

Group - I

Paper 6 – Commercial & Industrial Law and Auditing

Section I: Commercial and Industrial Law

1. Comment on the following based on legal provisions as per the Indian Contract Act, 1872.

**(A) K takes a seat in a bus run by VV Travels. VV travels operate bus service between Kolkata and Durgapur. The bus was standing at its Bay in the Bus Terminus. Examine whether this amounts to a contract under The Indian Contract Act, 1872.**

**Answer:**

There is an implied offer to public at large by a transport company to carry passengers from one destination to another. When K takes a seat in the bus, there is an implied acceptance of the offer on his part, and there comes into existence a valid contract.

**(B) R sent a consignment of goods worth ₹190,000 by railway and got railway receipt. He obtained an advance of ₹160,000 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 ₹190,000. Decide in the light of provisions of the Indian Contract Act, 1872, whether the bank would succeed in the said suit?**

**Answer:**

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 ₹190,000 against Railway.

**(C) A offered to purchase shares of XYZ Ltd on 1<sup>st</sup> May 2012. The company made allotment of shares on 30<sup>th</sup> November 2012. A refused to accept the shares. Can it do so?**

**Answer:**

According to Sec 6(2) of the Indian Contract Act, 1872 an offer is revoked by lapse of time prescribed in the proposal or by lapse of reasonable time without communication of acceptance. What is reasonable time is question of fact in each case.

In the given case the offer lapsed as it was not accepted within reasonable time [*Ramsgate Victoria Hotel Co. vs Montefiore.*]

**(D) P, Q and R jointly borrowed `500,000 from W. The whole amount was repaid to W by Q. Decide in the light of the Indian Contract Act, 1872 whether:**

- (i) Q can recover the contribution from P and R,**
- (ii) Legal representatives of P are liable in case of death of P,**
- (iii) Q can recover the contribution from the assets, in case R becomes insolvent.**

**Answer:**

Section 42 of the Indian Contract Act, 1872 requires that when two or more persons have made a joint promise, then, unless a contrary intention appears by the contract, all such persons jointly must fulfill the promise. In the event of the death of any of them, his representative jointly with the survivors and in case of the death of all promisees, the representatives of all jointly must fulfill the promise.

Section 43 allows the promisee to seek performance from any of the joint promisors. The liability of the joint promisors has thus been made not only joint but "joint and several". Section 43 provides that in the absence of express agreement to the contrary, the promisee may compel any one or more of the joint promisors to perform the whole of the promise.

Section 43 deals with the contribution among joint promisors. The promisors, may compel every joint promisors to contribute equally to the performance of the promise (unless a contrary intention appears from the contracts). If any one of the joint promisors makes default in such contribution the remaining joint promisors must bear the loss arising from such default in equal shares.

As per the provisions of above sections,

- (i) Q can recover the contribution from P and R because P, Q, R are joint promisors.
- (ii) Legal representative of P are liable to pay the contribution to Q. However, a legal representative is liable only to the extent of property of the deceased received by him.
- (iii) 'Q' also can recover the contribution from R's assets.

**2. (A) W offered to sell his flat to H for ₹15 lacs. H replied purporting to accept the offer and enclosed a cheque for ₹8 lacs. He also promised to pay the balance of ₹7 lacs in 20 installments of ₹35000 each. Examine the validity of contract.**

**Answer:**

According to Section 7 of the Indian Contract Act, 1872, acceptance must be unqualified and absolute, it must conform to offer. If the parties are not *ad idem* on all matters concerning the offer and acceptance, there is no contract.

In the given case the acceptance is qualified and hence not a valid acceptance. As a result there is no valid contract.

**(B) 'S' agreed to become an assistant for 5 years to 'P' who was a Lawyer practicing at Delhi. It was also agreed that during the term of agreement 'S' will not practise on his own account**

**in Delhi. At the end of one year, 'S' left the assistantship of 'P' and began to practise on his own account. Referring to the provisions of the Indian Contract Act, 1872, decide whether 'S' could be restrained from doing so?**

**Answer:**

An agreement in restraint of trade/ business/ profession is void under Section 27 of the Indian Contract Act, 1872. But an agreement of service by which a person binds himself during the term of the agreement not to take service with anyone else directly or indirectly to promote any business in direct competition with that of his employer is not in restraint of trade. However, in the given case 'S' cannot be restrained by an injunction from doing so.

**(C) Minor under the Indian Contract Act, 1872 is always beneficiary.**

**Answer:**

As per the Indian Contract Act, 1872, an agreement with a minor is void ab initio. However there is nothing that debars him from becoming a beneficiary i.e. payee, endorsee or promisee in a contract. The law does not regard him incapable of accepting a benefit.

**3. (A) What tests can be applied in determining whether a person is an agent of another?**

**Answer:**

The test for determining whether a person is or is not an agent is whether that person has the capacity to bind the principal and make him answerable to a third person by bringing him (the principal) into legal relations with the third person and thus establish a privity of contract between the party and the principal. If yes, he is agent, otherwise not. This relationship of agency may be created either by express agreement or by implication.

**(B) C, the holder of an overdue bill of exchange drawn by A as surety for B, and accepted by B, contracts with X to give time to B. Is A discharged from his liability?**

**Answer:**

According to Section 136 of the Indian Contract Act, 1872, where a contract to give time to the principal debtor is made by the creditor with a third person and not with the principal debtor, the surety is not discharged. In the given question the contract to give time to the principal debtor is made by the creditor with X who is a third person. X is not the principal debtor. Hence A is not discharged.

**(C) R found a purse in MB Shopping Plaza. He deposited the purse to the manager of the mall so that it can be handed over to true owner. However the purse remained unclaimed. R now wants to claim the purse back. Will R succeed in his claim?**

**Answer:**

According to the Indian Contract Act, 1872, till the owner is found out, the property in goods will vest with the finder and he can retain the goods as his own against the whole world (except the owner, of course).

So in the given case R will succeed in his claim.

**4. (A) B buys goods from A on payment but leaves the goods in the possession of A. A then pledges the goods to C who has no notice of the sale to B. State whether the pledge is valid and whether C can enforce it. Decide with reference to the provisions of the Sale of Goods Act, 1930.**

**Answer:**

This is based on the provisions of Section 30 (1) of the Sale of Goods Act, 1930 which provides an exception to the general rule that no one can give a better title than he himself possesses. As per the provisions of the section, if a person has sold goods but continues to be in possession of them or of the documents of title to them, he may pledge them to a third person and if such person obtains them in good faith without notice of the previous sale, he would have good title to them. Accordingly, 'C' the pledgee who obtains the goods in good faith from A without notice of the previous sale, gets a good title. Thus the pledge is valid.

**(B) P purchased from Q 5000 tins of canned fruit to be packed in cases, each containing 50 tins but Q supplied cases containing 25 tins. Does P have right to reject the goods?**

**Answer:**

This is based on the provisions of Section 15 of the Sale of Goods Act, 1930. P is entitled to reject the goods because the goods were not packed according to the description. It is to be noted that if the goods do not correspond with the description but such goods are fit for buyer's purpose, even then the buyer may reject the goods and the seller cannot take defense by saying that the goods will serve buyer's purpose.

**(C) 'Risk is transferred only on delivery.' Give your views on the statement in light of the Sale of Goods Act, 1930.**

**Answer:**

Risk is transferred only when sale is complete, irrespective of whether the goods are delivered or not (Sec 26). Sec 26 of the Sale of Goods Act, 1930 provides that, unless otherwise agreed, the goods are at buyer's risk when the property in the goods passes to the buyer whether delivery has been made or not. Until then, buyer is not responsible for loss or damage of goods.

**(D) R sells 200 bales of cloth to S and sends 150 bales by lorry and 50 bales by Railway. S receives delivery of 150 bales sent by lorry, but before he receives the delivery of the bales sent by railway, he becomes bankrupt. R being still unpaid, stops the goods in transit. The official receiver, on S's insolvency claims the goods.**

**Answer:**

The case is based on section 50 of the Sale of Goods Act, 1930 dealing with the right of stoppage of the goods in transit available to an unpaid seller. The section states that the right is exercisable by the seller only if the following conditions are fulfilled.

