

Paper-6: COMMERCIAL AND INDUSTRIAL LAWS AND AUDITING

Full Marks: 100

Time Allowed: 3 Hours

The figures in the margin on the right side indicate full marks.

- Please: (i) Answer all bits of a question at one place
(ii) Open a new page for answer to a new question
(iii) Attempt the required number of question only.

Answer Question No. 1 and Question No. 5 which are compulsory and attempt any two from the rest in Section-I and any two from the rest in Section-II.

Section-I
(50 Marks)
(Commercial and Industrial Laws)

Question 1: Answer all questions

[2 X 7 = 14]

(i) H lends a sum of ₹15,000 to D, on the security of two shares of a Limited Company on 1st April 2011. On 15th September, 2011, the company issued two bonus shares. D returns the loan amount of ₹15,000 with interest but H returns only two shares which were pledged and refuses to give the two bonus shares. Advise D in the light of the provisions of the Indian Contract Act, 1872.

(ii) Mr. D of RB Textile Ltd. enters into a contract with RS Garments Show Room for supply of 1,000 pieces of Cotton Shirts at ₹300 per shirt to be supplied on or before 31st December, 2011. However, on 1st November, 2011 RB Textiles Ltd informs the RS Garments Show Room that he is not willing to supply the goods as the price of Cotton shirts in the meantime has gone up to ₹350 per shirt. Examine the rights of the Retail Garments Show Room in this regard.

(iii) B holds agricultural land on a lease granted by A, the owner. The land revenue payable by A to the Government being in arrear, his land is advertised for sale by the Government. Under the Revenue law, the consequence of such sale will be termination of B's lease. B, in order to prevent the sale and the consequent termination of his own lease, pays the Government, the sum due from A. Referring to the provisions of the Indian Contract Act, 1872 decide whether A is liable to make good to B, the amount so paid?

(iv) G's goods were seized by Custom Authorities. Whether this is bailment under Indian Contract Act, 1872?

(v) In an agreement between P and Q, there is a condition that they will not institute legal proceeding against each other without consent. Is the contract valid or void?

(vi) R sent a consignment of goods worth ₹ 160,000 by railway and got railway receipt. He obtained an advance of ₹80,000 from the bank and endorsed and delivered the railway receipt in favour of the bank by way of security. The railway failed to deliver the goods at the destination. The bank filed a suit against the railway for ₹ 160,000. Decide in the light of provisions of the Indian Contract Act, 1872, whether the bank would succeed in the said suit?

(vii) What is the permissible limit of deductions from wages under the Payment of Wages Act, 1936.

Answer:

(i) As per provisions of Section 163(4) of the Indian Contract Act, 1872, "in the absence of any contract to the contrary, the bailee is bound to deliver to the bailor, any increase or profit which may have accrued from the goods bailed."

Applying the provisions to the given case, the bonus shares are an increase on the shares pledged by D to H. So H is liable to return the shares along with the bonus shares and hence D the bailor, is entitled to them also.

(ii) In the given problem RB Textiles Ltd has indicated its unwillingness to supply the cotton shirts on 1st November 2011 itself when it has time upto 31st December 2011 for performance of the contract of supply of goods. It is therefore called anticipatory breach of contract. Thus RS Garments show room can claim damages from RB Textiles Ltd immediately after 1st November, 2011, without waiting upto 31st December 2011. The damages will be calculated at the rate of ₹50 per shirt i.e. the difference between ₹350 (the price prevailing on 1st November) and ₹ 300 the contracted price.

(iii) Yes, A is bound to make good to B the amount so paid. Section 69 of the Indian Contract Act, 1872, provides that "A person, who is interested in the payment of money which another is bound by law to pay, and who therefore pays it, is entitled to be reimbursed by the other. In the given case has made the payment of lawful dues of A in which B had an interest. Therefore, B is entitled to get the reimbursement from A.

(iv) Yes, the possession of the goods is transferred to the custom authorities. Therefore bailment exists and section 148 of Contract Act, 1872 is applicable.

(v) An agreement in restraint of legal proceedings is void as per Section 28 of the Indian Contract Act, 1872. Hence the agreement between P and Q would be void.

(vi) As per Sections 178 and 178A of the Indian Contract Act, 1872 the deposit of title deeds with the bank as security against an advance constitutes a pledge. As a pledge, a banker's rights are not limited to his interest in the goods pledged. In case of injury to the goods or their deprivation by a third party, the pledgee would have all such remedies that the owner of the goods would have against them. In *Morvi Mercantile Bank Ltd. vs. Union of India*, the Supreme Court held that the bank (pledgee) was entitled to recover not only the amount of the advance due to it, but the full value of the consignment. However, the amount over and above his interest is to be held by him in trust for the pledgor. Thus, the bank will succeed in this claim of ₹ 160,000 against Railway.

