

Paper-6: COMMERCIAL AND INDUSTRIAL LAWS AND AUDITING

**SECTION - I
(Commercial and Industrial Law)**

STUDY NOTE 1 - LAWS OF CONTRACTS:

Question 1:

(a) Point out with reasons whether the following agreements are valid or void:

- (i) Kamala promises Ramesh to lend ₹ 50,000 in lieu of consideration that Ramesh gets Kamala's marriage dissolved and he himself marries her.
- (ii) Sohan agrees with Mohan to sell his black horse. Unknown to both the parties, the horse was dead at the time of agreement.
- (iii) Ram sells the goodwill of his shop to Shyam for ₹ 4,00,000 and promises not to carry on such business forever and anywhere in India.
- (iv) In an agreement between Prakash and Girish, there is a condition that they will not institute legal proceeding against each other without consent.

(v) Ramamurthy, who is a citizen of India, enters into an agreement with an alien friend.

(b) X transferred his house to his daughter M by way of gift. The gift deed, executed by X, contained a direction that M shall pay a sum of ₹ 5,000 per month to N (the sister of the executant). Consequently M executed an instrument in favour of N agreeing to pay the said sum. Afterwards, M refused to pay the sum to N saying that she is not liable to N because no consideration had moved from her. Decide with reasons under the provisions of the Indian Contract Act, 1872 whether M is liable to pay the said sum to N.

(c) A hires a carriage of B and agrees to pay ₹ 500 as hire charges. The carriage is unsafe, though B is unaware of it. A is injured and claims compensation for injuries suffered by him. B refuses to pay. Discuss the liability of B.

Answer:

(a)

- (i) Void Agreement: As per Section 23 of the Indian Contract Act, 1872 an agreement is void if the object or consideration is against the public policy.
- (ii) Void Agreement: As per Section 20 of the Indian Contract Act, 1872 the contract caused by mistake of fact are void. There is mistake of fact as to the existence of subject-matter.
- (iii) Void agreement: As per Section 27 of the Indian Contract Act, 1872 an agreement in restraint of trade is void. However, a buyer can put such a condition on the seller of good will, not to carry on same business. However, the conditions must be reasonable regarding the duration and the place of the business.

(iv) **Void agreement:** An agreement in restraint of legal proceedings is void as per Section 28 of the Indian Contract Act, 1872.

(v) **Valid agreement:** An agreement with alien friend is valid, but an agreement with alien enemy is void.

(b) As per Section 2(d) of the Indian Contract Act, 1872, it is not necessary that consideration must be move from promisor only, thus it may be moved by any other person including a stranger to the transaction.

The problem is based on a case of "Chinnava v Ramawa" in which the Court clearly observed that the consideration need not necessarily move from the party itself, it may move from any person.

Thus M is liable to pay the said sum to N and cannot deny her liability on the ground that consideration did not move from N.

(c) According to Section 150, of the Indian Contract Act, 1872, if the goods are bailed for hire, the bailor is responsible for damages, whether he was aware about the existence of such types of faults in the goods bailed or not.

Thus in given case, B is liable to compensate A for the injuries suffered even if he has no knowledge of the defect in the carriage.

Question 2:

(a) **Mr. Seth an industrialist has been fighting a long drawn litigation with Mr. Raman another industrialist. To support his legal campaign Mr. Seth enlists the services of Mr. X a legal expert stating that an amount of ₹ 5 lakhs would be paid, if Mr. X does not take up the brief of Mr. Raman. Mr. X agrees, but at the end of the litigation Mr. Seth refuses to pay. Decide whether Mr. X can recover the amount promised by Mr. Seth under the provisions of the Indian Contract Act, 1872.**

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

(c) **X, Y and Z jointly borrowed ₹ 50,000 from A. The whole amount was repaid to A by Y. Decide in the light of the Indian Contract Act, 1872 whether:**

(i) **Y can recover the contribution from X and Z,**

(ii) **legal representatives of X are liable in case of death of X,**

(iii) **Y can recover the contribution from the assets, in case Z becomes insolvent.**

Answer:

(a) The problem as asked in the question is based on one of the essentials of a valid contract. Accordingly, one of the essential elements of a valid contract is that the agreement must not be one which the law declares to be either illegal or void.

Further Contract Act specifies that any agreements in restraint of trade, marriage, legal proceedings etc., are void agreements.

Thus Mr. X cannot recover the amount of ₹ 5 lakhs premised by Mr. Seth because it is an illegal agreement and cannot be enforced by law.

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

(c)

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

Question 3:

(a) A contracted with B to supply him (B) 500 tons of iron-steel @ ₹ 5,000 per ton, to be delivered at a specified time. Thereafter, A contracts with C for the purchase of 500 tons of iron-steel @ ₹ 4,800 per ton, and at the same time told 'C' that he did so for the purpose of performing his contract entered into with B. C failed to perform his contract in due course. Consequently, A could not procure any iron-steel and B rescinded the contract. What would be the amount of damages which A could claim from C in the circumstances? Explain with reference to the provisions of the Indian Contract, 1872.

(b) Mr. Ahuja of Delhi, wanting to buy a house engaged Mr. Singh as his agent in West Extension area. Mr. Singh bought a house for ₹ 20 lakhs in the name of a nominee and then purchased it himself for ₹ 24 lakhs. He then sold the same house to Mr. Ahuja for ₹ 26 lakhs. Mr. Ahuja later comes to know the mischief of Mr. Singh and tries to recover the excess amount paid to Mr. Singh. Is he entitled to recover any amount from Mr. Singh? If so, how much? Explain.

(c) K is the wife of A. She Purchased a saree on Credit from B. B demanded the amount from A. A refused to make the payment. B filed a suit against A for the same amount. Decide in light of Indian Contract Act, whether B would succeed.

Answer:

(a) The problem in the question is based on the provisions of the Indian Contract Act, 1872 as contained in section 73. Section 73 provides that when a contract has been broken the party who suffers loss by such breach is entitled to receive compensation for any loss or damage caused to him thereby which naturally arose in the usual course of things from such breach or which the parties knew when they made the contract to be likely to result from the breach of it [Hadley v Baxendale]

In the instant case 'A' had intimated to 'C' that he was procuring iron steel from him for the purpose of performing his contract with 'B' Thus, C had the knowledge of the special circumstance. Therefore, 'A' is entitled to claim from 'C' ₹1,00,000 (difference between the procuring price of iron steel and contracted selling price to 'B') being the amount of profit 'A' would have made by the performance of his contract with 'B'.

If A had not told C of B's contract then the amount of damages would have been the difference between the contract price and the market price on the day of default.

(b) Mr. Ahuja is entitled to recover ₹ 6 Lakhs from Mr. Singh.

Where an agent without the knowledge of the principal, deals in the business of agency on his own account, the principal may:-

1. Repudiate the transaction
2. Claim from the agent any benefit which may have resulted to him from the transaction.

(c) According to Indian Contract Act, 1872, where any husband and wife are living together, the wife is presumed to be an agent of her Husband. Thus, the husband is bound to pay the bills for household credit purchased by her wife provided the following conditions are satisfied:-

1. Husband and wife must be living together
2. They are living in a Domestic establishment of their own and wife should be in charge of domestic establishment.
3. Wife must purchase the Article suited to the style in which they are living

Thus if all above conditions are satisfied wife shall be assumed as an agent and husband is liable.

In given case, K is the wife of A. She purchased a saree on Credit from B. B demanded the amount from A. A refused to make the payment. B filed a suit against A for the same amount. Based upon the assumption that all above conditions are satisfied we may conclude that A is liable to bear the cost of sarees as purchased by his wife K.

Question 4:

(a) M Ltd., contracts with Shanti Traders to make and deliver certain machinery to them by 30.6.2014 for ₹ 11.50 lakhs. Due to labour strike, M Ltd. could not manufacture and deliver the machinery to Shanti Traders. Later, Shanti Traders procured the machinery from another manufacturer for ₹12.75 lakhs. Shanti Traders was also prevented from performing a contract which it had made with Zenith Traders at the time of their contract with M Ltd. And were compelled to pay compensation for breach of contract. Advise Shanti Traders the amount of compensation which it can claim from M Ltd., referring to the legal provisions of the Indian Contract Act.

(b) Akhilesh entered into an agreement with Shekhar to deliver him (Shekhar) 5,000 bags to be manufactured in his factory. The bags could not be manufactured because of strike by the workers and Akhilesh failed to supply the said bags to Shekhar. Decide whether Akhilesh can be exempted from liability under the provisions of the Indian Contract Act, 1872.

(c) State with reasons whether the following statement is correct or incorrect:

If the pawnor makes a default in the payment of debt, or performance of duty, as agreed, the pawnee has a right to sell the thing pledged for which no reasonable notice of the sale is required.

Answer:

(a) Section 73 of the Indian Contract Act, 1872 provides for consequences of breach of contract. According to it, when a contract has been broken, the party who suffers by such breach is entitled to receive from the party who has broken the contract, compensation for any loss or damage caused to him thereby which naturally arose in the usual course of things from such breach or which the parties knew when they made the contract, to be likely to result from the breach of it.

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Such compensation is not given for any remote and indirect loss or damage sustained by reason of the breach.