- (i) The seller must be unpaid
- (ii) He must have parted with the possession of goods
- (iii) The goods must be in transit
- (iv) The buyer must have become insolvent
- (v) The right is subject to the provisions of the Act.

Applying the provisions to the given case, R being still unpaid, can stop the 50 bales of cloth sent by railway as these goods are still in transit.

**(E) At an auction sale, F made the highest bid for an article of X. State the legal position in the following cases:**

**Case I: If F withdrew the bid before the fall of hammer though he knew that one of the condition of the sale was bid once made cannot be withdrawn'.**

**Case II: If X appointed two persons A and B, to bid on his behalf. The sale was notified subject to a right to bid.**

**Answer:**

Case I: F's bid was an offer to buy and he was entitled to withdraw his bid before the sale is completed as per express provision of Section 64(2). [*Payne v. Cave*]

Case II: It amounts to fraud and sale is voidable at the option of the buyer because the seller could appoint only one person to bid on his behalf. [Sec 64(3) and Sec 64(6)]. Here the intention of the seller was not to protect his interest but to raise the price. [*Thornett v Haines*]

**5. (A) X, Y and Z were joint owners of a bus and possession of the said bus was with Y. P purchased the bus from Y without knowing that X and Z were also owners of the bus. Decide in the light of provisions of the Sale of Goods Act, 1930, whether the sale between Y and P is valid or not?**

**Answer:**

This problem is based on Section 28 of the Sale of Goods Act, 1930 which lays down an exception to the general rule that a person cannot transfer a better title than that he himself possesses. A person who is one of joint owners may transfer a better title than he possesses. Section 28 provides that – "if one of several joint owners of goods has the sole possession of them by permission of the co-owners, the property in goods is transferred to any person who buys them of such joint owner in good faith and has not at the time of the contract of sale notice that the seller has no authority to sell".

**(B) Sometimes 'breach of condition' is treated as 'breach of warranty' under the provisions of the Sale of Goods Act, 1930. Under what circumstances?**

**Answer:**

According to Section 13 of the Sale of Goods Act, 1930 a breach of condition may be treated as breach of warranty in following circumstances:

- (i) Where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition,
- (ii) Where the buyer elects to treat the breach of condition as breach of a warranty.
- (iii) Where the contract of sale is non-severable and the buyer has accepted the whole goods or any part thereof.
- (iv) Where the fulfillment of any condition or warranty is excused by law by reason of impossibility or otherwise.

**(C) A contracts to sell B, by showing sample, certain quantity of fairness lotion described as 'Imported'. The lotion when delivered matches with the sample, but is not 'imported' but 'Made in India' of the same company. Referring to the provisions of Sale of Goods Act, 1930 advise the remedy, if any, available to B.**

**Answer:**

B has a remedy to repudiate the contract. According to section 15 of the Sale of Goods Act, 1930, when the goods are sold by sample as well as by description, there shall be an implied condition that the goods shall correspond to the sample as well as description. In this case, A supplied fairness lotion which did correspond with the sample but was not correspond to the description of 'Imported'. Hence the B has the right to repudiate the contract.

**(D) K the owner of a Maruti Santro car wants to sell his car. For this purpose he hand over the car to M, a mercantile agent for sale at a price not less than ₹150, 000. The agent sells the car for ₹90, 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.**

**Answer:**

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 v. King*

**(E) X buys synthetic pearls for a high price thinking that they are natural pearls. The seller though understood X's intention, kept silent. Examine the remedies X has against the seller as per the Sale of Goods Act, 1930.**

**Answer:**

X has no remedy against the seller as the doctrine of Caveat Emptor will apply.

'Caveat emptor' means "let the buyer beware", i.e. in sale of goods the seller is under no duty to reveal unflattering truths about the goods sold. Therefore, when a person buys some goods, he must examine them thoroughly. If the goods turn out to be defective or do not suit his purpose, or if he depends upon his skill and judgment and makes a bad selection, he cannot blame anybody excepting himself.

The rule is enunciated in the opening words of section 16 of the Sale of Goods Act, 1930 which runs thus: "Subject to the provisions of this Act and of any other law for the time being in force, there is no implied warranty or condition as to the quality or fitness for any particular purpose of goods supplied under a contract of sale"

**6. Examine the following cases in light of laws relating to employees:**

**(A) Employees of an electricity generation station claimed that their unit is covered under the definition of 'factory' considering the process of transforming and transmission of electricity generated at the power station as a 'manufacturing process. Will their claim succeed?**

**Answer:**

As per section 2(k) of The Factories Act, 1948, manufacturing process means any process for-

- (i) Making, altering, repairing, ornamenting, finishing, packing, oiling, washing, cleaning, breaking up, demolishing, or otherwise treating or adapting any article or substance with a view to its use, sale, transport, delivery or disposal, or
- (ii) Pumping oil, water, sewage or any other substance; or
- (iii) Generating, transforming or transmitting power; or

- (iii) Composing types for printing, printing by letter press, lithography, photogravure or other similar process or book binding;
- (iv) Constructing, reconstructing, repairing, refitting, finishing or breaking up ships or vessels; (Inserted by the Factories (Amendment) Act, 1976, w.e.f. 26-10-1976.)
- (v) Preserving or storing any article in cold storage;

Process undertaken at electricity generating station, substation transferring and transmitting electricity is not a manufacturing process and are not thus factory- [*Delhi Electricity Supply Undertaking vs. Management of DESU, AIR(1973)SCC 365*]

**(B) 'D' joined BE Engineering Works (P) Ltd. on 5.3.2012. On 8<sup>th</sup> December, 2012 he was laid off as the management wanted to slow down due to shortage of power. 'X' was not allowed lay-off compensation on the ground that his period of service was less than one year. Is the claim of management valid under the Industrial Disputes Act, 1947?**

**Answer:**

Under Sec. 25-B of Industrial Disputes Act, 1947, an employee shall be deemed to be in continuous service of one year if he has worked for at least 240 days during the period of 12 months preceding the reference date of calculation.

'D' has worked for 273 days before he was laid off. So he is entitled to lay-off compensation and can claim the same.

**(C) Y, a laboratory assistant consumes a chemical during the night shift and dies. The chemical was not of the laboratory kit. His wife claimed compensation under the Employees Compensation Act, 1923.**

**Answer:**

The Employer is not liable to pay compensation as it is a case of suicide by the employee. The apex court observed in *Mackenzie & Co. v. Ibrahim Mohammad Isaac*(1970) S C 1906 that the words 'in course of employment' means in course of the work which the employee who is employed to do and which is incidental to it. Further the words 'during the course of employment' the injury should result from some risk incidental to duties of service owing to the employer. If the accident is inclined with some risk situated with employment, then the employee would succeed in getting compensation.

**7. State your views on the following in light of laws relating to employees:**

**(A) XYZ (P) Ltd. imposed a fine on P, one of its employees for regularly reporting late for work. The fine was imposed on 4<sup>th</sup> April, 2013. The management wanted to recover the amount in September, 2013 during half yearly increment. Can the Company recover as per the Payment of Wages Act, 1936?**

**Answer:**

As per Sec. 8(7) of The Payment of Wages Act, 1936 no fines can be recovered after expiry of 90 days from the date on which it is imposed. So XYZ (P) Ltd. will not be able to recover the fine in September, 2013 as the gap exceeded 90 days.

**(B) X is engaged in two types of job in a factory, that of a mechanic and watchman. The wage rates are different for two different jobs. The employer calculates his minimum wage at an average rate. State whether this is correct as per the Minimum Wages Act, 1948?**

**Answer:**

Where an employee does two or more classes of work to each of which a different minimum rate of wages is applicable, the employer shall pay to such employee in respect of the time respectively occupied in each such class of work, wages at not less than the minimum rate in force in respect of each such class. Thus employer just cannot pay him at simple average rate of both wages of both classes of job.

