the audit assignment, certain important factors are taken into consideration viz.

- (1) Requirement of audit personnel for the assignment
- (2) Documentation of the audit procedures and of evidence
- (3) Quality control exercised over performance of the assignment etc.

Audit personnel for the assignment: -

Experience and training of audit personnel engaged for the assignment should be considered particularly keeping in view the relevant industry. Prior practical experience of the industry helps in carrying out the study of the system and procedures in vogue. For this purpose, two pronged approaches may be adopted by the cost auditors. First, a study of the industry and the second, study of the Annual Reports of the auditee company for the past at least 5 years. The cost audit team to whom the assignment is to be delegated need appropriate direction and supervision. It is therefore, essential that they accomplish the following tasks:

- (i) Physical inspection of the activities and the area where they are performed;
- (ii) Knowledge of the key personnel responsible for the activities and for the maintenance of cost records;
- (iii) Physical inspection of the cost accounting records and other records relating to activities;
- (iv) Study of the statements of budgets, plans and strategies relating to activities;
- (v) Study of the Cost Accounting system used and the basis according to relevant CAS. The audit personnel should be asked to collect the documentary evidence for the above tasks and file in the relevant cost audit file for future reference.

Documentation of the audit procedures and of evidence: -

The cost auditor should document all matters which are important in providing evidence to support the opinion given in the report. Documentation means the working papers prepared by and for or obtained and retained by the cost auditor in connection with the performance of the audit or compliance function. Working papers record the evidence resulting from the work performed, to support the cost auditors' opinion. It is important to remember that the documents may include issues beyond accounting data as other information such as production schedule, quantitative and statistical data etc. may be required for preparation of performance analysis.

Quality control over performance of the assignment: -

Supervision and control involve direction, review and monitoring of the audit assignment in hand. The personnel carrying out these responsibilities generally perform the following functions during the course of audit.

- (i) Monitoring the progress of the preparation / maintenance of cost accounting records;
- (ii) Reviewing that the audit assistants do have necessary skill and competence to understand the system and procedure to carry out the assigned tasks as per the overall plan;
- (iii) Being aware of the cost accounting and auditing questions raised during carrying out of the assignment and assessing their significance and modifying the plan and programme, as considered necessary; and
- (iv) Removing the differences of professional judgement between the personnel and deciding the level which is appropriate for reference purpose.

4. (a):**Computation of Landed cost of Material (As per CAS-6):**

Particulars	Amount (₹)
Basic material cost =180,000 x 86.45 the ex-rate prevalent on the date of import.)	1,55,61,000
Import Duty	7,78,050
Freight	1,50,600
Demurrage for delay ₹ 75,000	Not included
Bank charges for LOC ₹ 30,000	Not included
Total	1,64,89,650
Less: Import Subsidy	3,00,000
Cost of Material	1,61,89,650

4. (b)

As per CAS 12 – High value spare, when replaced by a new spare and is reconditioned, shall be recognised as property, plant and equipment, when they meet the definition of property, plant and equipment and depreciated accordingly. Otherwise, such items are classified as inventory and recognised in cost as and when they are consumed.

If the company is covered under Ind AS, such spare is capitalized as Property, Plant & Equipment.

The property, plant and equipment are depreciated when they are available for use.

Treatment of Repairs & Maintenance as per CAS-12

The amount to be treated in repairs and maintenance is as follows:

	Particulars	₹ Crores
A	Equipment Cost	20
B	Cost of New Spare	2
	Total Cost (A + B)	22
Less:	Depreciation for 5 years	11
	Depreciated value of Equipment & Spare	11

Particulars	₹ Crores
Reconditioning cost of old Spare	0.20
Depreciated Value of old Spare	1.00
Book Value of Reconditioned spare	1.20
Less: Current market value of reconditioned spare to be restated in the Books of Accounts	0.50
Amount to be treated in Repairs and Maintenance	0.70

Thus, the amount to be treated in repairs and maintenance is ₹ 70 lakh.