Applying the above principle of law to the given case, M Ltd is liable to compensate for the loss of ₹1.25 lakhs (₹12.75 less ₹11.50 i.e. ₹1.25 lakhs) which had naturally arisen due to default in performing the contract by the specified date.

Regarding the amount of compensation which Shanti Traders were compelled to make to Zenith Traders, it depends upon the fact whether M Ltd knew about the contract of Shanti Traders for supply of the contracted machinery to Zenith Traders on the specified date.

If he was aware that M Ltd is also liable to reimburse the compensation which Shanti Traders had to pay to Zenith Traders for breach of contract. Otherwise M Ltd is not liable.

(b) The performance does not become absolutely impossible on account of strikes, lockout and civil disturbances and the contract in such a case is not discharged unless otherwise agreed by the parties to the contract.

In this case Mr. Akhilesh could not deliver the bags as promised because of strike by the workers. This difficulty in performance cannot be considered as impossible of performance and hence Mr. Akhilesh is liable to Mr. Shekhar for non-performance of contract.

(c) Incorrect, As per Section 176 of the Indian Contract Act, 1872 in case of default in payment by Pawnor, Pawnee has a right to sell the thing pledged on giving the pawnor reasonable notice of the sale.

Any sale made by the pawnee without giving a reasonable notice will be void.

STUDY NOTE 2 - LAWS RELATING TO SALE OF GOODS:

Question 5:

(a) "Only the owner of goods can transfer a good title-none else" but there are some exception. Please cite a few of such exceptions with detailed provision.

(b) Write a short note on; Transfer of Property in Unascertained Goods.

(c) Mr. B (a broker) by the order of Mr. A purchases 10 Drums of oil for A from Mr. C. Afterwards Mr. A refuses to receive oil. Mr. C sues. Mr. B defends but failed. Mr. B has to pay cost, damages and incurs expense. Can B recover any amount from A?

Answer:

(a)

(i) Sale by mercantile agent: Besides owner, good title can be transferred in following cases by mercantile agent who is in possession of either the goods or documents of titles to the goods with the consent of the owner and sells the goods in the ordinary course of business as a mercantile agent. The buyer gets good title provided the buyer buys in good faith and for value.

(ii) Sale by one of Joint owners: Where one of the several joint owners of goods has the sole possession thereof with permission of the co-owners the property in goods is transferred to any person who buys them in good faith and has not at the time of contract of sale notice that the seller has no authority to sell.

(iii) Sale by a person in possession under voidable contract - A person who obtained possession of goods under voidable contract on the ground of fraud, misrepresentation, coercion or undue influence can pass on good title provided the buyer buys in good faith and without notice of seller's defect of title.

(iv) Sale by seller in possession of goods after sell - where a seller having sold goods continues in possession thereof or of documents of title to the goods, the delivery or transfer by such person or by a mercantile agent acting for such person of the goods by way of sale, pledge or other disposition will pass a good title to transferee provided he buys in good faith and without notice of previous sale.

(v) Sale by buyer in possession of goods.

(vi) Sale by unpaid seller (54(3)).

(vii) Sale by a finder of lost goods (Section 169).

(viii) Sale by Pawnee (Section 176)

(ix) Sale by an official receiver or official assignee or liquidator of the Company.

(b) Transfer of Property of Unascertained Goods: (Section 23 of the Sale of Goods Act, 1930)

Where there is a contract for the sale of unascertained or future goods by description and the goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the consent of the buyer or by the buyer with the consent of seller, the property in the goods there up on passes to the buyer. Such assent may be expressed or implied, and may be given either before or after the appropriation is made.

As per section 18 of Sale of Goods Act where there is a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer unless and until the goods are ascertained. 'Ascertainment' is the process by which the goods answering the description are identified and set apart.

(c) In this case 'A' is liable to 'B' for such damages, costs and expenses because the Employer or an agent is bound to indemnify him against the consequences of all lawful acts done by such agent in exercise of the Authorities conferred upon him. 'B' acted on the instruction of 'A'.

Question 6:

(a) A seller may deliver goods to a carrier with a right of disposal. Comment

(b) Justify the following:

(i) On 30.11.13 Mr. Sham agrees to sell a painting to Mr. Ram for ₹ 5,000 but Mr. Sham died on 8.12.13. Mr. Sham's son claimed ₹ 10,000, Can Mr. Ram obtain the painting at ₹ 5,000 which was agreed to by Mr. Sham?

(ii) Mr. Sham informs Mr. Ram that Mr. Sham's estate is free from encumbrances. Mr. Ram buys the property fully relating on Mr. Sham. Subsequently it revealed that the estate was mortgaged. What will be the position of Mr. Ram?

(iii) Mr. Ram gives diamond to Mr. Sham on "sale or return" basis on the same day; Mr. Sham gives those diamonds to Mr. Jadu on "sale or return" basis. Those diamonds were lost from Mr.

Jadu on the same day, who will the loss?

(iv) Mr. Sham orders on Mr. Ram to deliver certain goods at Mumbai. While the goods are lying at Mumbai Railway Station. The Station Master informs Mr. Sham that the goods are held at station at Mr. Sham's risk, but Mr. Sham became insolvent. Has Mr. Ram has any right as an unpaid seller?

(c) M/s. Wholesaler agreed to supply 1,000 Pcs. of Cotton Shirts to M/s. Retailer at ₹300 per shirt by 31.05.2014. On 01.02.2014 M/s. Wholesaler informs the Retailer that he is not willing to supply the shirt as the price of shirt increased to ₹350 each. Examine the right of M/s. Retailer.

Answer:

(a) Where there is a contract for the sale of specific goods or where goods are subsequently appropriated to the contract, the seller may, by the terms of the contract or appropriation, reserve the right of disposal of the goods until certain conditions are fulfilled. In such case, notwithstanding the delivery of the goods to a buyer, or to a carrier or other bailee for the purpose of transmission to the buyer, the property in the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled.

(b)

(i) A contract of sale of goods is a contract where by the seller transfer or agrees to transfer the property in goods to the buyer for price.

A contract may provide for payment by installment or that the delivery or payment or both shall be postponed.

Subject to the provisions of any law for the time being in force, a contract of sale may be made in writing or by word of mouth.

In this case although the contract was not executed but in view of above, Ram, may enforce 'Sham's heirs for the painting at ₹ 5000 which was agreed to by 'Sham'.

(ii) In this the contract is voidable at the option of Ram, he may avoid the contract. He may insist on its being carried out and the mortgaged debt redeemed.

(iii) Ownership under sale on return remains with seller until it passes to buyer. Mr. Sham, giving diamonds to Jadu, acquires ownership. Although the diamonds were lost from Mr. Jadu's custody on the same day but he was not owner in this case. The owner i.e. Sham shall bear the loss i.e. Mr. Sham shall pay to Mr. Ram.

(iv) Mr. Ram has lost his right of stoppage in transit; the intimation by the station master that the goods are held at the Station at Mr. Sham's rights has transformed the position of station master into a bailee of Mr. Sham instead of Mr. Ram. The transit has thus come to an end.

An unpaid seller can stop the goods in transit in the event of buyers' insolvency. The transit being over, the right is thus lost.

(c) In terms of the provisions of Section 32 and 33 of the Sale of Goods Act, 1930; unless otherwise agreed, delivery of the goods and payment of the price are concurrent conditions, that is to say, the- seller shall be ready and willing to give possession of the goods to the buyer in exchange for the price, and the buyer shall be ready and willing to pay the price in exchange for possession of the goods.

Rights of the Buyer according to the Sale of Goods Act, 1930 include:

(1) To have delivery of the goods as per contract. (Sec. 31 & 32);

(2) To sue the seller for recovery of the price, if already paid, when the seller fails to deliver the

goods;

- (3) To sue the seller for damages if the seller wrongfully neglects or refuses to deliver the goods to the buyer (Sec 57);
- (4) To sue the seller for specific performance;
- (5) To sue the seller for damages for breach of a warranty or for breach of a condition treated as breach of a warranty (Sec 59);
- (6) To sue the seller the damages for anticipatory breach of contract (Sec 60)

In the instant case M/s. Retailer can exercise any of his rights discussed above.

Question 7:

(a) Mr. X was shopping in a self-service Super market. He picked up a bottle of cold drink from a shelf. While he was examining the bottle, it exploded in his hand and injured him. He files a suit for damages against the owner of the market on the ground of breach of condition. Comment, under the Sale of Goods Act, 1930, whether Mr. X would succeed in his claim?

(b) W contracted to erect machinery on V's premises on the condition that the price shall be paid on completion of work. During the progress of work the premises and machinery were destroyed by an accidental fire. Referring to the provisions of the Sale of Goods Act, 1930, decide whether the parties are bound to perform their promises and can W recover the price of the work actually done?

(c) What do you understand by the term 'delivery' in relation to the Sale of Goods Act, 1930?

Answer:

(a) This is based on Section 16(2) of the Sale of Goods Act, 1930, which states that where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be of merchantable quality. Though the term 'merchantable quality' is not defined in the Act, it means that in the present case, the bottle must be properly sealed. In other words, if the goods are purchased for self-use, they should be reasonably fit for the purpose for which it is being used. In the instant case, on an examination of the bottle of cold drink, it exploded and injured the buyer. Applying the provision of Section 16(2), Mr. X would succeed in claim for damages from the owner of the shop.