(vii) The total amount of deductions which may be made in a wage period u/s 7(2) from the wages of any employed person should not exceed 75% of wages earned if such deductions are made wholly or partly for payment to co-operative societies under Sec.7(2)(j). In any other case, the total deductions should not exceed 50% of total wages earned during the wage period [Sec.7 (3)]. Where total deductions authorized under Sec.7 (2) exceeds 75% or 50% as the case may be, the excess may be recovered in such a manner as prescribed [Provisio to Sec. 7(3)].

Question 2:

(i) **What is meant by Anticipatory Breach of Contract?**

(ii) **What is meant by 'Undue Influence'?**

(iii) State the circumstances where under an agent is personally liable to a third party for the acts during the course of agency?

(iv) When a contract need not be performed?

(v) A sold his car to B for ₹175,000. After inspection and satisfaction, B paid ₹87,500 and took possession of the car and promised to pay the remaining amount within a month. Later on A refuses to give the remaining amount on the ground that the car was not in a good condition. Advise A as to what remedy is available to him against B.

(vi) K the owner of a Fiat car wants to sell his car. For this purpose he hands over the car to M, a mercantile agent for sale at a price not less than ₹100, 000. The agent sells the car for ₹75,000 to B, who buys the car in good faith and without notice of any fraud. M misappropriated the money also. K sues B to recover the Car. Decide given reasons whether K would succeed.

[2+4+4+2+3+3 = 18]

Answer:

(i) Anticipatory breach of contract occurs when the promisor refuses altogether to perform his promise and signifies his unwillingness even before the time for performance has arrived. In such a situation the promisee can claim compensation by way of loss or damage caused to him by the refusal of the promisor. For this, the promisee need not wait till the time stipulated in the contract for fulfillment of the promise by the promisor is over.

(ii) Section 16 of the Indian Contract Act, 1872, states that a contract is said to be induced by undue influence where the relations subsisting between the parties are such that the parties are in a position to dominate the will of the other and used that position to obtain an unfair advantage over the other.

A person is deemed to be in that position:

- 1.** where he holds real or apparent authority over the other or stands in a fiduciary relation to him;
- 2.** where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of old age, illness or mental or bodily distress.
- 3.** where a man who is in position to dominate the will of the other enters into contract with him and the transaction appears to be unconscionable, the burden of proving that it is fair, is on him, who is in such a position.

When one of the parties who has obtained the benefits of a transaction is in a position to dominate the will of the other, and the transaction between the parties appears to be unconscionable, the law raises a presumption of undue influence [section 16(3)]. Every transaction where the terms are to the disadvantage of one of the parties need not necessarily be considered to be unconscionable. If the contract is to the advantage of one of the parties but the same has been made in the ordinary course of business the presumption of undue influence would not be raised.

(iii) Under the following circumstances an agent is personally liable.

- 1.** When he represents that he has authority to act on behalf of his principal, but who does not actually possess such authority or who has exceeded that authority and the alleged

employer does not ratify his acts. Any loss sustained by a third party by the acts of such a person (agent) and who relies upon the representation is to be made good by such an agent.

2. Where a contract is entered into by a person apparently in the character of agent, but in reality on his own account, he is not entitled to required performance of it.
3. Where the contract expressly provides for the personal liability of the agent.
4. When the agent signs a negotiable instrument in his own name without making it clear that he is signing as an agent.
5. Where the agent acts for a principal who cannot be sued on account of his being a foreign Sovereign, Ambassador, etc.
6. Where the agent works for a foreign principal.
7. Where a Government Servant enters into a contract on behalf of the Union of India in disregard of Article 299 (1) of the Constitution of India, In such a case the suit against the agent can be instituted by the third party only and not by the principal (Chatturbhuj v. Moheshwar).
8. Where according to the usage of trade in certain kinds of business, agents are personally liable.
9. Where his authority is coupled with interest, he can be sued only to the extent of his interest in the subject matter

(iv) A contract need not be performed under following circumstances:

1. When performance becomes impossible.
2. When parties to contract agree to substitute it with a new one or rescind it or alter it. (Sec. 6)
3. When the promisee waives or remits the performance of promise made to him, wholly or in part or extends the time of performance or accepts any other satisfaction for it. (Sec.63)
4. When a person at whose option it is voidable, rescinds it (Sec. 64)
5. When the promisee refuses or neglects to provide reasonable facilities to the promisor for performance of the promise. (Sec.67)
6. When the contract is illegal.