**(C) The payment of contribution to provident fund of an employee, to be made by his employer, who has become insolvent, a preferential payment as per the provisions of the Employees Provident fund and Miscellaneous Provisions Act, 1952.**

**Answer:**

According to Section 11 of the Employee's Provident Fund and Miscellaneous Provisions Act 1952, if the employer is adjudged as insolvent or if the employer is a company and an order winding thereof has been made, the amount due from the employer whether in respect of the employee's contribution or employer's contribution must be included among the debts which are to be paid in priority to all other debts in the distribution of the property of the insolvent or the assets of the company. In other words, this payment will be a preferential payment provided the liability thereof has accrued before this order of adjudication or winding up is made.

**8. (A) Y is working as a marketing personnel in a company. The following payments were made to him by the company during the previous financial year:**

- (i) overtime allowance,**
- (ii) dearness allowance**
- (iii) commission on sales**
- (iv) employer's contribution towards pension fund**
- (v) value of food.**

**Examine as to which of the above payments form part of "salary" of WX under the provisions of the Payment of Bonus Act, 1965.**

**Answer:**

According to Section 2(21) of the Payment of Bonus Act, 1965 salary and wages means all remuneration other than remuneration in respect of overtime work, capable of being

expressed in terms of money, which would if the terms of employment, express or implied, were fulfilled, be payable to an employee in respect of his employment, or of work done in such employment. It includes dearness allowance, i.e. all cash payment by whatever name called, paid to an employee on account of a rise in the cost of living. But the term excludes:

- (i) Any other allowance which the employee is for the time being entitled to;
- (ii) The value of any house accommodation or of supply of light, water, medical attendance or other amenities of any service or of any concessional supply of food grains or other articles;
- (iii) Any traveling concession;
- (iv) Any contribution paid or payable by the employer to any pension fund or for benefit of the employee under any law for the time being in force.
- (v) Any retrenchment compensation or any gratuity or other retirement benefit payable to the employee or any ex-gratia payment made to him; and
- (vi) Any commission payable to the employee.

It may be noted that where an employee is given, in lieu of the whole or part of the salary or wage payable to him, free food allowance or free food by his employer, such food allowance or the value of such food shall be deemed to form part of the salary or wage for such employee.

In view of the provisions of Section 2(21) explained above, the payment of dearness allowance and value of free food by the employer forms part of salary of Y while remaining three payments i.e. payment for overtime, commission on sales and employer's contribution towards pension funds does not form part of his salary.

**(B) Gratuity can be withheld by the employer non-vacation of official quarter by the employee under the Payment of Gratuity Act, 1972.**

**Answer:**

Gratuity cannot be withheld for non-vacation of service quarters by retiring employees. Gratuity can only be forfeited to the extent of damage or loss where services have been terminated for any act of willful omission or negligence causing damage /loss/destruction of employer's property and not for non-vacation of service quarters.

Gratuity is exempted from attachment in execution of any decree or order in any Civil, Revenue or Criminal Court.

**9. (A) P draws a cheque of ₹15000 in favour of Q in lieu of payment of debt. P after issuing the cheque to Q instructed the bank for stop payment in respect of the cheque issued. Is this an offence under the Negotiable Instruments Act, 1881?**

**Answer:**

Section 138 of the Negotiable Instruments Act, 1881 states that where any cheque drawn by a person on an account maintained by him with a banker for payment of any amount of money to another person from out of that account for the discharge, in whole or in part, of any debt or other liability, is returned by the bank unpaid either because of the amount of money standing to the credit of that account is insufficient to honour the cheque or that it exceeds the amount arranged to be paid from that account by an agreement made with that bank, such person shall be deemed to have committed an offence .

Asking payee not to present the cheque or issuing 'Stop Payment' instructions to the Banker gets covered u/s 138. Hence P is deemed to have committed offence.

**(B) Would the answer differ in (A) if P had made a gift to Q?**

**Answer:**

If cheque is issued only as a gift and not in discharge of any debt, P cannot be booked u/s 138 of the Negotiable Instruments Act, 1881. But onus of proof lies only on P. If he fails to prove, presumption u/s 139 of the Negotiable Instruments Act, 1881 shall be extended.

Section 139 in The Negotiable Instruments Act, 1881 states It shall be presumed, unless the contrary is proved, that the holder of a cheque received the cheque of the nature referred to in section 138 for the discharge, in whole or in part, of any debt or other liability.

Stop Payment instructions shall not preclude him from his liability.

**(C) A promissory note is made without specifying the time for payment. The holder added 'on demand' on face of the instrument. Does that amount to changing character of the instrument as per the Negotiable Instrument Act,1881?**

**Answer:**

A promissory note made without specifying time is payable on demand. So adding "on demand" on face of the instrument does not change the character of the instrument.

**10. (A) X has balance of ₹5500/- in YZ Bank. He draws a cheque of ₹20,000 in favour of C knowing fully that he has no O/D facility. The cheque is dishonoured. Is notice of dishonour to X necessary?**

**Answer:**

Notice of dishonour is not necessary when the party charged could not suffer damage for want of notice. As such notice of dishonour to X is not necessary.

**(B) P draws a bill on Q. Q accepts the bill without any consideration. The bill is transferred to R without consideration. R transferred it to S for value. Can S sue the prior parties of the bill?**

**Answer:**

Section 43 of the Negotiable Instruments Act, 1881 provides that a negotiable instrument

made, drawn, accepted, indorsed or transferred without consideration, or for a consideration which fails, creates no obligation of payment between the parties to the transaction. But if any such party has transferred the instrument with or without endorsement to a holder for consideration, such holder, and every subsequent holder deriving title from him, may recover the amount due on such instrument from the transferor for consideration or any prior party thereto.

In the given case, P has drawn a bill on Q and Q accepted the bill without consideration and transferred it to R without consideration. Later on in the next transfer by R to S is for value. According to provisions of the aforesaid section 43, the bill ultimately has been transferred to S with consideration. Therefore, S can sue any of the parties i.e. P, Q or R, as S obtained a good title on it being taken with consideration.

**(C) P, a major, and Q, a minor, executed a promissory note in favour of R. Examine with reference to the provisions of the Negotiable Instruments Act, 1881 the validity of the promissory note and whether it is binding on P and Q.**

**Answer:**

Every person competent to contract has capacity to incur liability by making, drawing, accepting, endorsing, delivering and negotiating a promissory note, bill of exchange or cheque (Section 26, para 1, Negotiable Instrument Act, 1881).

As a minor's agreement is void, he cannot bind himself by becoming a party to a negotiable instrument. But he may draw, endorse, deliver and negotiate such instruments so as to bind all parties except himself (Section 26, para 2).

In view of the provisions of Section 26 explained above, the promissory note executed by P and Q is valid even though a minor is a party to it. Q, being a minor is not liable; but his immunity from liability does not absolve the other joint promisor, namely P from liability.

**11. (A) Ascertain the date of maturity of a bill payable hundred days after sight and which is presented for sight on 4th September, 2013.**

**Answer:**

In this case the day of presentment for sight is to be excluded i.e. 4th September, 2013. The period of 100 days ends on 13th December, 2013 (September 27 days + October 31 days + November 30 days + December 13 days). Three days of grace are to be added. It falls due on 16th December, 2013.

**(B) A bill is drawn in UK on M, a trader in India and accepted payable in Kolkata. Whether it is an inland bill or foreign instrument?**

**Answer:**

The bill is a foreign instrument since it is drawn outside India.

**(C) X promises to pay Y, by a Promissory note, `5000 and all other sums, which shall be due. Examine the validity of the promissory note.**

**Answer:**

The sum payable is not certain within the meaning of Section 4 of the Negotiable Instruments Act, 1881. Hence the Promissory Note is not a valid one.