(b) Section 8 of the Sale of Goods Act, 1930 states that where there is an agreement to sell specific goods and subsequently the goods without the fault of seller or buyer perish before the risk passes to the buyer, the agreement becomes void. In the given case the premises and machinery get destroyed because of accidental fire before the risk passes to the buyer and therefore both parties were excused from further performance.

W having contracted for an entire work for a specific price to be paid on completion of work, could not recover any price for the work actually done.

(c) Delivery is defined under the act as 'a voluntary transfer of possession from one person to another.' [Sec. (2)]. As per Section 33, delivery of goods sold may be affected by doing anything which parties agree to be treated as delivery. Thus delivery of goods may be:

1. Actual or physical delivery :

Physical possession of goods is handed over to buyer from seller.

2. Symbolic delivery:

In this case delivery involves transfer of some symbol that signifies real possession or control of goods. For example, endorsement of Railway Receipt, delivery of godown key etc.

3. Constructive delivery :

In this case there is only an acknowledgement on the part of the person holding possession of goods that he holds them on behalf of buyer. There are three types of constructive delivery:

- (i) When buyer holding the goods, as bailor holds them as his own.
- (ii) When seller holding the goods, holds them as bailee of the buyer.
- (iii) When third person holding the goods on behalf seller, now agrees to hold them on behalf of buyer

STUDY NOTE 3 - LAWS RELATING TO EMPLOYEES:

FACTORIES ACT:

Question 8:

(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?

(b) Pragma Ltd. is a navratna undertaking having its factories throughout India. The company has an impeccable record of best welfare measures and working conditions. Does the company require appointing welfare officers?

(c) Discuss the general duties of an 'occupier' under the Factories Act, 1948

Answer:

(a) 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

(iv) Composing types for printing, printing by letter press, lithography, photogravure or other similar process or book binding;

(v) Constructing, reconstructing, repairing, refitting, finishing or breaking up ships or vessels; (Inserted by the Factories (Amendment) Act, 1976, w.e.f. 26-10-1976.)

(vi) 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) According to Section 49(1) of The Factories Act, 1948, in every factory wherein five hundred or more workers are ordinarily employed the occupier shall employ in the factory such number of Welfare officers as may be prescribed. The State Government may prescribe the duties, qualifications and Conditions of service of officers employed under sub-section (1). [Sec 49(2)].

In the given question Pragya Ltd. is a navratna undertaking having its factories throughout India. If the company has five hundred or more workers it is required to appoint welfare officers.

(c) General duties of an 'occupier' are discussed in sec 7A of the Factories Act, 1948. These are as follows:

Every occupier shall ensure, so far as is reasonably practicable, the health, safety and welfare of all workers while they are at work in the factory.

Without prejudice to the generality of the provisions of sub-section (1), the matters to which such duty extends, shall include –

- (i) the provision and maintenance of plant and systems of work in the factory that are safe and without risks to health;
- (ii) the arrangements in the factory for ensuring safety and absence of risks to health in connection with the use, handling, storage and transport of articles and substances;
- (iii) the provision of such information, instruction, training and supervision as are necessary to ensure the health and safety, of all workers at work;
- (iv) the maintenance of all places of work in the factory in a condition that is safe and without risks to health and the provision and maintenance of such means of access to, and egress from, such places as are safe and without such risks;
- (v) the provision, maintenance or monitoring of such working environment in the factory for the workers that is safe, without risks to health and adequate as regards facilities and arrangements for their welfare at work.

Except in such cases as may be prescribed, every occupier shall prepare, and, as often as may be appropriate, revise, a written statement of his general policy with respect to the health and safety of the workers at work and the organisation and arrangements for the time being in force for carrying out that policy, and to bring the statement and any revision thereof to the notice of all the workers in such manner as may be prescribed.

INDUSTRIAL DISPUTE ACT:

Question 9:

(a) Discuss Adjudication as a method of settling industrial disputes under the Industrial Dispute Act, 1947

(b) Shine Ltd. was running in continuous losses for 5 years. As a result, the company's financial position worsened. The company declared lay-off of 10 of its employees. The employees protested the lay-off. Is this action of employer justified?

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

Answer:

(a) The Industrial Dispute Act, 1947 provides for three tier system of adjudication of industrial disputes. The cases either may be referred by government to court after the receipt of failure report from conciliation officer or directly by any party. Labour courts and Industrial Tribunal may be constituted by State Governments while National Tribunal is constituted by Central Government.

Labour Courts (Sec 7)

The appropriate Government may, by notification in the Official Gazette, constitute one or more Labour Courts for the adjudication of industrial disputes relating to any matter specified in the Second Schedule and for performing such other functions as may be assigned to them -, under this Act.

Industrial Tribunal (Sec 7A)

The appropriate Government may, by notification in the Official Gazette, constitute one or more Industrial Tribunals for the adjudication of industrial disputes relating to any matter, whether specified in the Second Schedule or the Third Schedule and for performing such other functions as may be assigned to them under this Act.

National Tribunal (Sec 7B)

The Central Government may, by notification in the Official Gazette, constitute one or more National Industrial Tribunals for the adjudication of industrial disputes which, in the opinion of the Central Government, involve questions of national importance or are of such a nature that industrial establishments situated in more than one State are likely to be interested in, or affected by, such disputes

(b) As per section 2(kkk) of the Industrial Dispute Act lay-off - means failure, refusal or inability of an employer to give employment to a workman (a) whose name is borne on the muster –rolls of his industrial establishment, and (b)who has not been retrenched. The failure, refusal or inability of an employer to give employment may be due to- (1) shortage of coal, power, or raw materials, (2) the accumulation of stocks (3) breakdown of machinery (4) natural calamity or any other connected reasons.

In the given problem, because of continuous losses, the company's financial position worsened. The company declared lay-off of 10 of its employees. The words 'for any other reason' used in the definition is analogous to the reasons given in the definition. But the cause stated by the company is not covered under the definition. As such, the action of the employer is not justified. Similar observation was made in J. K Hosiery vs. LAT of India.

(c) Conciliation refers to the process by which representatives of employees and employers are brought together before a third party with a view to discuss, reconcile their differences and arrive at an agreement through mutual consent. The third party acts as a facilitator in this process. Conciliation is a type of state intervention in settling the Industrial Disputes. The Industrial Disputes Act empowers the Central & State governments to appoint conciliation officers and a Board of Conciliation as and when the situation demands.

Conciliation Officer:

The appropriate government may, by notification in the official gazette, appoint such number of persons as it thinks fit to be the conciliation officer. The duties of a conciliation officer are:

- (i) To hold conciliation proceedings with a view to arrive at amicable settlement between the parties concerned.
- (ii) To investigate the dispute in order to bring about the settlement between the parties concerned.
- (iii) To send a report and memorandum of settlement to the appropriate government.
- (iv) To send a report to the government stating forth the steps taken by him in case no settlement has been reached at.

The conciliation officer however has no power to force a settlement. He can only persuade and assist the parties to reach an agreement. The Industrial Disputes Act prohibits strikes and lockouts during that time when the conciliation proceedings are in progress.

WORKMEN COMPENSATION ACT & CONSUMER PROTECTION ACT:

Question 10:

(a) How do you define 'disablement' under the Workmen's Compensation Act, 1923?

(b) Gopal made a complaint before the Consumer Disputes Redressal Forum for seeking compensation against the State Electricity Board contending that due to fluctuations and fall in electricity voltage in his small scale industrial unit, he suffered production loss. Will he succeed under the Consumer Protection Act, 1986?

(c) Explain the method of calculation of wages as per Workmen Compensation Act, 1923.

(d) What do you understand by the term 'defect' in goods under the Consumer Protection Act, 1986?

Answer:

(a) Disablement implies loss of capacity to work or move. Disablement leads to loss or reduction in earning capacity of workman. Disablement may be partial or total. Further it may be temporary or permanent. Partial disablement reduces the earning capacity of workman as a result of some accident. It may be temporary or permanent. Temporary partial disablement reduces the earning capacity of workman in any employment in which he was engaged at the time of employment.

Permanent partial disablement reduces the earning capacity in every employment the worker was capable of doing at the time of employment.

Total disablement u/s 2(1) (l) means worker becomes incapable in performing any work which he could perform before accident. Total disablement is deemed to result from every injury specified in Part I of Schedule I or combination of injuries specified in Part II resulting in loss of earning capacity to the extent of 100% or more.

(b) The claim is maintainable. The case is similar to that of Kerala State Electricity Board v Raveendran in which National Commission considered a complaint regarding fall in electricity voltage damaging the machine and affecting production. Compensation was awarded to the aggrieved party taking in the above facts.

(c) As per section 5 of Workmen Compensation Act, 1923, the expression "monthly wages" means the amount of wages deemed to be payable for a month's service (whether the wages are payable by the month or by whatever other period or at piece rates), and calculated] as follows, namely:—

- (i) where the workman has, during a continuous period of not less than twelve months immediately preceding the accident, been in the service of the employer who is liable to pay compensation, the monthly wages of the workman shall be one-twelfth of the total wages which have fallen due for payment to him by the employer in the last twelve months of that period;
- (ii) where the whole of the continuous period of service immediately preceding the accident during which the workman was in the service of the employer who is liable to pay the compensation was less than one month, the monthly wages of the workman shall be the average monthly amount which, during the twelve months immediately preceding the accident, was being earned by a workman employed on the same work by the same employer, or, if there was no workman so employed, by a workman employed on similar work in the same locality;]
- (iii) in other cases [including cases in which it is not possible for want of necessary information to calculate the monthly wages under clause (b)], the monthly wages shall be thirty times the total wages earned in respect of the last continuous period of service immediately preceding the accident from the employer who is liable to pay compensation, divided by the number of days comprising such period.