(v) As per the section 55 of the Sale of Goods Act, 1930 an unpaid seller has a right to institute a suit for price against the buyer personally. The said Section lays down that—

Where under a contract of sale the property in the goods has passed to buyer and the buyer wrongfully neglects or refuses to pay for the goods, the seller may sue him for the price of the goods [Section 55(1)].

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Where under a contract of sale the price is payable on a certain day irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price. It makes no difference even if the property in the goods has not passed and the goods have not been appropriated to the contract [Section 55(2)].

This problem is based on above provisions. Hence, A will succeed against B for recovery of the remaining amount. Apart from this A is also entitled to:

1. Interest on the remaining amount.
2. Interest during the pendency of the suit.
3. Costs of the proceedings

(vi) The problem in this case is based on the provisions of the Sale of Goods Act, 1930 contained in the proviso to Section 27. The proviso provides that a mercantile agent is one who in the customary course of his business, has, as such agent, authority either to sell goods, or to consign goods, for the purpose of sale, or to buy goods, or to raise money on the security of goods [Section 2(9)]. The buyer of goods from a mercantile agent, who has no authority from the principal to sell, gets a good title to the goods if the following conditions are satisfied:

1. The agent should be in possession of the goods or documents of title to the goods with the consent of the owner.
2. The agent should sell the goods while acting in the ordinary course of business of a mercantile agent.
3. The buyer should act in good faith.
4. The buyer should not have at the time of the contract of sale notice that the agent has no authority to sell.

In the instant case, M, the agent, was in the possession of the car with K's consent for the purpose of sale. B, the buyer, therefore obtained a good title to the car. Hence, K in this case, cannot recover the car from B. A similar decision, in analogous circumstances, was taken in *Folkes vs. King*.

Question 3:

(i) Fortunate Ltd. was running in continuous losses for 7 years. As a result, the company's financial position worsened. The company declared lay-off of 25 of its employees. The employees protested the lay-off. Is this action of employer justified?

(ii) An electrician, who had to go frequently to a heating room from a cooling plant, contracted pneumonia which resulted in his death. Is the employer liable to pay compensation under the Employees Compensation Act, 1923?

(iii) F failed to give details of travelling expenses on account of tour inspite of several reminders. His company deducted the amount of tour advance from F's salary after expiry of 3 months. Is the company justified under the Payment of Wages Act, 1936?

(iv) X, an out worker prepared goods at his residence and later on supplied these goods to the M/s ABC . Is he an employee under the Minimum Wages Act, 1948?

(v) Y, on retirement withdrew the entire amount of his accumulation in the provident fund. Later on, he was re-appointed for a fixed tenure. The PF Inspector claimed contribution in respect of salary paid to Y. Is the demand made by PF Inspector tenable in law under The Employees 'Provident Funds and Miscellaneous Provisions Act, 1952?

(vi) What are the consequences of “destruction of goods” under the Sale of Goods Act, 1930, where the goods have been destroyed after the agreement to sell but before the sale is affected.

(vii) G absented himself from duty without applying for leave and left the job. When he claimed gratuity, the company refused to pay gratuity quoting his absence from duty without proper leave resulted in break in service. Will he get gratuity?

[3+2+2+3+2+3+3 = 18]

Answer:

(i) As per section 2(kkk) of the Industrial Dispute Act lay-off - means failure, refusal or inability of an employer to give employment to a workman (a) whose name is borne on the muster –rolls of his industrial establishment, and (b) who has not been retrenched. The failure, refusal or inability of an employer to give employment may be due to-

1. shortage of coal, power, or raw materials,
2. the accumulation of stocks
3. breakdown of machinery
4. natural calamity or any other connected reasons.

In the given problem, because of continuous losses, the company's financial position worsened. The company declared lay-off of 25 of its employees. The words 'for any other reason' used in the definition is analogous to the reasons given in the definition. But the cause stated by the company is not covered under the definition. As such, the action of the employer is not justified. Similar observation was made in J. K Hosiery vs. LAT of India.

(ii) According to Section 3 of the Employees Compensation Act, 1923 , employer is liable to pay compensation if personal injury is caused in course of employment. The course of employment is not interrupted by intervals of rest.