**(D) P by inducing Q obtains a Bill of Exchange from him fraudulently in his (P) favour. Later, he enters into a commercial deal and endorses the bill to R towards consideration to him (R) for the deal. R takes the bill as a Holder-in-due-course. R subsequently endorses the bill to P for value, as consideration to P for some other deal. On maturity the bill is dishonoured. P sues Q for the recovery of the money.**

**With reference to the provisions of the Negotiable Instruments Act, 1881 decide whether P will succeed in the case?**

**Answer:**

The problem stated in the question is based on the provisions of the Negotiable Instruments Act as contained in Section 53. The section provides: 'Once a negotiable instrument passes through the hands of a holder in due course, it gets cleansed of its defects provided the holder was himself not a party to the fraud or illegality which affected the instrument in some stage of its journey. Thus any defect in the title of the transferor will not affect the rights of the holder in due course even if he had knowledge of the prior defect provided he is himself not a party to the fraud. (Section 53).

Thus applying the above provisions it is quite clear that P who originally induced Q in obtaining the bill of exchange in question fraudulently, cannot succeed in the case. The reason is obvious as P himself was a party to the fraud.

**12. (A) When is a LLP not bound by act of its members?**

**Answer:**

A limited liability partnership is not bound by any act of a member in dealing with a person if:

- i) the member in fact has no authority to act for the limited liability partnership by doing that thing;
- ii) the person knows that the member has no authority or does not know or believe him to be a member of limited partnership.

**(B) A Limited Liability Partnership is a body corporate, so shall have perpetual succession and can carry on business with any number of partners under the Limited Liability Partnership Act, 2008. Do you agree?**

**Answer:**

This is discussed in Section 6 of the Limited Liability Partnership Act, 2008. As per the section:

- (1) Every limited liability partnership shall have at least two partners.
- (2) If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

**13. (A) List the circumstances under which an LLP formed under the Limited Liability Partnership Act, 2008 may be wound up by tribunal?**

**Answer:**

A limited liability partnership may be wound up by the Tribunal:

- (i) the limited liability partnership decides that limited liability partnership be wound up by the Tribunal;
- (ii) If, for a period of more than six month, the number of partners of the limited liability partnership is reduced below two;
- (iii) if the limited liability partnership is unable to pay its debts;
- (iv) if the limited liability partnership has acted against the interests of the sovereignty and integrity of India, the security of the State or public order;
- (v) if the limited liability partnership has made a default in filing with the Registrar the Statement of Account and Solvency or annual return for any five consecutive financial years; or
- (vi) if the Tribunal is of the opinion that it is just and equitable that the limited liability partnership be wound up.

**(B) Limited Liability Partnerships are body corporate. Do you agree? Justify.**

**Answer:**

Limited Liability Partnerships formed and registered under Limited Liability Partnership Act, 2008 are body corporate. All LLPS have the following features:

- (i) A limited liability partnership is a body corporate formed and incorporated under this Act and is legal entity separate from that of its partners.
- (ii) A limited liability partnership shall have perpetual succession.
- (i) Any change in the partners of a limited liability partnership shall not affect the existence, rights or liabilities of the limited liability partnership.
- (iv) Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a limited liability partnership.
- (v) Any individual or body corporate may be a partner in a limited liability partnership.

**(C) Explain the concept of 'whistle blowing' with respect to the Limited liability Partnership Act, 2008.**

**Answer:**

The concept has been discussed in Sec 31 of the Limited liability Partnership Act, 2008. As per the sec:

- (1) The Court or Tribunal may reduce or waive any penalty leviable against any partner or employee of a limited liability partnership, if it is satisfied that-
  - (a) such partner or employee of a limited liability partnership has provided useful information during investigation of such limited liability partnership; or
  - (b) when any information given by any partner or employee (whether or not during investigation) leads to limited liability partnership or any partner or employee of such limited liability partnership being convicted under this Act or any other Act.
- (2) No partner or employee of any limited liability partnership may be discharged, demoted, suspended, threatened, harassed or in any other manner discriminated against the terms and conditions of his limited liability partnership or employment merely because of his providing information or causing information to be provided pursuant to sub-section (1).

**14. (A) Write a note on 'Competition Advocacy' in respect of the Competition act, 2002?**

**Answer:**

### **Competition Advocacy [Section 49]**

1. The Central Government may, in formulating a policy on competition (including review of laws related to competition), or any other matter, and a State Government may, in formulating a policy on competition or on any other matter, as the case may be, make a reference to the Commission for its opinion on possible effect of such policy on competition and on receipt of such a reference, the Commission shall, within sixty days of making such reference, give its opinion to the Central Government or the State Government as the case may be, which may thereafter take further action as it deems fit.
2. The opinion given by the Commission under sub-section (1) shall not be binding upon the Central Government or the state Government as the case may be in formulating such policy.
3. The Commission shall take suitable measures for the promotion of competition advocacy, creating awareness and imparting training about competition issues.

**(B) Write a note on Competition Commission of India (Establishment and Composition).**

**Answer:**

### **Establishment of Commission [Section 7]**

1. With effect from such date as the Central Government may, by notification, appoint, there shall be established, for the purposes of this Act, a Commission to be called the "Competition Commission of India".
2. The Commission shall be a body corporate by the name aforesaid having perpetual succession and a common seal with power, subject to the provisions of this Act, to acquire, hold and dispose of property, both movable and immovable, and to contract and shall, by the said name, sue or be sued.
3. The head office of the Commission shall be at such place as the Central Government may decide from time to time.
4. The Commission may establish offices at other places in India.

### **Composition of Commission [Section 8]**

1. The Commission shall consist of a Chairperson and not less than two and not more than six other Members to be appointed by the Central Government.
2. The Chairperson and every other Member shall be a person of ability, integrity and standing and who has special knowledge of, and such professional experience of not less than fifteen years in, international trade, economics, business, commerce, law, finance, accountancy, management, industry, public affairs or competition matters, including competition law and policy, which in the opinion of the Central Government, may be useful to the Commission.
3. The Chairperson and other Members shall be whole time Members.

**15. (A) PIO under the RTI Act, 2005 rejected X's application because he wanted too many information which PIO found difficult to handle. Explain the provision.**

#### **Answer:**

The RTI Act, 2005 does not permit rejection of application simply because it relates to large number of documents. In any case, in practice officials should consider the processing of applications as a cooperative activity, such that the official should work with the applicants to assist them to get information they need. If a large number of records are involved in relation to a request, the PIO can contact the requestor and clarify their request to see if they can reach a mediated solution that will give the requestor what they want without unnecessarily burdening the PIO. This recognises that in some cases at least, a broad application may be simply because the requestor was not sure what was available. No penalty is shall lie against PIO for anything which is in good faith done or intended to be done under this Act or any rule made thereunder.(Sec 21)

If some information requested work relates to the work of another public authority within the same department or in another department, The PIO has the power to transfer those parts of the application to such public authority under Sec 6(3) of the Act.

**(B) The residents of HBC locality wanted one street in the area to be repaired before monsoon which was in highly dilapidated state. They approached the local MLA who expressed inability**

**due to exhaustion of MLA Funds. The residents refuse to believe. Advise them in context of Right to Information Act, 2005.**

**Answer:**

The resident may apply to Public Information Officer under RTI Act, 2005 in writing or through electronic means in English or Hindi or in the official language of the area, to the PIO, specifying the list of works sanctioned using their MLA's funds and also the balance amount enclosing the prescribed fee.

The PIO is required to supply information within 30 days from the date of application. Based on information supplied the residents can satisfy themselves about the truth of their MLA's statement.

**(C) Is the Assistant Public Information Officer (APIO) as assistant to the Public Information Officer (PIO)?**

**Answer:**

No, the APIO is not an assistant to the PIO. An APIO may be appointed at the sub-district or sub-divisional level where a public authority may not have an office or administrative unit. This is particularly useful for Departments of the Government of India which are rarely found below the district level. Appointment of APIOs may also be useful in States which have human habitats situated in difficult, remote and inaccessible terrain.

An(y) APIO, like the PIO is an independent information officer in an administrative jurisdiction / office and will have all the powers (and be responsible for all the functions) as ordained for a PIO, under the RTI, 2005 Act.