(d) As defined in Section 2(1)(f) of the Consumer Protection Act, 1986, "defect" means any fault, imperfection or short coming in the quality, quantity, potency, purity or standard which is required to be maintained by or under any law for the time being in force or under any contract express or implied or as is claimed by the trader in any manner whatsoever in relation to any goods.

PAYMENT OF WAGES ACT & MINIMUM WAGES ACT:

Question 11:

(a) What do you understand by the term 'Industrial establishment' under the Payment of Wages Act, 1936?

(b) With whom does the responsibility of fixing minimum rates of wages lie?

(c) Define the term 'Cost of living index number' in relation to Minimum Wages Act, 1948.

Answer:

(a) According to Section 2(ii) of the Payment of Wages Act, 1923, "industrial or other establishment" means any –

(a) tramway service or motor transport service engaged in carrying passengers or goods or both by road for hire or reward;

(aa) air transport service other than such service belonging to or exclusively employed in the military naval or air forces of the Union or the Civil Aviation Department of the Government of India;

(b) dock wharf or jetty;

(c) Inland vessel mechanically propelled;

(d) mine quarry or oil-field;

(e) plantation;

(f) workshop or other establishment in which articles are produced adapted or manufactured with a view to their use transport or sale;

(g) establishment in which any work relating to the construction development or maintenance of buildings roads bridges or canals or relating to operations connected with navigation irrigation or to the supply of water or relating to the generation transmission and distribution of electricity or any other form of power is being carried on;

(h) any other establishment or class of establishments which the Central Government or a State Government may having regard to the nature thereof the need for protection of persons employed therein and other relevant circumstances specify by notification in the Official Gazette.

(b) This is provided in Sec 3 of the Minimum Wages Act, 1948.

The responsibility of fixing minimum wages lies with appropriate government. The appropriate government shall in the manner hereinafter provided-

(a) fix the minimum rates of wages payable to employees employed in an employment specified in Part I or Part II of the Schedule and in an employment added to either Part by notification under section 27:

Provided that the appropriate government may in respect of employees employed in an employment specified in Part II of the Schedule instead of fixing minimum rates of wages under this clause for the whole State fix such rates for a part of the State or for any specified class or classes of such employment in the whole State or part thereof;

(b) review at such intervals as it may think fit such intervals not exceeding five years the minimum rates of wages so fixed and revise the minimum rates if necessary:

Provided that where for any reason the appropriate government has not reviewed the minimum rates of wages fixed by it in respect of any scheduled employment within any interval of five years nothing contained in this clause shall be deemed to prevent it from reviewing the minimum rates after the expiry of the said period of five years and revising them if necessary and until they are so revised the minimum rates in force immediately before the expiry of the said period of five years shall continue in force.

(c) According to Sec 2(d) of the Minimum Wages Act, 1948, 'Cost of living index number' in relation to employees in any scheduled employment in respect of which minimum rates of wages have been fixed means the index number ascertained and declared by the competent authority by notification in the Official Gazette to be the cost of living index number applicable to employee in such employment.

PAYMENT OF BONUS ACT & PAYMENT OF GRATUITY ACT:

Question 12:

(a) Notun Textiles Limited has three separate units at three separate places in the country. Every unit of the said company prepares and maintains separate Balance Sheet and Profit and Loss Account. One of these units is incurring continuous losses and hence bonus is not paid to the employees of this unit. Decide, under the Payment of Bonus Act, 1965 whether the employees of the said unit can claim bonus on the ground that the unit incurring loss is a part of one single establishment?

(b) Abhay Textiles Ltd. employed 20 full-time and 5 part-time employees who were drawing salary of less than ₹ 10,000 per month. After completing service of 28 days, in an accounting year, 10 full-time employees submitted their resignations and left the service of the company. The Board of directors of this company decided not to give the bonus to the employees, who resigned, to the remaining full-time employees and to the part-time employees. Against the decision, all the employees applied to the authorities for relief. Decide, stating the provisions of the Payment of Bonus Act, 1965, whether the employees, who resigned, remaining full-time employees and part-time employees will get relief.

(c) The management of Shanti Mills Ltd. entered into an agreement with their employees to pay them bonus based on production in lieu of Bonus based on profits, from the accounting year 2013. The employees further agreed to forego their right to receive minimum bonus and instead accept 25% of their salary/wage as bonus based on productivity. Is such an agreement valid? Examine in the light of the provisions of the Payment of Bonus Act, 1965.

(d) Seema is employed in ABC Ltd., a seasonal establishment. The factory was in operation for four months during the financial year 2013-14. Seema was not in continuous service during this period. However, she has worked for sixty days. Referring to the provisions of the Payment of Gratuity Act, 1972 decide whether Seema is entitled to gratuity payable under the act. Would your answer be the same in case Seema works for 100 days?

(e) How is the amount of Gratuity determined in case of the following employees:

- (i) A monthly rated employee
- (ii) A piece rated employee
- (iii) An employee of a seasonal establishment

(f) Aswani who was an employee of Sun Televisions Limited, retired on 1st January, 2013 after 30 years of continuous service. The company did not pay the amount of gratuity to Aswani till the end of December, 2013. Now, Aswani claims the amount of gratuity along with interest. Decide, under the Payment of Gratuity Act, 1972 whether Aswani will succeed in his claim?

Answer:

(a) All the 3 units shall be treated as 3 separate establishments since all the 3 units maintain separate B/S and P&L Account.

Employees of the unit which is incurring losses:

- are not entitled to claim bonus on the ground that the unit incurring loss is a part of one single establishment;
- are entitled to minimum bonus as per the provisions of Sec. 10, 12, 13 and 14 of the Act, since minimum bonus is payable whether or not there is any allocable surplus (and whether the establishment has made a profit or incurred a loss).
- However, for the purpose of computation of bonus, the amount of allocable surplus shall be taken for that particular unit only, and not of all the 3 units taken together.

(b) The Act is applicable to the establishment since the establishment has employed 20 or more persons during any day of the AY; and if the provisions of the Act become applicable to an establishment once, they shall continue to be applicable notwithstanding subsequent reduction in the number of persons employed (Sec. 1).

20 full-time and 5 part-time employees are 'employees' within the definition of 'employee' [Sec. 2(13)].

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The 10 full-time employees who resigned are not eligible for bonus since they have not worked for 30 days (Sec. 8).

The remaining 10 full-time employees and all the 5 part time employees are eligible for bonus, since they have worked for 30 days or more during the AY (Sec. 8) and even a part-time employee is entitled to bonus (Automobile Karmchari Sangh v Industrial Tribunal).

(c) The agreement of Shanti Mills Ltd. with its employees is void in so far as it purports to deprive the employee of their right to minimum bonus; and in so far as it purports to entitle the employees to receive bonus exceeding 20% of salary or wages.

The employees are entitled to receive minimum bonus.

(d) Seema is not entitled to since she has not actually worked for not less than 75% of the number of days on which the gratuity establishment was in operation during such period.

If Seema had worked for 100 days then she would have been entitled to gratuity since the number of days on which she would 100 days have worked, in that case, would have been 75% or more of the number of days on which the establishment was in operation

(e) Calculation of amount of gratuity:

(i) In case of monthly rated employee:

- The gratuity shall be payable @ 15 days wages for every completed year of service or part thereof in excess of 6 months.
- 'Wages' means last drawn wages.
- 'Month' means a period of 26 days.
- Thus, gratuity shall be computed as follows:
- Last drawn wages x $15/26$ x Completed years of service (including a part of year in excess of 6 months).

(ii) In case of piece rated employee:

- Gratuity shall be computed as follows:
- Last drawn wages x $15/26$ x Completed years of service (including a part of year in excess of 6 months).
- Last drawn wages shall be computed by taking average of the total wages received by him for a period of 3 months immediately preceding the termination of his employment. While computing daily wages, the total wages of last 3 months is to be divided by number of days the employee actually worked, and not by the number of days or the number of working days in the said period of 3 months.
- For the purpose of computation of last drawn wages, wages paid for overtime work shall not be included in 'wages'.

(iii) In the case of an employee of a seasonal establishment:

- Such an employee shall be paid gratuity at the rate of 7 days' wages for each season.

(f) If the employer fails to pay the gratuity within the prescribed time (i.e., within 30 days of termination of employment), the controlling authority is empowered to issue a certificate, known as the recovery certificate to the collector to recover the amount of gratuity.

Before issue of such certificate, the controlling authority shall give the employer a reasonable opportunity of being heard.

The employer shall also be liable to pay compound interest at such rate as may be notified by CG from time to time. The interest shall be paid starting from the date of expiry of prescribed period for payment of gratuity and ending with the actual date of payment of gratuity.

However, the interest payable shall not exceed the amount of gratuity payable.

The gratuity shall be recovered by the collector in the same manner as if it were arrears of land revenue. The gratuity so recovered shall be paid to the person entitled to payment of gratuity.