In the given problem, an employee had to frequently go into a heating room and from there to a cooling room in course of his duties. He suffered pneumonia and died. This is out of employment and employer is liable to pay compensation. [Indian News Chronicle Ltd. vs Lazarus(1951) 3 FJR 190]

(iii) According to Sec. 7(2) f and Sec . 12 of the Payment of Wages Act, 1936 no recovery can be made of such advances given for travelling expenses. The recovery of such advance is governed by rules made by appropriate Government in this regard. So the company on its own cannot make such recovery.

(iv) As per section 2(i) of the Minimum Wages Act, 1948 an “employee” means any person who is employed for hire or reward to do any work, skilled or unskilled, manual or clerical, in a scheduled employment in respect of which minimum rates of wages have been fixed; and includes an out- worker to whom any articles or materials are given out by another person to be made up, cleaned, washed, altered, ornamented, finished, repaired, adapted or otherwise processed for sale for the purposes of the trade or business of that other person where the process is to be carried out either in the home of the out- worker or in some other premises not being premises under the control and management of that other person; and also includes an employee declared to be an employee by the appropriate Government; but does not include any member of the Armed Forces of the 2 [Union].

So X is an employee under the Minimum Wages Act, 1948.

(v) An employee who has been member of PF, withdrew the full amount of his accumulations is an 'excluded employee.' However, once he is reappointed in connection with work of the company, he attracts definition of 'employee' and the Act becomes applicable to him afresh. In *Harrison Malayalam Ltd. and Ors vs. RPFC & Ors.* (CAL H.C) 2001 I LLJ 1160, the company was held liable to cover an employee who took VRS and later appointed for a lump sum basis. Thus the demand made by authorities is tenable.

(vi) Destruction of Goods-Consequences:

1. In accordance with the provisions of the Sale of Goods Act, 1930 as contained in Section 7, a contract for the sale of specific goods is void if at the time when the contract was made; the goods without the knowledge of the seller, perished or become so damaged as no longer to answer to their description in the contract, then the contract is void ab initio. This section is based on the rule that where both the parties to a contract are under a mistake as to a matter of fact essential to a contract, the contract is void.

2. In a similar way Section 8 provides that an agreement to sell specific goods becomes void if subsequently the goods, without any fault on the part of the seller or buyer, perish or become so damaged as no longer to answer to their description in agreement before the risk passes to the buyer. This rule is also based on the ground of impossibility of performance as stated above.

It may, however, be noted that section 7 & 8 apply only to specific goods and not to unascertained goods. If the agreement is to sell a certain quantity of unascertained goods, the perishing of even the whole quantity of such goods in the possession of the seller will not relieve him of his obligation to deliver the goods.

(vii) Section 2A of the Payment of Gratuity Act, 1972 provides that an employee shall be said to be in continuous service for a period if he has, for that period, been in uninterrupted service, including service which may be interrupted on account of sickness, accident, leave, absence from duty without leave (not being absence in respect of which an order 3 [treating the absence as break in service has been passed in accordance with the standing orders, rules or regulations governing the employees of the establishment), lay-off, strike or a lock-out or cessation of work not due to any fault of the employee, whether such uninterrupted or interrupted service was rendered before or after the commencement of this Act.

Therefore G is eligible and will get Gratuity.

Question 4:

(i) Explain the term 'Arbitration' for resolution of industrial dispute under the Industrial Dispute Act, 1947.

(ii) What is the procedure of fixing minimum wages under the Minimum Wages Act, 1948?

(iii) S delivered his car to M for repairs. M completed the work, but did not return the car to S within reasonable time, though S repeatedly reminded M for the return of car. In the meantime a big fire occurred in the neighborhood and the car was destroyed. Decide whether M can be held liable under the provisions of the Indian Contract Act. 1872.

(iv) Explain the term 'designated partners' under LLP Act, 2008.

[5+5+2+6 = 18]

Answer:

(i) Arbitration:

A process in which a neutral third party listens to the disputing parties, gathers information about the dispute, and then takes a decision which is binding on both the parties. The conciliator simply assists the parties to come to a settlement, whereas the arbitrator listens to both the parties and then gives his judgement.

Advantages of Arbitration:

- It is established by the parties themselves and therefore both parties have good faith in the arbitration process.
- The process is informal and flexible in nature.
- It is based on mutual consent of the parties and therefore helps in building healthy Industrial Relations.

Disadvantages:

- Delay often occurs in settlement of disputes.
- Arbitration is an expensive procedure and the expenses are to be shared by the labour and the management.
- Judgment can become arbitrary when the arbitrator is incompetent or biased.