5. (a):**Reconciliation of Profit between Cost Accounts and the Financial Accounts:**

Particulars	₹	₹
Profit as per the Financial Accounts		17,73,350
Add: Trading Loss	24,250	
4/5th of Renovation Expenses Amortized	3,10,000	
CSR Contribution	<u>29,000</u>	3,63,250
Less: Profit on Sale of Assets	1,38,000	
Income from Investments	42,250	
Net over valuation of closing inventory in the financial records ₹ (32,700 – 14,800)	<u>17,900</u>	(-)1,98,150
Profit as per the Cost Accounts		19,38,450

5. (b):

A forensic audit investigation follows a systematic method starting from of planning the investigation to conviction through Court. The steps can be summarized as follows:

- **Planning the Investigation:** This initial phase involves defining the scope of the audit based on the suspected fraud, setting objectives, and mapping out the investigation strategy to meet legal standards.
- **Collecting and Analysing Evidence:**
- **Data Analysis:** Auditors use specialized techniques to identify anomalies in numerical data and computer-assisted audit tools to uncover patterns and suspicious transactions.
- **Document and Digital Forensics:** This involves examining physical documents for tampering or forgery and recovering and analysing electronic data from computers and servers to find evidence of fraudulent activity.
- **Tracing Funds:** Funds are traced to identify unauthorized transactions, discrepancies, and the full extent of the fraud.
- **Reporting Findings:** The gathered evidence and findings are meticulously documented in a clear, precise, and detailed written report. This report provides objective and credible evidence that can be understood by a judge or jury.
- **Court Appearance:** The forensic auditor is prepared to appear in court to explain their findings, present the evidence collected, and clarify the investigative methods used, acting as an expert witness.

6. (a):

Power of Search and Seizure by the Authority (Section 17 of the Prevention of Money Laundering Act, 2002):

A Director or any other officer not below the rank of Deputy Director authorised by him for the purpose of this section, on the basis of information in his possession, has reason to believe (the reason for such belief to be recorded in writing) that any person-

1. has committed any act which constitutes money-laundering or
2. is in possession of any proceeds of crime involved in Money-Laundering or
3. is in possession of any records relating to Money-Laundering
4. is in possession of any property related to crime

then, subject to the rules made in this behalf, he may authorise any officer subordinate to him to-

1. enter and search any building, place, vessel, vehicle or aircraft where he has reason to suspect that such records or proceeds of crime are kept.
2. break open the lock of any door, box, locker, safe, almirah or other receptacle for exercising the powers conferred by clause (a) where the key thereof are not available.
3. Seize any record or property found as a result of such search.
4. Place marks of identification of such record or property, if required or make or cause to be made extracts or copies therefrom.
5. Make a note or an inventory of such record or property.
6. Examine on oath any person, who is found to be in possession or control of any record or property, in respect of all matters relevant for the purpose of any investigation under this Act.

Where it is not practicable to seize such record or property, the officer authorised under sub-section (1), may make an order to freeze such property whereupon the property shall not be transferred or otherwise dealt with, except with the prior permission of the officer making such order, and a copy of such order shall be served on the person concerned:

Provided that if, at any time before its confiscation under sub-section (5) or sub-section (7) of section 8 or section 58B or sub-section (2A) of section 60, it becomes practical to seize a frozen property, the officer authorised under sub-section (1) may seize such property.

The authority, who has been authorised under sub-section (1) shall, immediately after search and seizure or upon issuance of a freezing order, forward a copy of the reasons so recorded along with material in his possession, referred to in that sub-section, to the Adjudicating Authority in a sealed envelope, in the manner, as may be prescribed and such Adjudicating Authority shall keep such reasons and material for such period, as may be prescribed.

Where an authority, upon information obtained during survey under section 16, is satisfied that any evidence shall be or is likely to be concealed or tampered with, he may, for reasons to be recorded in writing, enter and search the building or place where such evidence is located and seize that evidence:

Provided that no authorisation referred to in sub-section (1) shall be required for search under this sub-section.

The authority seizing any record or property under sub-section (1) or freezing any record or property under sub-section (1A) shall, within a period of thirty days from such seizure or freezing, as the case may be, file an application, requesting for retention of such record or property seized under sub-section (1) or for continuation of the order of freezing served under sub-section (1A), before the Adjudicating Authority.

6. (b):

Techniques of Management Audit:

Techniques employed by a management auditor in effectively discharging her/his responsibility depends on the area of review.

As for example, 'Financial performance related reviews' calls for use of 'Break Even Point'. Make or Buy, Cost rationalization, Cost Benefit Analysis, Marginal Cost and Standard Costing etc.

(i) **Accounting or economic techniques:**

- (a) Break-even analysis
- (b) Budgetary control including a flexible budget system
- (c) Cost management techniques indicating how an organisation's assets should be allocated over competing projects or to decide whether it is worth proceeding with the investment, keeping in view the proportionate vale of expenditure on such projects.
- (d) Discounted cash flow and net present value methods
- (e) Cost-benefit analysis
- (f) Standard costing and marginal costing
- (g) Activity-based costing to test the relevance of costs to activities
- (h) Quality analysis of company transactions

(ii) **Scientific techniques e.g. Linear Programming, Transportation and Assignment etc., are perused for desired income:**

- (a) Computer Models: There are many types of problems that can be solved on a computer e.g. decision on the material mix, product, mix, make or buy etc.
- (b) Network Analysis: To analyse strings of tasks to arrange them in sequential or parallel order to complete the project in the shortest possible time.
- (c) Mathematical programming for solving by heuristic (trial and error) techniques:
To determine the best material mix, best use of the organisation's transport fleet, the best mix of products to obtain, to maximize profits and optimum use of labour, finance, equipment, etc. Linear programming is usually effective when relationships vary in linear order, whereas quadratic programming may be used when the variations are in the order of the square root of some other factors.