Hence Aswani may follow the above rules for settlement of his claim.

EMPLOYEES' PROVIDENT FUND AND MISCELLANEOUS PROVISIONS ACT:

Question 13:

(a) Examine with reasons, the validity of the following nominations made under the provisions of the Employees' Provident Fund and Miscellaneous Provisions Act, 1952:

- 1. J nominated N (his son) as a nominee.**
- 2. M nominated S (his wife) and K (a friend) as nominees.**
- 3. R who does not have a family nominated A (a close relative) as a nominee.**
- 4. G nominated N (a friend) as a nominee because he does not have a family at the time of nomination. Later, after one year he gets married to Z.**

(b) M Group of Industries sold its textile unit to G Group of Industries. M Group contributed 25% of total contribution in Pension Scheme, which was due before sale under the provisions of Employees Provident Fund and Miscellaneous Provisions Act, 1952. The transferee company (G Group of Industries) refused to bear the remaining 75% contribution in the Pension Scheme. Decide, in the light of the Employees Provident Fund and Miscellaneous Provisions Act, 1952, who will be liable to pay for the remaining contribution in case of transfer of establishment and upto what extent?

(c) R, a 57 years old district judge was appointed by Central Government as presiding Officer of the Employees Provident Funds Appellate Tribunal from a period of five years. After three years, he (R) resigns from his office and ceases to work with immediate effect without handing over the charge to his successor, who was not appointed by the Government till that date. Examine the validity of R's action to cease work under the provisions of the Employee's Provident Funds and Miscellaneous Provisions Act, 1952.

Answer:

(a)

- 1. Nomination by J in favour of N is valid, since N is a member of the family of J (since son is covered under the definition of 'family').**
- 2. Nomination by M in favour of S is valid, since S is a member of the family of M (since wife is covered under the definition of 'family'); But in favour of K is void, since K is not a member of the family of M (since K is only a friend, and a friend is not covered under the definition of 'family').**
- 3. Nomination by R in favour of A is valid although A is not covered under the definition of family; but if the employee does not have a family, then, nomination may be made in favour of any person.**
- 4. Nomination by G in favour of N is valid but it becomes void immediately on marriage since a nomination made in favour of a person who is not a member of the family, becomes void immediately when the employee subsequently acquires a family.**

(b) Joint and several liability: M Group of Industries and G Group of Industries shall be jointly and severally liable to pay the remaining 75% liability on account of contribution due under the pension scheme.

Limitation of liability: Liability of G Group of Industries shall be limited to the value of assets obtained by it under the transfer of the establishment.

(c) R continues to be in office till the remaining period of his office, viz. 2 years; or till his successor enters upon his office; or till the expiry of 3 months from the date of resignation; whichever is the earliest.

R's decision to cease work is not valid, unless he is permitted by CG to relinquish his office sooner

STUDY NOTE 4 – OTHER LAWS:

RTI ACT & LIMITED LIABILITY PARTNERSHIP:

Question 14:

(a) How can an existing partner cease to be a partner of LLP?

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

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

(d) Explain the term 'right to information' under the RTI Act, 2005.

Answer:

(a) According to Sec 24(1) of the Limited Liability Partnership Act, 2008, A person may cease to be a partner of a limited liability partnership in accordance with an agreement with the other partners or, in the absence of agreement with the other partners as to cessation of being a partner, by giving a notice in writing of not less than thirty days to the other partners of his intention to resign as partner. Sec 24(2) of the Act states the additional ground on which a partner ceases to be a partner; A person shall cease to be a partner of a limited liability partnership-

(a) on his death or dissolution of the limited liability partnership; or

(b) if he is declared to be of unsound mind by a competent court; or

(c) if he has applied to be adjudged as an insolvent or declared as an insolvent.

Notice is required to be given to ROC when a person becomes or ceases to be partner or for any change in partners.

(b) 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).

(c) 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 there under. (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.

(d) Sec 2(j) of the Right to Information 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;

NEGOTIABLE INSTRUMENTS ACT & COMPETITION COMMISSION ACT:

Question 15:

(a) J accepted a bill of exchange and gave it to K for the purpose of getting it discounted and handing over the proceeds to J. K having failed to discount it returned the bill to J. J tore the bill in two pieces with the intention of cancelling it and threw the pieces in the street. K picked up the pieces and pasted the two pieces together, in such manner that the bill seemed to have been folded for safe custody rather than cancelled. K put it into circulation and it ultimately reached L, who took it in good faith and for value. Is J liable to pay the bill under the provisions of the Negotiable Instruments Act, 1881?

(b) The drawer, 'D' is induced by 'A' to draw a cheque in favour of P, who is an existing person. 'A' instead of sending the cheque to 'P', forges his name and pays the cheque into his own bank. Whether 'D' can recover the amount of the cheque from 'A's banker. Justify.

(c) Flora Ltd, an exporter of garments reached an agreement with the suppliers of raw material stipulating the source of material for ensuring quality of goods to be exported. Comment whether this amounts to anti competitive agreement under the Competition Act, 2002?

(d) ABee Ltd. made an initial public offer of certain number of equity shares. Examine whether these shares can be considered as 'Goods' under the Competition Act, 2002 before allotment.

Answer:

(a) L is a holder in due course, since he acquired the bill in good faith and for value; and since he became the possessor of the bill payable to bearer (assumed that the bill was payable to bearer) (Sec. 9)

J cannot deny the validity of the bill, since no drawer or acceptor of a bill shall, in a suit by a holder in due course, be permitted to deny the validity of the bill as originally drawn, and thus, L who is the holder in due course, acquires a good title to the bill (Sec. 120).

L is entitled to recover the payment of the bill from J and all prior parties, since a holder in due course has the right to sue all the prior parties (Sec. 36)

(b) D's banker is not liable since a paying banker is not liable even if it is subsequently found that any endorsement on the cheque has been forged; provided the paying banker made the payment in due course (Sec. 85).

A's banker is not liable since a collecting banker is not liable for any loss caused to the true owner due to defect title of the holder; provided the collecting banker acted in good faith and without negligence while collecting the amount of the crossed cheque as an agent (Sec. 131).

(c) According to section 3 of the Competition Act, 2002, no enterprise or association of enterprises or person or association of persons shall enter into any agreement in respect of production, supply, distribution, storage, acquisition or control of goods or provision of services, which causes or is likely to cause an appreciable adverse effect on competition within India. In terms of this provision, an agreement stipulating the source of raw material for ensuring the quality of goods to be exported is not anti-competitive agreement.

(d) Section 2(i) of Competition Act, 2002 defines 'goods' as follows:

'Goods' means goods as defined the Sale of Goods Act, 1930 and includes –

1. products manufactured, processed or mined;
2. debentures, stock and shares after allotment;
3. in relation to goods supplied, distributed or controlled in India, goods imported into India.

Hence, debentures and shares can be considered as 'goods' within the meaning of section 2(i) of Competition Act, 2002 only after allotment and not before allotment.

SECTION - II (Auditing)

STUDY NOTE 5 & 6 – AUDITING BASICS:

Question 16:

(a) What is the importance of having the accounts audited by independent professional auditors?

(b) 'Doing an audit is full of risk'. Narrate the factors which cause the risk.

Answer:

(a) The principal advantage of an independent audit lies in the fact that the society is able to get an informed, objective and forthright opinion on the financial statements of enterprises which are used in making significant economic decisions by interested segments of the society, e.g., shareholders, creditors, bankers, etc. Irrespective of the fact whether audit is compulsory, statutory or voluntary, the audit of accounts by an independent professional auditor becomes important for every individual and every type of organisation.

It is only through audited accounts by an independent professional auditor that the shareholders of a company are assured that the funds invested by them are safe and they are being used for only the purposes for which they were raised and collected. The chief utility of audit lies in ensuring reliable financial statements on the basis of which the state of affairs may be easy to understand. Information contained in the statement of accounts of a business are primarily intended for the owners.

However, many others make use of the information for different purposes.

- Management of the business uses it for decision-making purposes.
- Lenders and creditors examine it to establish the degree of safety of their money.
- Government levies tax putting a prima facie reliance on the statements and regulates the socio-economic state of affairs on a summary view of the information contained in various accounting statement made available to it.
- Investors review the information for making investment decisions.
- Financial analysts can use the information to assess the performance of an entity.

Financial statements are of great significance to workers as well; they want to be assured that reasonable and legitimate share of the revenue earned by the organisation has been paid to them as bonus and the distribution pattern has not violated the norms of social justice.

To ensure the acceptable degree of reliability and accuracy of the financial statements, examination and appraisal of accounts and the financial picture by an independent auditor is necessary.

In the company form of organisation, there is a divorce between ownership and management – shareholders are so scattered that they have no direct control on the day-to-day administration of the company while in a proprietary concern, accounts may be audited to get funds from financial institution, etc. and a partnership firm may get its accounts audited to decide questions such as valuation of goodwill at the time of admission, retirement and death of a partner.

The report of an independent auditor is, therefore, the only real safeguard available to the various parties interested in the financial affairs of the entity. It is due to the independence of the auditor, leading to an objective report, that the risk of people being misled by untrue or fraudulent financial statement is minimized. As a by-product, managements get attuned to open and truthful financial statements.