There are two types of arbitration:

Voluntary Arbitration:

In voluntary arbitration the arbitrator is appointed by both the parties through mutual consent and the arbitrator acts only when the dispute is referred to him.

Compulsory Arbitration:

Implies that the parties are required to refer the dispute to the arbitrator whether they like him or not. Usually, when the parties fail to arrive at a settlement voluntarily, or when there is some other strong reason, the appropriate government can force the parties to refer the dispute to an arbitrator.

(ii) Section 5 of the Minimum Wages Act, 1948 provides for fixing and revising minimum wages under the minimum wages which states that—

1. In fixing minimum rates of wages in respect of any scheduled employment for the first time under this Act or in revising minimum rates of wages so fixed the appropriate government shall either—
 - A. appoint as many committees and sub-committees as it considers necessary to hold enquiries and advise it in respect of such fixation or revision as the case may be, or
 - B. by notification in the Official Gazette, publish its proposals for the information of persons likely to be affected thereby and specify a date not less than two months from the date of the notification on which the proposals will be taken into consideration.

2. After considering the advice of the committee or committee appointed under clause (a) of sub-section (1) or as the case may be, all representations received by it before the date specified in the notification under clause (b) of that sub-section, the appropriate government shall by notification in the Official Gazette, fix or as the case may be revise the minimum rates of wages in respect of each scheduled employment and unless such notification otherwise provides it shall come into force on the expiry of three months from the date of its issue :

Provided that where the appropriate government proposes to revise the minimum rates of wages by the mode specified in clause (b) of sub-section (1) the appropriate government shall consult the Advisory Board also.

(iii) The problem asked in the question is based on the provisions of section 160 and 161 of the Indian Contract Act 1872. Accordingly, it is the duty of the bailee to return or deliver the goods bailed according to the bailor's directions, without demand, as soon as the time for which they were bailed has expired, or the purpose for which they were bailed for any loss, destruction of the goods from that time (Section 161), notwithstanding the exercise of reasonable care on his part.

Therefore, applying the above provisions in the given case, Mahesh is liable for the loss, although he was not negligent, but because of his failure to deliver the car within a reasonable time (Shaw & Co. v. Symmons & Sons).

(iv) The term, "Designated partners" is defined in Section 7 of LLP Act, 2008.

1. Every limited liability partnership shall have at least two designated partners who are individuals and at least one of them shall be a resident in India :

Provided that in case of a limited liability partnership in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such bodies corporate shall act as designated partners.

Explanation:

For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less than one hundred and eighty-two days during the immediately preceding one year.

2. Subject to the provisions of sub-section (1),—

(i) if the incorporation document—

- specifies who are to be designated partners, such persons shall be designated partners on incorporation; or
- states that each of the partners from time to time of limited liability partnership is to be designated partner, every partner shall be a designated partner;

(ii) any partner may become a designated partner by and in accordance with the limited liability partnership agreement and a partner may cease to be a designated partner in accordance with limited liability partnership agreement.

3. An individual shall not become a designated partner in any limited liability partnership unless he has given his prior consent to act as such to the limited liability partnership in such form and manner as may be prescribed.

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4. Every limited liability partnership shall file with the registrar the particulars of every individual who has given his consent to act as designated partner in such form and manner as may be prescribed within thirty days of his appointment.
5. An individual eligible to be a designated partner shall satisfy such conditions and requirements as may be prescribed.
6. Every designated partner of a limited liability partnership shall obtain a Designated Partner Identification Number (DPIN) from the Central Government and the provisions of sections 266A to 266G (both inclusive) of the Companies Act, 1956 shall apply mutatis mutandis for the said purpose.

Section-II (50 Marks) (Auditing)

Question 5: Answer all questions

[2 X 7 = 14]

Comment on the following:

- (i) Foreign branch of a company can be audited only by an auditor of that country.**
- (ii) Sec 292A of the Companies Act, 1956 lays down auditor's duty as a member of Audit Committee.**
- (iii) The scope of verification is much wider than that of vouching.**
- (iv) The auditor can rely on work of an expert of valuation of assets.**
- (v) As per Indian GAAP, where the company has obtained credit limits from a bank but has not availed them, the details of unused credit lines need not be disclosed in the financial statements.**
- (vi) The Cost Auditor of a company cannot function as an internal auditor of the same company.**
- (vii) The system of propriety audit is applied in respect of all public limited companies.**

Answer:

- (i) The statement is false. As per Section 228(1) of the Companies Act, 1956, where a company has branch office, the accounts of that office shall be audited by the company's auditor appointed under section 224 or by a person qualified for appointment as auditor of the company under section 226. Where the branch office is situated in a country outside India, any of the above or an Accountant qualified to act as auditor in the country concerned can be appointed as branch auditor.**

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(ii) The statement is false. Auditor is not a member of the Audit Committee constituted under section 292A of the Companies Act, 1956 and has no right to vote. However, he shall attend and participate at the meetings of the Audit Committee.