(iii) **Statistical techniques** are in use to point out comparatives, scenario planning etc.

- (a) Activity Sampling: It is one of the many ways in which the present workloads can be measured to obtain controls to be exercised by management
- (b) Monte Carlo Simulation: In this, several variables are drawn from a large statistical population which has an equal choice of being selected and obtaining the best sample possible.
- (c) Exponential smoothing
- (d) Inter-firm comparison.

(iv) **Personnel techniques** like interviewing, Training methods are perused for manpower and the quality related assignments.

- (a) Attitude survey
- (b) Ergonomic (Man-machine relationship)
- (c) Training methods
- (d) Profitability and productivity measurement

(v) **General Techniques:**

(a) Statistical theory of management is an attempt to emphasize what should be the practical approach to a problem by-

- Analysing the problem to establish the basic difficulties and factors involved.
- Establish management by objectives
- Identifying the likely ways of tackling the problems in the light of objectives to develop a solution.
- Determine the key factors affecting management decision-making
- Evaluating alternative courses of action
- Evaluate each alternative in terms of economy, efficiency, and best fit.
- Specifying the action required to exploit the situation to the best advantage of the organisation.

- a. Brain storming
- b. Transfer pricing
- c. Management by Objectives
- d. Management by exception
- e. Corporate Planning
- f. Information theory

7. (a):

The Steps in an IT Security Audit:

(a) Define the Objectives:

Layout the goals that the auditing team aims to achieve by conducting the IT security audit. Make sure to clarify the business value of each objective so that specific goals of the audit align with the larger goals of the company.

List of questions as a starting point for brainstorming and refining of objectives for the audit:

- Which systems and services do you want to test and evaluate?
- Do audit digit IT infrastructure, physical equipment, and facilities, or both?
- Is disaster recovery on the list of concerns? What specific risks are involved?
- Does audit need to be geared towards proving compliance with a particular regulation?

(b) Plan the audit:

A thoughtful and well-organised plan is crucial to success in an IT security audit.

Define the roles and responsibilities of the management team and the IT system administrators assigned to perform the auditing tasks, as well as the schedule and methodology for the process. Identify, monitor, report, and data classification tools that the team will use and any logistical issues they may face, like taking equipment offline for evaluation.

Once decided on all the details, document and circulate the plan to ensure that all staff members have a common understanding of the process before the audit begins.

(c) Perform the Auditing Work:

The auditing team should conduct the audit according to the plan and methodologies agreed upon during the planning phase. This will typically include running scans on IT resources like file-sharing services, database servers, and SaaS application like Office 365 to assess network security, data access

levels, user access rights, and other system configurations. Also physically inspect the data centre for resilience to fires, floods, and power surges as part of a disaster recovery evaluation.

During this process, interview employees outside the IT team to assess their knowledge of security concerns and adherence to company security policy, so any holes in the company's security procedures can be addressed moving forward.

(d) Report the Results:

Complete audit-related documentation into a formal report that can be given to management, stakeholders or the regulatory agency. The report should include a list of any security risks and vulnerabilities detected in IT systems, as well as actions that IT staff recommend to mitigate them.

(e) Take Necessary Action:

Follow through with the recommendations outlined in the audit report. Examples of security enhancement actions can include:

- Performing remediation procedures to fix a specific security flaw or weak spot/s.
- Training employees in data security compliance and security awareness.
- Adopting additional best practices for handling sensitive data and recognizing signs of malware and phishing attacks.
- Acquiring new technologies to strengthen existing systems and regularly monitor infrastructure for security risk.