(b) An independent audit whether performed in terms of relevant statutory legislation or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgments made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks. Factors which cause such risk in conducting an audit are discussed below:

1. Exercising judgment on the part of the auditor:

The auditor's work involves exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.

2. Nature of audit evidence:

The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such evidence may far exceed the benefits.

3. Inherent limitations of internal control:

Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite natural that an audit suffers from control risk on account of inherent limitations of internal control risk and detection risk on account of test nature of audit and judgment and estimates involved in formulating accounting policies.

Question 17:

(a) As an auditor, how will you vouch and /or verify the following?

- (i) Recovery of Bad Debts written off.**
- (ii) Borrowing from Banks**
- (iii) Trade Marks and Copyrights.**
- (iv) Sales Return.**

Answer:

(a)

(i) Recovery of Bad Debts written off:

1. Ascertain the total amount of bad debts.
2. Ensure that all recoveries of bad debts have been properly recorded in the books of account.
3. Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.
4. Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(ii) 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:

1. 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.
2. 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.
3. 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.

4. Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.
5. 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

(iii) Trade Marks and Copyrights:

1. Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinize the same and confirm that all of them are shown in the Balance Sheet.
2. Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trademarks and copyrights have been duly registered.
3. Verify existence of copyright by reference to contract between the other and noting down the terms of payment of royalty.
4. See that the value has been determined properly and the costs incurred for the purpose of obtaining the trademarks and copyrights have been capitalized.
5. Verify existence of copyright by reference to contract between the author and the entity and to check the payments of royalty made to author.
6. Ascertain that the legal life of the trademarks and copyrights and see that they have not expired.
7. Ensure that amount paid for both the intangible assets is properly amortized having regard to appropriate legal and commercial considerations.

(iv) Sales Return:

1. Examine the accounting basis for such transactions with reference to corresponding Debit Note. The relevant correspondence may also be examined.
2. Verify by reference to relevant corresponding record in goods inward book or the stores records. Further, the figures in these documentary evidences should be compared with the original invoices for rates and other charges and calculation should also be checked.
3. Examine in depth to eliminate the possibility of fictitious sales returns for covering bogus sales recorded earlier when such returns outwards are in substantial figure either at the start or end of the accounting year.
4. Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.

Question 18:

(a) No entry is passed for cheques received by the auditee on the last day of the year, but not yet deposited with the bank. Comment.

(b) Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts at the year-end. Comment.

Answer:

(a) It is a quite normal that in any ongoing business entity many a times cheques are received from the customs on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank. Though normally speaking, it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.

As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the debtors' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the debtors' ledger should ensure that proper accounting entries have been passed by crediting respective debtors' accounts. The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

(b) Direct confirmation of balances from debtors/creditors in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor. Debtors balances may be confirmed the balance either as at the date of the balance sheet, or as at any other selected date which is reasonably close to the date of the balance sheet.

The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially mis-stated.

Therefore, it is not necessary that balances of debtors/creditors should necessarily be verified only at the end of the year. In fact, in order to incorporate an element of surprise, the auditor may consider different confirmation dates periodically, i.e., Dec, 31 as a cut-off date in one year and June 30 in another year and so on. Therefore, the statement that balance confirmation from debtors/creditors can only be obtained for balances standing in their accounts at the year-end is not correct.

STUDY NOTE 7 – COMPANIES ACT AND PROVISIONS RELATING TO AUDITS:

Question 19:

(a) Who can audit the accounts of a branch of a company?

(b) List the areas to be covered while conducting the audit of an NGO incorporated as a company under section 25 of the Companies Act, 1956.

Answer:

(a) Where a company has a branch office, the accounts of that office shall be audited by the company's auditor appointed under section 224 or by a person qualified for appointment as auditor of the company under section 226, or where the branch office is situated in a country outside India, either by the company's auditor or a person qualified as aforesaid or by an accountant duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

(b) While planning the audit of a Non- Governmental Organisation (NGO), the auditor may concentrate on the following:

- Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates; and
- Reviewing the legal form of the organisation and its Memorandum of Association, Articles of Association, rules and Regulations.
- Reviewing the NGO's Organisation chart, Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and Formats, budgetary policies, if any.
- Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material is omitted:

- Corpus Fund:

The contributions/grants received towards corpus be vouched with reference to the letters from the donor(s). The interest income be checked with investment Register and physical investments in hand.

- Reserves:

Vouch transfers from projects/programmes with donors letters and board resolutions of NGO. Also check transfers and adjustments made during the year.

- Ear-marked Funds:

Check requirements of donors' institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

- Project/Agency Balances:

Vouch disbursements and expenditures as per agreements.

- Loans:

Vouch loans with loan agreements receipt counter –foil issued.

- Fixed Assets:

Vouch all acquisitions/sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/agreements for the grants. For immovable property, check title, etc.

- Investments:

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Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and disinvestments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

- Cash in Hand and Bank Balance:

Physically verify the cash in hand and imprest balance, at the close of the year. Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

- Stock in Hand:

Verify stock in hand and obtain certificate from the management for the quantities and valuation of the same.

- Programme and Project Expenses:

Verify agreement with donor/contributor (s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

- Establishment Expenses:

Verify that provident fund, life insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

Check in details the contribution and grants for projects and programs, receipts from Fund arising programmes, Membership Fee and any Subscription related matters and any other matters that are related to Interest and Dividends.

Question 20:

(a) List the disadvantages of Joint Audit.

(b) Varun Ltd. is holding 75% of Equity Shares of Pawan Ltd. and prepares the financial statement applying AS - 21, As an auditor how would you verify the cost of control and the minority interest as stated in the Consolidated Financial Statement.

Answer:

(a) The following may be the disadvantages of a joint audit:

- Sharing of fees;
- Psychological problem, where firms of different standing are associated in Joint audits;
- Superiority complex of some auditors may affect the work of co-auditor;
- Problem arises regarding co - ordination of the work;
- Areas of work of common concern being neglected;
- Uncertainty about the liability for the work done.

(b) Following are the areas to be covered during verification of Cost of Control —

- The percentage of holding;
- Is there any type of purchase of Preference Shares or not?
- Date of acquisition, if there is any purchase in lot considering the same;
- Date of holding;

- Date of balance sheet;
- Date of Consolidation;
- Whether there is any bonus issue of shares, whether it is before holding or after holding, whether the issue of bonus properly accounted for or not?
- Whether there is any event affecting the value of reserves or not, like revaluation of fixed assets, acquisition of debentures etc;
- Whether there is any payment of dividend by the subsidiary company? Whether the dividend pre or post acquisition? In case of purchase in lot whether proper analysis is done considering the percentage of acquisition of shares?
- Whether there is any proposed dividend? If yes, whether the same has been properly accounted for or not?
- Whether there is any incident of disposal of shares or not?

Following are the areas to be covered during verification of Minority Interest —

- Percentage of shares held by the minority shareholders;
- Whether there is any incident of disposal of shares or not?
- Proportion and amount of profit to be received by the minority shareholders;
- Whether there is any type of up-stream transaction?
- Whether there is any type of unrealized profits to be adjusted?
- Proportion of dividend to be received by the minority holders etc.

Question 21:

(a) Discuss the areas to be covered by an auditor while splitting the shares of face value from ₹ 10 to ₹ 2 per share of a company.

(b) State the procedure for appointment of an auditor of a company.

(c) State the liabilities of a company auditor.

(d) Describe the procedure of submission of Cost Audit Report by the Auditor of a company.

Answer:

(a)

- Confirm that alteration was authorised by articles.
- Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
- Verify also with reference to Form filed with the ROC.
- Verify that alteration had been effected in copies of Memorandum Articles, etc.
- Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

(b) As per section 224 every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed.

Provided, that before any appointment or re-appointment of auditor or auditors is made by any company at any annual general meeting, a written certificate shall be obtained by the company from the auditor or auditors proposed to be so appointed to the effect that the

appointment or re-appointment, if made, will be in accordance with the limits specified in sub-section (1B).

(c) Auditor's liability is most dynamic & always changing from time to time. In past auditors were held liable to their principals only but now a days they are liable to third parties too. Auditors liabilities can be classified as under:

1. Liabilities for Negligence.
2. Liabilities under the Companies Act 1956 and Companies Act, 2013
3. Liabilities for misfeasance.
4. Liabilities under Penal Code.
5. Liabilities under Chartered Accountants Act,1949 and under Cost & Works Accountants Act 1959. (under specific reference)
6. Liabilities under the I.Tax Act 1961.
7. Liabilities to the third parties.

(d) An auditor shall make his report to the Central Government in such form and within such time as may be prescribed and shall also at the same time forward a copy of the report to the company as per section 233B (4).

The company shall, within thirty days from the date of receipt of a copy of the report referred to in sub-section (4), furnish the Central Government with full information and explanations on every reservation or qualification contained in such report.

After considering the report of cost auditor and explanations given by the company, the Central Government can ask for further information and explanations. The company shall submit the same within prescribed time as per section 233B (8) of the 1956 Act.

STUDY NOTE 8 – REVIEW AND AUDIT OF INTERNAL CONTROL SYSTEM:

Question 22:

(a) Describe the techniques used to evaluate an Internal Control System.

(b) What are the different types of audit found in Government departments?