(iii) The statement is true. Vouching enable the auditor to know whether the transactions are genuine and valid to enable the auditor to report on the financial statements with reference to relevant documentary evidence. Vouching is the substantive testing/examination of transaction at their point of origin. On other hand, verification process encompasses the inquiry into the ownership/ title, existence, valuation, completeness and presentation of assets and liabilities in the balance sheet. Verification usually deals with the final balance in the Final Accounts viz the balance sheet and profit and loss account.

(iv) The statement is true. Valuation is the duty of management and the auditor can rely of certificate issued by an authorized valuer as to valuation of assets in the balance sheet.

(v) The statement is true. Only the current portion of the debt or whatever is the amount which is outstanding on the date of the preparation of the financial statement is to be disclosed. There is no requirement as to disclosure of unused limits.

(vi) The statement is true. The Cost Auditor is required to comment on the scope and performance of the internal audit as per the provisions of the Cost Audit (Report) Rules, 2011. If the Cost Auditor also functions as internal auditor, he will not be able to discharge his duties in proper and dispassionate manner.

(vii) The statement is false. The term 'propriety' has been defined by Kholler as " that which meets the tests of public interest , commonly accepted customs and standards of conduct and particularly as applied to professional performance, requirements of Government regulations , and professional codes." The system of propriety audit is applied in respect to Government companies and Government departments because public money and public interest are involved therein.

In case of non-government companies, the auditor has to comment upon some of the propriety aspects in the transactions of the companies, for example under CARO 2003 pursuant to section 227 of Companies Act. Otherwise, nongovernment company auditors do not conduct propriety audit unlike in case of Government Companies.

Question 6:

(i) The Directors of KBK Ltd. proposes to transfer unclaimed dividend to Profit and Loss Account. The auditor can agree with management over this as dividend is declared out of profit.

(ii) Discuss the principles, which are useful in assessing the reliability of audit evidence.

(iii) What are the risks associated with going concern assumptions which the auditor should consider judging appropriateness underlying the preparation of financial statements?

(iv) As an auditor, how will you vouch and/or verify, 'Sale proceeds of Scrap Material.'

[4+4+5+5 = 18]

Answer:

(i) The statement is false. If any amount of dividend is not claimed within a period of 30 days from the date of declaration of dividend, the company is required to transfer the total amount

of unclaimed dividend to a special account in a scheduled bank called "Unpaid dividend Account of _____ Company Ltd or Pvt Ltd." within seven days from the date of expiry of thirty days.

If any amount remains unclaimed for a period of seven years from the date of such transfer, then amount shall be transferred to the Investor Education and Protection Fund.

The Ministry of Corporate Affairs has issued a Circular, notified in the Gazette of India G.S.R. 352(E) dated May 10, 2012, notifying the Rule "Investor Education and Protection Fund (Uploading of information regarding unpaid and unclaimed amounts lying with Companies) Rules, 2012". As per this Rule, companies have to identify and upload details of unclaimed dividend on their website.

(ii) Audit evidence refers to any information, verbal or written, obtained by the auditor on which he bases his opinion on financial statements.

The audit evidence may be of varied nature and can assume various forms. For example, a signature on the voucher of a designated official, the payee's receipt, etc. Even the information obtained by the auditor by discussing with the officials of the company also constitutes audit evidence.

The reliability of audit evidence depends on its source- internal or external, and on its nature - visual, documentary, or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence:

- External evidence (e.g. confirmation received from third party) is usually more reliable than internal evidence.
- Internal evidence is more reliable when related internal control is satisfactory.
- Evidence in the form of documents and written representations is usually more reliable than oral representations.
- Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

(iii) An auditor's report helps to establish the credibility of financial statements, it does not a guarantee as to the future viability of the entity.

An entity's continuance as a going concern for the near future, generally around one year after the balance sheet date is assumed in the preparation of financial statement in the absence of any information to the contrary.

However, the auditor should consider the risk that the going concern assumption may no longer be appropriate. Examples of indications of risks that the continuance as a going concern may be questionable are:

1. Financial Indications:

- Negative net worth or negative working capital.
- Substantial operating losses, and negative cash flows from operations.
- Adverse key financial ratios.
- Excess short-term borrowings to finance long-term assets.
- Arrears of dividend.
- Increase of creditors, and inability to pay them on due dates.
- Inability to repay the long-term loans on maturity.