**(D) What does Right to Information mean under the RTI Act, 2005?**

**Answer:**

Sec 2(j) of the RTI Act, 2005, states:

"Right to Information" means the right to information accessible under this Act which is held by or under the control of any public authority and includes the right to:

- (i) inspection of work, documents, records;
- (ii) taking notes, extracts or certified copies of documents or records;
- (iii) taking certified samples of material;
- (iv) obtaining information in the form of diskettes, floppies, tapes, video cassettes or in any other electronic mode or through printouts where such information is stored in a computer or in any other device.

**(E) Annual Confidential Reports are confidential and need not be communicated to employees. State your views quoting a case law in this regard.**

**Answer:**

Annual Confidential Reports:

Judgment of the Supreme Court – In the case of Dev Dutt Vs Union of India - 2008 – TIOL - SC - Service - Dated 12-05-2008 - "Good" entry in ACR - Denial of promotion because only four "very good" out of five years – Every entry in ACR of a government servant must be communicated to him within a reasonable time - whether it is poor, fair, average, good or very good - Otherwise adverse effect on two counts: If he knows: He could improve his performance in future or he can represent against a lower entry - Non-communication is an arbitrary act violating Article 14 of the Constitution.

So justice cannot be denied and ACR need to be communicated to employees.

### SECTION II – AUDITING

**16. Comment on the following statements based on legal provisions:**

**(A) According to Sec 227(1) of the Companies Act, 1956, the auditor can call for any explanations or information from the officers and employees of the company.**

**Answer:**

The statement is false. According to the Companies Act, 1956, the auditor can call for explanations or information which he thinks is relevant for the purpose of audit and proper discharge of his duties.

**(B) The scope of verification is much wider than that of vouching.**

**Answer:**

The statement is true. Vouching enables 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.

**(C) Auditor is entitled to rely on work performed by others.**

**Answer:**

SA 200 (AAS 1) on, "Basic Principles Governing an Audit" envisages manifold circumstances when an auditor would have to depend upon the work performed by others. Such other parties may be experts, other auditors including branch auditors or his own assistants.

SA 200 while laying down “Work Performed by Others” as one of the basic principle governing an audit makes it clear that in cases where the auditor is required to delegate a part of his work to his assistants or use the work performed by other auditors/experts, he continues to remain responsible for expressing his opinion on the financial statements. Thus, he can rely on work performed by others provided he exercises reasonable skill and care and he has no reason to believe that he should not have so relied.

The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

In case of statutory assignments, like relying on audit report of branches conducted by other auditors, he should expressly state the fact of such reliance.

**(D) Reclassification of long term investment as short term investment is made at cost as on the date of classification.**

**Answer:**

The statement is false. As per AS-13 , 'Accounting for Investments' the transfer should be at lower of cost and carrying amount of the investment at the date of reclassification of long term as short term investment.

**(E) Where the accounts of the company do not present a 'true and fair' view, the auditor of the company can give a qualified opinion.**

**Answer:**

The statement is false. An adverse opinion is appropriate where the reservations or the objections are so substantial that the auditor feels, that the accounts do not give a 'True and Fair' view. Qualified opinion would imply that the financial statement project a 'True and Fair' view subject to certain reservations.

**(F) Internal check is part and parcel of internal control.**

**Answer:**

The statement is true. Internal control is a plan of organisation and covers all methods and procedures adopted by management to assist its objectives of ensuring the orderly and efficient conduct of business. It includes financial and physical control and covers internal check and internal audit also. Hence internal check is part of internal control.

**(G) Audit is concerned with ethics of business.**

**Answer:**

The statement is false. Audit is not concerned with ethics of business unless the business itself is illegal or unlawful.

**(H) A company can refuse to provide access to its books of accounts to the company's**

**auditor outside normal working hours of the company , as it will inconvenience the accounts staff.**

**Answer:**

The statement is false. Section 227(1) of the Companies Act, 1956, provides that every auditor of a company shall have a right of access to books , accounts and vouchers of the company at all times and shall be entitled to require from the officers of the company such information and explanations as he may think necessary for proper performance of his duties. The auditor thus has the right of access to the records kept by the company at all times and may therefore, inspect them in the course of performance of his duties as auditor. As per law, the company cannot refuse to provide such access after regular office hours.

**(I) The appointment of Mr. A as statutory auditor was held to be void ab initio. So the company holds another annual general meeting and appoints Mr. B, through a special resolution.**

**Answer:**

Where the appointment of an auditor is void ab initio, it is as if no auditor has been appointed at all. Section 224(3) of the Companies Act, 1956 will come into play. As per this subsection, where at an annual general meeting, no auditors are appointed or reappointed, the Central Government shall appoint a person to fill the vacancy . Hence, in the given situation, the vacancy cannot be filled up by the company, but only by the Central Government. Accordingly, the appointment of Mr. B as new auditor at subsequent meeting will not be valid.

**(J) Operational audit is merely an extension of Internal Audit.**

**Answer:**

The statement is true. In operational audit function, the internal auditor goes beyond financial controls and looks into operational areas also. Operational auditing having scope and objectives similar to that of Internal Audit is therefore an extension of Internal Audit.

**(K) Audit Committee has a two-fold relationship and has therefore, to react only with management and Internal Auditor.**

**Answer:**

The statement is false. The audit committee has a fourfold responsibility and therefore has to interact with management, internal auditor, statutory auditor and the public.

**(L) Shareholders, by a majority vote, have authorized the Board of Directors to keep the books of accounts of the company in its Administrative Office, as against the earlier practice of keeping them in the Registered Office. The ROC was not informed about this change. Company intends that this practice is in order.**

**Answer:**

The statement is false. As per Section 209 of the Companies Act, 1956, the books of accounts can be kept in a place other than its registered office also, but the Board of Directors should within seven days, file a written notice to the Registrar of Companies, the full address of the new place. Here the company has not complied with this mandatory requirement.

**(M) There is no need to design better internal controls in an EDP or computerized system.**

**Answer:**

The statement is false. Computerisation, automatically implies a constant review of the system to increase the efficiency in producing reliable data. As a result, the internal controls are normally better designed under computerized systems. Automatic checks are instituted and the responsibilities of various people are clearly stated.

**17. (A) What is an "Audit Evidence"?**

**Answer:**

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.

AAS 1 (SA 200) on "Basic Principles Governing and Audit", mention audit evidence as one of the basic principles and requires that the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

According to AAS 5 (SA 500) on Audit Evidence, sufficiency and appropriateness are inter-related and apply to evidence obtained from both compliance and substantive procedures.

**(B) What are the assertions with which an auditor is concerned with while obtaining audit evidence from substantive procedures?**

**Answer:**

An auditor is concerned with following assertions:

- (i) Existence: That an asset or liability exists at a given date.
- (ii) Rights and obligations: That an asset is a right of the concern and a liability is an obligation at a given date.
- (iii) Occurrence: That a transaction or event which took place pertains to the entity during the relevant period.
- (iv) Completeness: That there are no unrecorded assets, liabilities or transaction.

- (v) Valuation: That an asset or liability is recorded at an appropriate carrying value.
- (vi) Measurement: That a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period.
- (vii) Presentation and disclosure hat an item is disclosed classified and described in accordance with recognized accounting policies and practices and relevant statutory requirements.

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

**Answer:**

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:

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

**18. (A) Auditors of M/s FBG (P) Ltd. were changed for the accounting year 2012-13. The closing stock of the company as on 31.3.2012 amounting to ₹350 lacs continued as it is and became closing stock as on 31.3.2013. The auditors of the company propose to exclude from their audit programme the audit of closing stock of ₹350 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. Give your comments.**

**Answer:**

According to SA 510 "Initial Engagements – Opening Balances" requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

- (a) the closing balances of the preceding period have been correctly brought forward to the current period;
- (b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and
- (c) appropriate accounting policies are consistently applied.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the balance sheet date. The contention of the management that the stock has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the stock lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude from his audit programme the audit of closing stock.