Answer:

(a) Techniques for evaluation of Internal Control System:

- **Narrative Record:** It is a complete and exhaustive description of the system. It is appropriate in circumstances where a formal control system is lacking, like in the case of small businesses. Gaps in the control system are difficult to identify using a narrative record.
- **Check List:** It is a series of instructions that a member of the audit staff is required to follow. They have to be signed/ initialed by the audit assistant as proof for having followed the instructions given. A specific statement is required for every weakness area.
- **Flow Chart:** It is a pictorial representation of the internal control system depicting its various elements such as operations, processes and controls, which help in giving a concise and comprehensive view of the organization's working to the auditor. A complete flow chart would depict the process of raising documents, personnel involved in doing so, the flow of

documents through various departments, maintenance of records, flow of goods and consideration, and dealing with results. The internal control evaluation process becomes easier through a flow chart as a broad picture of all the controls involved can be gauged in a glimpse.

- **Internal Control Questionnaire:** This is the most widely used method for collecting information regarding the internal control system and involves asking questions to various people at different levels in the organization. The questionnaire is in a pre-designed format to ensure collection of complete and all relevant information. The questions are formed in a manner that would facilitate obtaining full information through answers in "Yes" or "No".

(b) Different types of Audit found in Government Departments are as under:

1. Appropriation Audit:

Appropriation Audit is directed primarily to ascertaining that the money expended has been applied to the purpose/purposes for which grants and appropriations specified in the schedule to an Appropriation Act passed under Article 204 of the Constitution have been provided and that the amount of expenditure against each grants of appropriation does not exceed the amount included in that schedule Audit has to satisfy itself that the expenditure which is being audited falls within the scope of a grant or an appropriation specified in the schedule to the Appropriation. Expenditure in excess of the amount of a grant or appropriation as well as expenditure not falling within the scope or intention of any grant or appropriation unless regularized as per Art 205 of the Constitution should be treated as unauthorised expenditure.

2. Audit against Regularity:

Audit against Regularity consists in verifying that expenditure conforms to the authority which governs it to the relevant provisions of the constitution and of the laws and rules made there under and is also in accordance with the Financial Rules, Regulations and orders issued by the competent authority. The work of audit in relation to Regularity of expenditure is of quasi-judicial in character. It involves interpretation of the constitution status, Rules and orders with reference to case laws of previous decisions and procedures. During the process of audit it should be seen that the rules and orders are not in consistent with any provisions of the constitution or of the laws made thereunder, they do not conflict with the orders and rules made by any higher authorities, the issuing authorities has got the necessary powers. All orders relating to delegation of powers should be scrutinized to see whether they are in order.

3. Audit of Sanctions to Expenditure:

The power to sanction expenditure from the Consolidated fund and the Contingency fund of a state is vested in the Governor of the State. The Sanction of the Governor or of fund of the State. One of the important functions of audit in relation to expenditure is to see that each item of expenditure is governed by the sanction of the competent authority.

Question 23:

(a) List the factors that influence an internal auditor's judgment at the time of obtaining audit evidence and how he obtains such evidence?

(b) State the areas of operation that are involved in an internal audit.

Answer:

While auditing, the internal auditor come across various assertions of the management. The internal auditor has to evaluate these assertions so that he would be able to express his opinion on the financial statements.

This evaluation can be made in the light of some facts and reasons. These facts and reasons are called 'Audit Evidence'.

The following factors influence internal auditor's judgment while obtaining audit evidence:

- the nature of the item;
- the adequacy of internal controls;
- the nature and size of the business carried on by the entity;
- Situations which may exert an unusual influence on the management;
- The financial position of the entity;
- The materiality of the item;
- The experience gained during the previous audits;
- The results of auditing procedures, including fraud or error which may have been found;
- The type of information available;
- The trend indicated by accounting ratios and analysis.

The internal auditor obtains evidence by any one or more of the following methods –

- **Inspection** — It consists of examining records, documents, or tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability depending on their nature, source and the effectiveness of internal controls over their processing.
- **Observation** — It consists of witnessing a process or procedure being performed by others.
- **Inquiry and Confirmation** — Inquiry consists of seeking appropriate information from a knowledgeable person inside or outside the entity, Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records.
- **Computation** — It consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.
- **Analytical Review** — It consists of studying significant ratios and trends and investigating unusual fluctuations and items.

(b) According to the Institute of Internal Auditors, internal audit involves five areas of operations:

- **Reliability and integrity of financial and operating information:** Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.
- **Compliance with laws, policies, plans, procedures and regulations:** Internal auditor should review the systems established to ensure compliance with those policies, plan and procedures, law and regulations which could have a significant impact on operations and reports and should determine whether the organization is in compliance thereof.
- **Safeguarding of Assets:** Internal auditors should verify the existence of assets and should review the means of safeguarding assets.
- **Economic and efficient use of resources:** Internal auditor should ensure the economic and efficient use of resources available.

Accomplishing of established objectives and goals for operations: Internal auditor should review operation or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.

Question 24:

- (a) Describe 'Voucher' and 'Vouching', in the context of internal audit.
- (b) Whether an Auditor opinion in a financial statement is persuasive or a conclusive in nature?
- (c) Discuss the significance of audit working papers.

Answer:

(a) A voucher is a piece of substantiating evidence, in the form of a written record of expenditure disbursement, or completed transaction.

Examples of vouchers are: Cash Memo, Sale Invoice. Purchase Requisition Slip, Purchase Invoice Gate Keeper's Note, Bank Paying Slip, Bank Statements. Minutes Book, etc.

The act of examining all documentary evidences (vouchers) is referred to as vouching. Its basic objective is to establish the authenticity of the transactions recorded in the primary books of account. Vouching is said to be 'the essence of auditing' or may be termed as the 'backbone of auditing'.

Importance of Vouching — Serves as evidence; Assurance; Preliminary for Verification; Establishes Authenticity.

(b) Auditors opinion in a financial statement is persuasive and not a conclusive in nature. In the financial statement, auditors gives their conclusion but based on that conclusion, user of the financial statement can't conclude the future viability of the Company or firm and took a decision on the basis of that opinion.

(c) Working Papers are necessary to –

- Aid in planning and performance of the audit;
- Aid in the supervision and review of the audit work;
- Provide evidence of the audit work performed to support the Auditor's opinion;
- Record and demonstrate the audit work from one year to another;
- Plan the timing and extent of audit procedures to be performed;
- Draw conclusions from the evidence obtained;
- Standardize the Working Papers and audit procedures to improve the efficiency of the audit;
- Facilitate the delegation of work as a means to control quality of work performed;
- Provide guidance to the audit staff with regard to the manner of checking the schedules;
- Fix responsibility on the staff member who signs each schedule checked by him, and
- Act as evidence in a Court of law when a charge of negligence is brought against the auditor.

Question 25:

- (a) Explain “Missing Vouchers” and its treatment in internal audit.
- (b) External confirmations are more reliable evidence than internal confirmations - Comment.

Answer:

(a) Missing Vouchers:

A missing voucher can be any of the following:

Missing Cash Memo, missing page in a Cash Collection Statement, missing inward challan for goods received, missing Inspection Report for material, missing TDS Certificate for tax deducted at source, missing Resolution to authorize increase in borrowing power by the company, missing Bank Statement for a day or a month, etc.

A voucher could become missing due to:

- Wrong or careless filing of document. E.g., missing Bank Statement for a day or a month, missing TDS Certificate.
- Unintentional non-awareness of statutory requirements. e.g., missing Resolution to authorize increase in borrowing power by the company, or accidental fire, or lost otherwise.
- Intention to hide the misappropriation by a person. e.g., non-recording of Purchas Invoices received later for goods received and taken in stocks, missing Cash Memo, etc.

The internal auditor should be careful and should carry out cross verification processes from other sources and documents to be able to form a firm opinion in the case of missing vouchers.

The auditor should qualify his report or give a Disclaimer of Opinion in this case, or may give Vouching and Verification an adverse report with reasoning on a particular issue depending upon the materiality of the missing voucher as necessary evidence on the issue.

(b) External Confirmations minimize the possibility that the result of the confirmation process will be biased because of the interception and alteration of confirmation request or responses. SA 500 (Revised) indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. That SA also includes the following generalizations applicable to audit evidence:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This SA is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

STUDY NOTE 9 – INFORMATION SYSTEM AUDIT:

Question 26:

(a) What is meant by the term “Information Security Audit”

(b) 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.

(c) What is Computer Auditing?

Answer:

(a) Information Security Audit is an audit of the level of information security in an organization. The controls in any business organization can be classified as technical, physical and administrative controls.

Thus, information security audit involves checking of security controls from the physical security of data centres to the logical security of databases.

When centred on the IT aspects of information security, it can be seen as a part of an information technology audit. However, information security encompasses much more than IT.

(b) 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:

1. All the transactions and information have been recorded,
2. Fraud and errors, if any, in preparing the accounts will be identified,
3. All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,
4. 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.

(c) In information processed on computers the one way of auditing is to get the printouts of all records, accounts and information and then check it as usual, but this is very time consuming and cannot evaluate the system of internal controls and certain errors found etc, remains undetected. The other more acceptable way is to evaluate the controls in the computer information system and then decide the nature of timing and extent of the substantive procedure to be followed and make use of computer in conducting compliance tests as well as substantive test, but the auditor must have sufficient knowledge of computer system even in certain of cases specialised skills in operations of computer system.