7. (b):

Benefits of Environmental Auditing:

By constructive environmental auditing, the following benefits can be derived:

- (i) **Improves efficiency of Environmental Management System (EMS):** Environmental auditing encourages an organisation to examine its operations constructively towards an effective EMS. It helps in assessing the performance of the EMS, identify deficiencies in the system, and provides the basis for environmental improvement plans. Based on the findings and recommendations of the environmental audit, management can take corrective actions.
- (ii) **Compliance with environmental laws and standards:** Status of adherence w.r.t environment rules and regulations can be monitored for upgrading governance process. Non-compliance may also lead to 'reputational risk'. The most important benefit of an environmental audit is that it ensures cost-effective compliance with environmental laws and regulations, industry guidelines and standards, and the company's environmental policies.
- (iii) **Risk Mitigation:** There is a growing belief that environmental issues represent a source of risk in terms of unforeseen or foreseen reputational damage or similar other risks. It is the concern regarding environmental risks which has led to the development of the field of environmental auditing. An environmental audit can act as an effective risk management tool for assessing compliance with environmental legislation, thereby, assisting the company in avoiding the related risks.
- (iv) **Meeting stakeholders' expectations:** Multiple stakeholders having varied interest and 'wish list'. Stakeholders have heightened expectations for a company's environmental performance. They are concerned about environmental responsibilities and protection of their interest. Conducting

environmental audits will help in reassuring various stakeholders, enhancement of reputation of the company as a good corporate citizen, which indicates better stakeholder management.

- (v) **Cost and environmental benefits, reduction in operational inefficiencies:** Environmental auditing can highlight areas of improvement by recommending cost effective solutions for environmental issues e.g. Water Treatment Plant, Solid Waste Handling Equipment, usage of AFR etc. By identifying operational inefficiencies, a company may be able to reduce its cost and/or improve its environmental performance.
- (vi) **Linking operating processes and environmental impacts:** Aligning operating processes with environmental related compliances and desired environmental improvement scope, not only enhances awareness among rank and file, also leads to better sustainability. By pinpointing both strengths and weaknesses in the environmental management and other operating systems relating to the environment regularly, an environmental audit encourages audit, encourages continual improvement.
- (vii) **Compliance with certification requirements:** Conducting an environmental audit can be an important step towards gaining companywide certifications like ISO 14001 or cradle to grave or product-specific certification from organisations like Energy Star, LEED, the Forest Stewardship Council, Chlorine Free Products Associations, etc.
- (viii) **Increases Employees' awareness of corporate environmental policy and responsibility:** Environmental audit demonstrates company's commitment to environmental protection. This in turn increases overall awareness of workers w.r.t. potential health hazards, risks and other needs.
- (ix) **Assists management in decision making:** Environmental Audit Reports can be perused by Management as tool for taking decisions on Investment, managing stakeholder expectations etc. Environmental Audit provides an environmental database to assist management decisions, competitive advantage by raising corporate profile concerning environmental issues, obtaining various accreditation. e.g. ISO 14001.

8. (a):

An internal control questionnaire on inventory should raise questions that evaluate controls over the entire inventory lifecycle:

Control Environment & Policies:

- Is there a formal inventory management policy document and communicated to all concerned?
- Is there a system of reviewing reports on inventory turnover, aging, and adjustments?

Safeguarding of Physical Inventory:

- Is inventory stored in a designated, secured area protected from fire, theft, water, pests?
- Is inventory periodically verified and properly insured?

Purchasing and Receiving:

- Are purchase requisitions authorized by competent staff and follow ABC system of control?
- Are bills received checked against rates, taxes, shortages, defectives, etc.?
- Are goods frequently inspected upon receipt?

Record Keeping and Adjustments:

- Are perpetual inventory records maintained (for raw materials, work-in-progress, and finished goods)?
- Are inventory valuation methods consistent and appropriate and write-downs for obsolete or damaged inventory properly handled?

Audit Guidance:

- Are services of Auditors solicited to gather information about the design and operation of controls.
- Are suggestions for Improvement leading to stronger controls adhered to?

8. (b):

The important points to be considered in receipt and payment verification while conducting audit of Hotels are as follows:

- (a) Consumptions shown in various physical stock accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.
- (b) All payments to the foreign collaborator, if any, are to be checked. Agency commission agreements and spent validation payment made to Brand Owner as per arrangement.
- (c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.
- (d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, and special shows, marriage parties etc. should be verified with bookings and the arrangements made.
- (e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.
- (f) The occupancy rate should be worked out, and collection made against the same. Benching of rates with other similar hotels and same quality of services, and with previous year. Material deviations should be investigated.
- (g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.
- (h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.
- (i) Apart from control over stock of edibles, control over issue and physical stock of linen, crockery, cutlery, glassware, silver, toilet items, etc. should be verified.
- (j) The auditor should verify the restaurant bills with reference to KOT (Kitchen Order Ticket).
- (k) The auditor should ensure that all taxes have been included in the client's bills.
- (l) Computation and payment of salaries and wages vis-a-vis number of employees must be checked.