**(B) No depreciation has been charged for the year ended 31<sup>st</sup> March 2013, in respect of a spare Car purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year. State your views as an auditor.**

**Answer:**

As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the spare car was kept ready for use as stand-by, it means it was intended to be used for the purpose of business. Depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31<sup>st</sup> March, 2013. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

**(C) Fixed assets have been revalued by HIG Ltd. and the resulting surplus has been adjusted against the brought forward losses .What is your opinion as an auditor?**

**Answer:**

The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS 10 on 'Accounting for Fixed Assets' requires that "an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution". Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

**19. (A) Draft the audit programme for audit of receipt of participation fees from delegates to the National Cost Convention.**

**Answer:**

The organization of three-day National Cost Convention is a one-time event. Normally, in view of mega-size of the event, a special cell is made in the organization to handle the entire event. Since few people would be handling the event, the internal controls may not

be that strong and, thus, more emphasis is required to be given on substantive procedure. Audit of receipt of participation fees should be under the following areas:

### **(I) Internal Control System**

- (i) Examine the organization structure of special cell created for the National Cost Convention, if any, and division of responsibilities amongst persons and control/custody over receipt books.
- (ii) Verify the internal control system for restricting the participation of unregistered delegates.

### **(II) Rate of Participation Fees**

- (i) Verify with reference to resolution passed by the Organizing Committee.
- (ii) Also verify the rate from the literature/registration form circulated for promotion of conference.

### **(III) Receipts of Participation Fees**

- (i) Verify counter foil of the receipts issued for individual registration.
- (ii) Ensure that receipts are issued for all the registration received in cash.
- (iii) Trace the receipts in Bank Statement or Cash Book – as the case may be.
- (iv) Verify Bank Reconciliation Statement and list out dishonoured cheques.
- (v) Verify subsequent recovery in respect of dishonoured cheques.

### **(IV) Overall Checking**

- (i) Verify the total receipts of participation fees shown in the financial statements with reference to total number of receipts issued to participants.
- (ii) Cross check the total number of delegates with reference to the following:
  - (a) Kits distributed to participants.
  - (b) Bill of caterer for providing meals during conference.
  - (c) Capacity of the Hall.
  - (d) Participation Certificate if any issued.

**(V) Foreign Delegates:** In case of foreign delegates – if registration fees are higher – ensure that they are registered at higher fees.

### **(VI) Special Issues**

- (i) Take out list of absentees and in case of nil absentees, probe the issue further.
- (ii) If certain participants are exempted from payment of fees – obtain the list along with proper authorization in this regard.

**(B) The HIJ College, an institution managed by WB Trust, has received a grant of ₹5 crore from Government nodal agencies for funding a project of research on rural health systems in India. Draft an audit programme for auditing this fund in the accounts of the college.**

**Answer:**

Audit of grant fund of a college:

1. The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.
2. The government policy on grant should be checked with the relevant application, brochure, and sanction advices.
3. The conditions stipulated in award of grant should be studied.
4. The receipt of grant should be vouched with bank statement.
5. The budgeted heads of expenses for the project and actual utilization of the fund should be checked.
6. The purchase of capital items covered within the project should be correctly capitalized. The same should be properly and distinctly shown in the balance sheet of the college. The cost of the asset should be adjusted for the grant amount.
7. The expenses of revenue nature incurred from and out of grant in the form of salaries to field staff, materials purchased, traveling, survey and field work expenses and analysis and preparation of reports etc should be vouched with the relevant vouchers.
8. The expenses should be accounted as withdrawal of amounts from the fund. It is to be checked that these expenses are not accounted in income and expenditure of the college.
9. In balance sheet, the fund account should be shown as a liability with a separate schedule indicating the receipts, payments and balance as on the date of closing of accounts.
10. The fund balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.
11. The physical verification of assets pertaining to the project should be done by the management of the college.
12. The progress of the project may be ascertained from the minutes, committee meeting extracts and reports. This must be done to ensure that the project fund is genuinely utilized for the purposes it intended for.

**20. As an auditor, how will you vouch and/or verify the following?**

- (a) Work-in-progress
- (b) Receipt of special backward area subsidy from Government
- (c) Recovery of Bad Debts written off
- (d) Borrowing from Banks
- (e) Machinery acquired under Hire-purchase system.

**Answer:**

**(a) Work-in-progress:**

The audit procedures regarding work-in-progress are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. The auditor may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date. Cost sheets of work-in-progress should be verified as follows:

- (i) Ascertain that the cost sheets are duly attested by the works engineer and works manager.
- (ii) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost sheets by reference to the records maintained in respect thereof.
- (iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimated cost expected.
- (iv) Ensure that the allocation of overhead expenses had been made on a rational basis.  
Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.

### **(b) Receipt of special backward area subsidy from Government**

- (i) The claim for backward area subsidy submitted to the authorities should be studied.
- (ii) It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature is to facto.
- (iii) The accounting of grant should be in accordance with AS 12 "Accounting for Government Grants". The revenue grant can be taken to income statement, with appropriate disclosure.
- (iv) The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to profit and loss account each year in proportion to depreciation of that asset charged in profit and loss account.
- (v) The receipt of the grant should be checked with bank statement, remittance challan etc.
- (vi) The conditions attached to grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

### **(c) Recovery of Bad Debts written off :**

- (i) Ascertain the total amount of bad debts.
- (ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.
- (iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.

- (iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

### **(d) Borrowing from Banks:**

Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

- (i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- (ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- (iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity

### **(e) Machinery acquired under Hire-purchase system.**

- (i) Examine the Board's Minute Book approving the purchase on hire-purchase terms.
- (ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, terms of payment and rate of purchase.
- (iii) Ascertain that the machinery has been included in the related assets account at its cash value. Also instalments due have been paid and the hire-purchase charges applicable to the period from the commencement of the agreement to the end of the financial year have been charged against current profits.
- (iv) Ensure that machinery acquired on hire purchase basis has been included at its cash value in the balance sheet and depreciation has been calculated on the cash value from the date of the purchase. The amount due to the hire purchase company in respect of the capital outstanding has either been shown as a deduction from the machinery account or as a separate amount under current liabilities.

### **21. As an auditor, comment on the following situations:**

**(A) One of the debtors of PQR Ltd. from whom ₹7 lacs is recoverable for credit sales gives a motor car in full settlement of dues. The directors estimate that the market value of the car transferred is ₹7.50 lacs. As on date of Balance Sheet, the car has not been registered in the name of PQR Ltd.**

**Answer:**

According to AS-10, Accounting for Fixed Assets, when fixed asset is acquired in exchange or in part exchange for another asset, the cost of asset acquired should be recorded either at fair market value or net book value of the asset given up. In present case book value is more evident than fair value of car estimated by the directors. Hence, Debtor' A/c should be credited with ₹7 lacs and motor car recorded at the same amount.

Taking principle of substance over form into consideration as laid down in AS 1, the auditor should ensure that the car's acquisition is recorded in the present year though the car is not registered in the name of the auditee.

**(B) M/s XYZ Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2012-13 it received a communication from an Insurance Company informing that premium amount for the accounting year 2011-12 was less charged by ₹95 lacs on account of arithmetical error on the part of Insurance Company. M/s XYZ Ltd. paid the said sum of ₹95 lacs during the accounting year 2012-13 by debiting the same to prior period expenses.**

**Answer:**

AS-5 has defined prior period expenses as those which arise in current period as a result of error or omission in the preparation of financial statement of one or more prior periods. The nature and amount of prior period items should be separately disclosed in the Profit & Loss A/c in a manner that their impact on current profit or loss can be prescribed.

In the given case:

- (i) Arithmetical mistake of ₹95 lacs in computing the amount of premium is not a prior period expense as per AS 5.
- (ii) The error was on part of insurance company.
- (iii) The accounting treatment by M/s XYZ Ltd. is thus incorrect.
- (iv) The auditor should ensure that the disclosure of ₹95 lacs is an ordinary item in current year's Profit & Loss A/c. This may be disclosed in Notes to Accounts.