- Entering into a scheme of arrangement with creditors for reduction of liability.
- 2. Operating Indications:
 - Loss of key management personnel without replacement.
 - Shortage of important supplies.
 - Loss of major market.
 - Industrial unrest.
- 3. Other Indications:
 - Non compliance with statutory requirements.
 - Sickness of entity under any statutory definition.
 - Changes in laws or any government policy, adversely affecting the working of the entity.
 - Pending legal proceedings against the entity, which will adversely affect the entity.

(iv) Sale Proceeds of Scrap Material:

- Review the internal control on scrap materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.
- Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of scrap materials.
- Review the production and cost records for determination of the extent of scrap materials that may arise in a given period.
- Compare the income from the sale of scrap materials with the corresponding figures of the preceding three years.
- Check the rates at which different types of scrap materials have been sold and compare the same with the rates that prevailed in the preceding year.
- See that scrap materials sold have been billed and check the calculations on the invoices.
- Ensure that there exists a proper procedure to identify the scrap material and good quality material is not mixed up with it.
- Make an overall assessment of the value of the realisation from the sale of scrap materials as to its reasonableness.

Question 7:

As an auditor, comment on the following situations:

(i) The method of depreciation on plant and machinery is to be changed from SLM basis to WDV basis from the current year.

(ii) The management tells you that WIP is not valued since it is difficult to know the same in view of multiple processes involved and in any case opening and closing WIP would be more or less the same.

Answer to MTP_Intermediate_Syllabus 2008_Dec 2014_Set 2

(iii) A company had a branch office, which recorded a turnover of ₹1,89,800 in the earlier year. The auditor's report of the earlier year had no reference regarding the branch although; the branch audit had not been carried out by the statutory auditor.

(iv) 'At the AGM of ABC Ltd., Mr Y was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry.

State, how the new auditor will be appointed by ABC Ltd.

[4+4+4+6 = 18]

Answer:

(i) Normally, the method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if:

1. The adoption of the new method is required by statute; (or)
2. For compliance with an accounting standard; (or)
3. It is considered that the change would result in a more appropriate presentation or presentation of financial statements of the enterprise.

Therefore, the auditor must ensure that the change in method of depreciation on plant and machinery from SLM to WDV basis from the current year is made in accordance therewith. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. Further, it should be ensured that the deficiency (since change is from SLM to WDV) arising to be adjusted in the year of change by way of a charge to the profit and loss account. He may also ascertain that the change in the method and the effect thereof on the profits of the entity is quantified and disclosed. If it is not done by the management, the auditor has to bring it to the notice of the shareholders through qualification in the audit report.

(ii) AS 2 deals with the principles and methods for determining the value at which inventories should be carried in the financial statements. Thus, items hold in the process of production is included in the definition of inventory.

In the given case, the management should have determined the stage of completion of the production and valued the work in process accordingly.

Work in Process (WIP) is normally, valued by taking the basic cost of materials, labour and proportionate factory overhead incurred upto the stage of completion. In view of the above, the argument that the value of opening and closing WIP is more or less same is not tenable as the cost of material, labour and overhead might be different and accordingly, arriving at the different valuation of opening and closing WIP is possible.

Moreover, WIP being a part of opening and closing stock, it needs to be shown in Profit and Loss A/c and carried as current assets in the balance sheet as per valuation.

Thus, if WIP is not valued, the auditor should qualify the report.

(iii) Under Section 228(4) of the Companies Act, 1956, the Central Government has formulated Companies (Branch Audit Exemption) Rules, 1961 to exempt any branch office of a company from being audited having regard to quantum of activity.

These Rules require that, if during the said financial year, the average quantum of activity of the branch does not exceed ₹2 lakhs or 2% of the average of total turnover and the earnings from other sources of the company as a whole, whichever is higher, the said branch is exempted.

In the case under review, the turnover is below ₹ 2 lakhs and other information has not been furnished. Accordingly, it may be presumed, exemption may have been granted but still it is necessary that the fact must be mentioned in the audit report.

Since, reference to branch is called for in the auditor's report even if the same has been exempted by the Central Government, the auditor remains responsible. The auditor has, however, no responsibility in respect of the audit of earlier period accounts.

(iv) Section 224(6) of the Companies Act, 1956 deal with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instance case, Mr Y has been validly appointed and thereafter he had resigned.

Thus a casual vacancy had been created on account of resignation. The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case); the Board cannot fill in that vacancy. The company in a general meeting can only fill the same.

Thus, in this case ABC Ltd will have to call an extra -ordinary general meeting (EGM) and appoint another auditor. The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

The provisions of the Companies Act, 1956 applicable for the appointment of an auditor in place of a retiring auditor would equally applicable in the instant case are given below:

1. Section 225(1): Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor.
2. Section 190(2): Special notice is to be sent to all members of the company at least 7 days before the date of the AGM.
3. Section 225(2): On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
4. Section 225(3): Representation if any, received from the retiring auditor should be sent to the members of the company.
5. Section 224A: Special resolution as required under this section should be duly passed.
6. Section 224(1B): Before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate is to be obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in Section 224(1B).
7. The incoming auditor should also satisfy himself that the notice provided for under Sections 224 and 225 has been effectively served on the outgoing auditor.

Question 8:

(i) Explain the 'Management Audit' process.

(ii) Write a short note on- Permanent Audit File.

(iii) In determining whether to use Computer Assisted Auditing Techniques (CAATs), what are the factors that an auditor has to consider?

(iv) What do you understand by internal checks?

(v) Assets purchased under hire-purchase system were reflected at their full value and the outstanding installments payable have been included under Sundry Creditors.

[4+4+4+4+2 = 18]

Answer:

(i) The management audit process may be summed up as follows:

1. Agreeing the parameters:

In consultation with the client, a format is designed which will meet the specific objectives of the Business, and this will cover who should be included in the audit, and the information which will help the business understand the management resource, and manage any potential risk to the business.

2. Management assessment:

Using management auditor's expertise as business psychologists, and understanding of the qualities needed to make an impact at top management level, the auditor will interview and psychometrically profile designated members of the management team. The assessment process will explore issues in relation to judgment and problem-solving, team leadership, impact and influence, delivery and execution, and capacity to provide strategic leadership.

3. Internal Management Audits:

For certain assignments, which involve an internal management audit, the management auditor might also include feedback to collate the perceptions of colleagues on some of the key issues which he believes will impact on the success of the organisation.

4. Reporting the conclusions:

The auditor will produce individual management assessment capability profiles, consolidating the information gained from the various sources of information.

The profiles will include summaries of the 'pros' and 'cons' in relation to the organisation and its needs. Where requested, auditor will provide strategic recommendations on the deployment of the talent and experience available, and will also provide 'signposts' on how each individual can optimise their contribution to the business and stretch their performance.

(ii) In the case of recurring audits, some working paper files may be classified as permanent audit files. Normally, auditor may consider classifying such papers as permanent which are required in case of recurring audit assignments. This file contains paper of continuing importance to succeeding audits. A permanent audit file normally includes :

- Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.
- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

(iii) In determining whether to use CAATs, the auditor should consider the following factors:

1. Availability of sufficient IT knowledge and expertise:

It is essential that members of the audit team should possess sufficient knowledge and experience to plan, execute and use the results of CAAT. The audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted.

2. Availability of CAATs and suitable computer facilities and data in suitable format:

The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package programme and entity's computer.

3. Impracticability of manual tests due to lack of evidence:

Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve, amounts of data that would overwhelm any manual procedure.

4. Impact on effectiveness and efficiency in extracting a data: It includes selection of samples, applying analytical procedures, time involved in application of CAAT, etc.

5. Time constraints in certain data, such as transaction details, are often kept for a short time and may not be available in machine -readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

(iv) Internal check means checks on day-to-day transactions which operate continuously as part of the routine system whereby work of one person is proved independently or is

complimentary to the work of another person. The object of internal check is prevention or early detection of fraud or error. Internal check is the part of internal control system and operates as a built-in device as far as the staff organization and job allocation aspects of the control system are concerned. The system in accounting implies organization of system of book keeping and arrangement of staff in such a manner that no one person can completely carry through a transaction and record every aspect thereof. Essential elements of a good internal check system are:

1. Existence of checks on the day-to-day transaction.
2. System operates continuously as a part of the routine system.
3. Work of each person is either proved independently or is made complementary to the work of another.

The objective of internal checks is to prevent and speedy detection of frauds, wastes and errors.

(v) AS 10 on "Accounting for Fixed Assets" requires that assets acquired under Hire Purchase System should be recorded at the cash value. In case cash value is not readily available it should be calculated with reference to hire-purchase payments and an appropriate rate of interest. , The penal interest, if any, should be charged off to revenue. Accordingly, the treatment; followed by the company is correct.