**22. As an auditor, what would you do in the following situations?**

**(A) The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year.**

**Answer:**

Semi-finished goods being composite part of the inventories, normally, constitute significant item in case of any entity. It is the duty of the auditor to ensure that entire inventories which are owned by the enterprise exist on that date and valuation thereof is also proper. Since the semi-finished goods belong to the company, it is necessary to ensure that the same have been included for in valuation of inventories. The auditor should also obtain direct confirmation about the quantity of inventories lying with the processors at the end of the year. Also, the auditor should see that the valuation has been made properly with reference to the stage of completion in respect of work-in-process inclusive of expenses incurred in

sending the goods for processing. In case, the amount happens to be material, such stock may be disclosed separately as stocks with processors.

**(B) The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.**

**Answer:**

The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of an expert.

SA 620( AAS 9 ) on "Using the Work of an Expert" also states that an expert may be engaged/employed by the client. It further requires the auditor to assess skill, competence and objectivity of the expert amongst other factors and evaluate the work of an expert independently to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of SA 620(AAS 9) before relying upon the certificate obtained by the management from the actuary.

**23. Explain how following are dealt in Auditor's Report as per CARO, 2003?**

**(A) No Cost Accounting records are maintained though the company is required to maintain the same.**

**Answer:**

Under CARO, 2003 where maintenance of cost records, where maintenance of cost records has been prescribed by the Central Government, the auditor of the company is specifically required to state whether such accounts and records as prescribed have been made and maintained.

Whether cost audit is ordered or not, the auditor should report on non maintenance of cost records.

**(B) A Term Loan was obtained from a bank for ₹90 lacs for acquiring R&D equipment, out of which ₹15 lacs was used to buy a car for use of the concerned director, who was overlooking the R&D activities.**

**Answer:**

Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of R&D equipment has been utilized for purchase of car which has no relation with R&D equipment. Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that the out of term loan of R&D lack, ₹15 lacs was not utilised for the purpose of acquiring the R & D equipment.

**(c) Fixed assets comprising 1/3<sup>rd</sup> of the total assets have been disposed off during the year by LMN Ltd.**

**Answer:**

Under CARO, 2003, an auditor is required to state if substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern. This clause requires the auditor to carry out adequate audit procedures to satisfy himself that the company shall be able to continue as going concern for the foreseeable future despite the sale of substantial part of the fixed assets.

Accordingly, in the instant case, the auditor should satisfy himself as to whether disposal off of 1/3<sup>rd</sup> of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets.

The Auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company.

Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the financial statements or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going concern assumption is resolved or not.

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

**Answer:**

Following two essential features of internal control are relevant here:

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

Weakness in internal control system in the instant case:

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

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

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

**Answer:**

The principles to be followed are enumerated below:

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

**25. (A) How would you audit 'Inventory Control and Management' as an Internal Auditor?**

**Answer:**

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

- (i) Has the inventory been classified for proper control? Is A, B, C system of inventory classification followed?

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

### **Some General Aspects:**

- (i) Sometimes used materials are returned to stores. In such cases procedure for recording would be the same as followed in case of unused materials except that these may or may not be priced. Usually separate stores ledger / bin cards are opened. See whether the procedure in this regard has been observed.
- (ii) Review whether any study has been made in regard to mechanization in stores receipt/issue, store accounting.
- (iii) Review whether proper numerical accounts have been kept in respect to stand by spares.
- (iv) See whether there are any Material Receiving Report pending disposal – recording valuation in stores ledger/bin card, accounting the accounts records etc.
- (v) Review the mode of valuation of closing stock.
- (vi) How soon the stores schedule is prepared for annual accounts purpose?
- (vii) Are the stores materials adequately covered by insurance against loss from fire and other risks?
- (viii) Is there proper coordination between:
  - (a) Central Purchase Department
  - (b) Local Purchase Department
  - (c) Stores Department
  - (d) Stock – verification Department
- (ix) In case there are number of factories producing same / similar products make comparative study regarding:
  - (a) Surplus materials
  - (b) Obsolete/slow-moving materials.
  - (c) Finished/work-in-progress stock
  - (d) Opening/closing stock of raw material, etc.

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

### **(B) Discuss the qualities a management auditor should possess.**

**Answer:**

The management auditor should possess the following qualities:

- i) Ability to understand the nature and objectives and problems faced by the organization.
- ii) He should have general understanding of different laws and regulations like Tax Laws, Company Laws etc.
- iii) Expert knowledge of management principles such as delegation of authority, management by exception, budgetary control, flow charts, etc.
- iv) Sufficient knowledge and experience in preparing and presenting reports to different levels of management.
- v) Working knowledge of engineering, costing, statistics, management accounting, industrial psychology etc.
- vi) Dynamic, tactfulness and a pleasing personality.

**26. (A) In a system based audit, test checking approach provides a good base for the auditor to form an opinion on the Financial statement. Explain your views.**

**Answer:**

System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control to provide assurance that:

- (i) All the transactions and information have been recorded,
- (ii) Fraud and errors, if any, in preparing the accounts will be identified,
- (iii) All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,
- (iv) There is compliance with statutory regulations.

After the auditor has ascertained the client's accounting system, he should assess it to satisfy the above-mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he resorts to actual testing of the system in operation. This he does on a selective basis, i.e., he adopts test checking technique. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and/or by auditing in depth. This approach is adopted in system based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability. By this, the auditor first establishes how reliable the system is and then decides how much detailed checking of the transactions and verification of assets and liabilities he must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In

case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

**(B) What are the main points involved in 'Performance Audit' under Government Accounting system?**

**Answer:**

Performance audit refers to an examination of a program, function, operation or the management systems and procedures of a governmental or non-profit entity to assess whether the entity is achieving economy, efficiency and effectiveness in the employment of available resources. The examination is objective and systematic, generally using structured and professionally adopted methodologies.

The scope of audit has been extended to cover efficient, economy and effectiveness audit or performance audit.

Efficiency audit look into whether various schemes/projects are executed and their operations conducts economically & see that amount spent gives expected result & projects carried out in an economical manner.

Economy aspect looks whether government has acquired financial, human and physical resources in an economical manner and that sanctioning and spending authority have observed economy.

Effectiveness looks into appraisal of performance of programmes, schemes, projects with overall targeted objectives.

Efficiency cum performance audit is examination of Financial & operational aspect of performance.

The performance audit involves preliminary study, planning & execution of audit & reporting.

**27. (A) An Audit of expenditure is one of the major components of Government Audit. In the context of "Government Expenditure Audit" write in brief, what do you understand by:**

**(i) Audit against Rules and Orders**

**(ii) Audit of Sanctions**

**(iii) Audit against Provision of Funds**

**Answer:**

Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred.

Briefly, these standards are explained below:

**(i) Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority. It is the function of

the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of auditor is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that :

(a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

(b) they are consistent with the essential requirements of audit and accounts as determined by the C & AG;

(c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

**(ii) Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

**(iii) Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriation made.

### **(B) What are the review areas of an IS Auditor?**

#### **Answer:**

The IS auditors may focus on following review areas:

**(i) Computerised systems and applications :** The auditor should verify that systems and applications are appropriate to the users' needs, efficient and adequately controlled to ensure valid, reliable, timely and secure input, processing and output at current and projected levels of system activity.

**(ii) Information Processing Facilities:** This facility must be controlled to ensure timely, accurate and efficient processing of applications under normal and potentially disruptive conditions.

**(iii) Systems Development:** An IS auditor should ensure that systems under development meet the objectives of the organization, satisfy user requirements and provide efficient, accurate and cost effective systems and applications. The auditor should also ensure that these systems are written, tested and installed in accordance with generally accepted standards for systems development.

**(iv) Management of Information Systems:** MIS must develop an organizational structure and procedures to ensure a controlled and efficient environment for information processing. This plan

should also specify the computers and peripheral equipments required to support all functions in an economic and timely manner.

**(v) Client/Server, Telecommunications and Intranets:** In a client/server environment, all applications that can be dedicated to a user are put on the client. All resources that need to be shared are put on the server. Auditors must ensure that controls are in place on the client as well as on the server and on the network. Auditors must provide the same level of control assurance in an Internet/Intranet environment as in a client/server environment, with special emphasis on TCP/IP and HTTP.

**28. (A) Discuss the control procedures which the auditor should adopt in applying CAAT (Computer Assisted Audit Technique) in an audit under EDP environment.**

**Answer:**

The common types of CAATs are audit software and test data. Audit software consists of computer programmes used by the auditor to process data of audit significance from the entity's accounting systems.

It may consist of package programmes, purpose-written programmes and utility programmes. Regardless of the source of programme, the auditor should substantiate their validity for audit purposes prior to use. Test Data techniques on the other hand are used in conducting audit procedures by entering data (a sample transactions) into an entity's computer systems and comparing the results obtained with the predetermined results. Test data is used to test specific controls in computer programmes, such as, on line password and data access.

**Controlling the CAAT Application:**

The use of a CAAT should be controlled by the auditor to provide reasonable detailed specifications of the CAAT have been met and that the CAAT is not improperly manipulated by the entity's staff. The specific procedures necessary to control the use of a CAAT will depend on the particular application in establishing audit control which require the auditor should consider the need to:

- (I) Approve the technical specifications and carry out a technical review of the work involving the use of the CAAT.
- (II) Review the entity's general IT controls which may contribute to the integrity of the CAAT, e.g., control over programme changes and access to computer files. When such controls cannot be relied upon to ensure the integrity of the CAAT, the auditor may consider processing the CAAT applications at another suitable computer facility.
- (III) Ensure appropriate integration of the output by the auditor into the audit process.

**Procedures carried out by the Auditor to control Audit Software Application :**

- (I) Participating in the design and testing of the computer programmes.
- (II) Checking the coding of the programme to ensure that it conforms with detailed programme specifications.
- (III) Requesting the entity's computer staff to review the operating system instructions to ensure that the software will run in the entity's computer installation.
- (IV) Running the audit software on small test files before running on the main data files.

- (V) Ensuring that the correct files were used, e.g. by checking with external evidence, such as control totals maintained by the user.
- (VI) Obtaining evidence that the audit software functioned as planned, for example, returning output and control information.
- (VII) Establishing appropriate security measures to safeguard against manipulations of the entity's data files.

The presence of the auditor is not necessarily required at the computer facility during the running of a CAAT to ensure appropriate control procedures. However, it may provide practical advantages, such as being able to control distribution of the output and ensuring the timely corrections of errors.

**Procedures carried out by the Auditor to Control Test Data Applications :**

- (I) Controlling the sequence of submissions of test data where it spans several processing cycles.
- (II) Performing test runs containing small amounts of test data before submitting the main audit test data.
- (III) Predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total.
- (IV) Confirming that the answered version of the programmes was used to process the test data.
- (V) Obtaining reasonable assurance that the programmes used to process the test data were used by the entity throughout the applicable audit period.

When using a CAAT, the auditor may require the co-operation of the entity's staff who have extensive knowledge of the computer installation. In such circumstances, the auditor should have reasonable assurance that the entity's staff did not improperly influence the results of the CAAT. Finally, the standard of working papers and retention procedures for a CAAT should be consistent with that on the audit as a whole. It may be convenient to keep the technical papers relating to the use of the CAAT separate from the other audit working papers. The working papers should contain sufficient documentation to describe the CAAT application.

**(B) As a protective function, the internal audit department has a big role to play in preventing frauds in any organization. Do you agree?**

**Answer:**

The internal audit department has a big role to play in preventing fraud in different organizations, as a part of protective functions. Every big organization has an internal audit manual and such a manual usually outlines the internal audit functions in detail in vulnerable areas, where loss through fraudulent means may arise frequently. Example of vulnerable area are stores receipt/consumption, cash expenditure , sizable receipt of cash, civil maintenance jobs, etc. The internal audit manual prescribes in detail the manner and procedure as to how internal audit function would be carried out in these areas. The manual also directs the frequency of such audit. If internal audit of such areas is done accordingly, the possibility occurrence of both visible and invisible frauds get eroded.

In discharging his functions in sensitive areas as mentioned aforesaid, the auditor has to be extra intelligent and imaginative too to enable him to think ahead of many others. However, it needs to be mentioned that the success of internal auditor in preventing fraud is also dependent on the cooperation from other department of the organization.

### **29. (A) Why do we need Management Audit?**

#### **Answer:**

The following are the circumstances wherein the management audit is useful:

- (i) To overcome the human limitations of Top Management.
- (ii) To improve the management's production.
- (iii) Circumstances of corporate planning deficiencies, organization's structured defects, ineffective management control system etc. warrants the necessity of management audit.
- (iv) In the circumstances of acquisition of another business entity, the acquiring organization needs to evaluate financial aspects, technical aspects and management aspects and analysis of these aspects takes the form of management audit.
- (v) Society at large likes to be assured that the top and middle level management discharge their functions efficiently and to the best advantage to the society, the management audit satisfy the different interest of groups like customers, employees, citizens, government etc. of the society and also guide the management in the application of scientific methods of business management for social well being.
- (vi) The statutory financial audit is generally annual and concerned with the past without having any forward approach. Statutory financial audit and internal audit along with statutory cost audit are essentially legalistic in terms of time given for its completion and nature of certification fails to provide the insight to the management in regard to unsuitability of structure to meet the entity's needs, poor leadership, inability to make decisions, poor vision and the enlightened managers realizes this fact and feels the need of management audit to identify the problems and guidance to overcome them.
- (vii) Foreign collaborators, while investing in other organizations feel the necessity of management audit to ensure that the funds invested are to be used properly for growth and expansion.
- (viii) Financial institutions conduct the management audit, while participating in equities of a company to avoid possible losses arising from inefficient management.
- (ix) Company itself feels the need of management audit to assess its managers' performances and link an incentive system to the results of such assessment.
- (x) While advancing loans, banks like to get the management audit conducted.

### **(B) What are the steps involved in carrying out management audit?**

#### **Answer:**

Management audit basically comprises of following three steps:

- (i) Examination of management performance. This involves:
  - Detailed diagnosis and study of activities.
  - Determination of purpose and relationships.

- (ii) Reporting defects and irregularities
  - Looking for shortcomings
  - Searching for problems
- (iii) Presenting suggestions for improvement.
  - Determination of alternatives
  - Testing of effectiveness
  - Ascertainment of solutions to problems
  - Presenting methods of improvement.

### **30. (A) Write short note on broad objectives of operational audit.**

#### **Answer:**

Broad objectives of operational audit:

- (i) Appraisal of controls: Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to, the result that can be attained will be subject to the other limiting constraints in the organization.
- (ii) Evaluation of performance: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance, the operational auditor's mind is invariably fixed on control aspects.
- (iii) Appraisal of objectives and plans: In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on.
- (iv) Appraisal of organisational structure: Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

### **(B) Write short note on Cut-off arrangement.**

#### **Answer:**

Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as "cut-off arrangement". It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and stock are not usually affected by the continuity of

the business and therefore, this arrangement is generally applied only to sales, purchase and stock. The auditor satisfies by examination and test-checks that the cut-off procedure are adequately followed and ensure that:

- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
- (ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of stock into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether stocks represented by those documents were included or excluded as appropriate during stock taking for perfect and correct presentation in the financial statements.

### **(C) What are the inherent limitations of Internal Control system?**

#### **Answer:**

Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as:

- (i) Management's consideration that cost of an internal control does not exceeds the expected benefits.
- (ii) Most controls do not tend to be directed at unusual transactions.
- (iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.
- (iv) The possibility that control may be circumvented through collusion with employees or outsiders.
- (v) The possibility that a person responsible for exercising control may abuse that authority.
- (vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.
- (vii) Manipulation by management with respect to transactions or estimates and judgments required in the preparation of financial statements.
- (viii) Inherent limitations of Audit.