Question 27:

(a) Explain various factors that render manual audit method ineffective in IS audit.

(b) Explain the various types of IT audit.

(c) How would an auditor go for auditing in an e-commerce environment?

Answer:

(a) The audit methods that are effective for manual audits prove ineffective in many IS audits because of the following factors:

Electronic evidence:

Essential evidence is not physically retrievable by most auditors, and it is not readable in its original electronic form.

Terminology:

The tools and techniques used in automated applications are described in terms that are difficult for the non-EDP auditor to understand.

Automated processes:

The methods of processing are automated rather than manual, making it difficult for the non-EDP auditor to comprehend processing concepts and the logic of these concepts.

New risks and controls:

Threats to computer systems and the countermeasures to those threats are new to non-EDP auditors, and the magnitude of the risks and the effectiveness of the controls are not understood.

Reliance on controls:

In manual systems, the auditor can place some reliance on hard-copy evidence regardless of the adequacy of the controls. Whereas, in automated systems, the electronic evidence is only as valid as the adequacy of controls.

(b) The various types of IT Audit are as follows:

1. System and Application:

An audit to verify that system and application are appropriate, efficient and adequately controlled ensure valid, reliable, timely and secure, input, processing and output at all levels of a system activity

2. Information Processing Facilities:

An audit to verify that this processing facility is controlled to ensure timely, accurate and efficient processing of applications under normal and potentially disruptive conditions.

3. Systems Development:

An audit to verify that the systems under development meet the objectives of the organisation and to ensure that the systems are developed in accordance with generally accepted standards for system development.

4. Management of I.T. and Enterprise Architecture:

An audit to verify that I.T. management has developed an organisational structure and procedures to ensure a controlled and efficient environment for information processing.

5. Client:

Tele communicator, Internets, Extranets

(c) E-Commerce denotes the buying and selling transactions through internet using computers. It may pose certain difficulties in accounting, revenue recognition etc. While accounting in such e-commerce environment, an auditor should consider the following guidelines contained in the International Auditing Practical Statement :

1. Evaluate the changes in the auditee's business environment as an effect of e-commerce.
2. Examine the business risk affecting the Balance Sheet due to e-commerce transactions.
3. The officers including chief information officer are enquired to get the real picture of e-commerce and its effect on the state of affairs of the auditee.
4. Evaluate the extent of risk addressed by the auditor due to use of e-commerce.
5. In case the auditee is using services of an Internet Service Provider, certain records of such service providers relating to the auditee be asked for and verified.
6. Measure the risk involved in e-commerce transactions in the case of use of public network.
7. See whether appropriate accounting policy is adopted for recording development costs and revenue recognition.
8. Verify the non compliances of taxation and legal matters in the case of international ecommerce.
9. Verify the controls established to reduce the risk associated with e-commerce transactions.
10. Verify the efficiency of physical, logical and technical controls established for authorization, authenticity, confidentiality, security for information etc. e.g. passwords, firewalls, encryption etc.
11. Evaluate the reliability of the system to check the completeness, accuracy, timeliness and authorization of information.
12. See that adequate controls regarding validation of input, prevention of transactions to be omitted or duplicated, acceptance of terms of agreement before order processing, prevention of acceptance of order if all steps are not completed by the customer, ensuring proper distribution of transaction details across multiple systems in a network and ensuring the retention of backup and security of the related record.

Question 28:

(a) Explain the relation between Computer Information System and Internal Controls.

(b) Explain CAAT.

Answer:

(a) An auditor is concerned with the control from the point of view of authenticity, accuracy, completeness, assets safeguarding etc. Though the internal control in computer information system are based on the principles same as those followed in manual system which means the system of authorisation and allotment of duties etc. are determined on the same basis as in the manual system.

Some of these controls are as under -

1. Password

This control is used to identify the person before the computer information system starts processing the task. This control assures that the data fed into and the processing done by the computer information system are authorised.

2. Edit Test

Edit test, Financial control test etc. help in correct data entry and the accurate processing by the computer information system.

3. Batch Cancellation Stamp

This control keeps check on the processing of data only once and the repetition is avoided.

4. Financial Control Total

Along with edit test, this control helps in saving of the data and complete processing of the data.

5. File Libraries

File libraries, locks on computer installation etc. are used to safeguard the computer information system from destruction and corruption.

6. Audit Trails

Ensures that all those record and process are maintained within the system from which financial statement are derived.

7. General Control

These control establish overall control of the activities of computer information system. These controls include a) Organisational Control b) System & Documentation Control c) Access Control d) Hardware Control e) Procedural Control etc.

8. Application Controls

Over and above general control, control over the application of the computer information system is very important. These controls include a) Input control b) Processing control and c) Output control

The Auditor should evaluate the above control measures to ascertain the effects of them on the system. A clear audit trail assists the auditor to audit on it, allows the Auditor to trace the transaction from input to output data. The proper electronic trail helps in tracing the transaction properly.

(b) Computer Assisted Audit Technique (CAAT):

Computer assisted audit technique uses computer to process the information, required for audit, stored in the auditee's information system. This technique is used for testing general controls and application controls and also for substantive procedures. This technique is also helpful in getting data from auditee's record as well as for analytical procedures.

The auditor must have expertise and experience in executing and using the results of the Computer Assisted Audit Technique. Before applying this technique auditor should get reasonable assurance of its integrity, reliability, usefulness and security through appropriate

planning, designing, processing and review of documentation. He should see that this technique is properly controlled. Auditor should maintain sufficient documents describing the application of the technique and regarding planning, execution, inputs, processing, output, source code, technical information about the auditee's accounting system, audit evidence and suggestions, if any, for use of the technique in future etc. Auditor should make necessary arrangements for data files to minimize the effect on auditee's routine activities.

Different Computer Assisted Audit Techniques available are as under.

1. Test data
2. Integrated Test Facility
3. Audit Software
4. Audit Automation
5. Core Image Comparison
6. Data Base Analysis
7. Embedded Code
8. Log Analyzers
9. Mapping
10. Modeling
11. Online Testing
12. Program Code Analysis
13. Program Library Analyzers
14. Snapshots
15. Source Comparison
16. Tracing

STUDY NOTE 9 – MANAGEMENT AUDIT:

Question 29:

(a) Draft a Management Audit questionnaire for Audit of Inventory.

(b) Discuss the qualities a management auditor should possess.

Answer:

(a) A management audit questionnaire for audit of inventory is given below:

Long Range Plans:

- Is inventory management sufficiently qualified to meet long-range company objectives?
- Are long-range inventory management plans coordinated with: production, purchasing and finance?
- Is inventory properly and efficiently stored to reduce obsolescence, pilferage, etc.
- Is there an adequate system to plan inventory in the long run at optimum levels?
- Are inventory plans and procedures audited periodically?

Short or Medium Range Plans:

- Is inventory management sufficiently qualified to meet short or medium range objectives?
- Are inventories under control as to type and amount?

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- Are short-range inventory management plans an integral part of production and purchasing?
- Is there an adequate inventory system to plan current inventory at optimum levels detect theft and compare physical to perpetual inventories?
- Are lead times figured into inventory levels for purchasing and manufacturing?
- Are reorder levels set?
- Do the plans include 'make' or 'buy' decisions to lower costs?

Organisation Structure:

- Is the inventory department under directions of a suitable person?
- Are the inventories and their in-plant movements organised and reported by their basic types, i.e., raw materials, work in progress and finished goods?
- Is there an effective system of physical inventory to disclose any irregularities or losses?
- Is the ABC analysis followed for the inventory control?

Communication:

- Is there an information system utilised that employs efficient management, methods and techniques to control inventories and to prepare periodic inventory reports that are of great value to management?
- Is there an effective communication system designed to assist in, keeping the inventory turnover rate high?
- Is there good managerial control over movement of work-in-process materials so that this inventory is kept at a minimum?

Control:

- Are inventory management control reports, methods and techniques integrated with production and purchasing?
- Are inventories properly stored to provide a minimum of:
 1. Obsolescence?
 2. Deterioration?
 3. Pilferage?
- Is inventory control integrated with:
 1. economic order quantities?
 2. re-order points?
- Have steps been taken to balance the cost generated by too small inventory against the cost of carrying excessive inventories to determine an optimum inventory turnover?
- Are inventory items physically counted to make sure that perpetual inventory records are accurate?
- Is inventory controlled through the use of the ABC concept (A = high-value items, B = medium-value items, C = low-value items)?
- Is there an effective management control system for receiving materials that are not on a purchase order, i.e., products returned by customers?

(b) The management auditor should possess the following qualities:

1. Ability to understand the nature and objectives and problems faced by the organisation.
2. He should have general understanding of different laws and regulations like Tax Laws, Company Laws etc.

3. Expert knowledge of management principles such as delegation of authority, management by exception, budgetary control, flow charts, etc.
4. Sufficient knowledge and experience in preparing and presenting reports to different levels of management.
5. Working knowledge of engineering, costing, statistics, management accounting, industrial psychology etc.
6. Dynamic, tactfulness and a pleasing personality.

Question 30:

(a) Explain the relevance of management audit in today's business scenario.

(b) State the advantages and limitations of Management Audit.

Answer:

(a) The relevance of management audit in today's business scenario may be enumerated as follows:

1. To overcome the human limitations of Top Management.
2. To improve the management's production.
3. Circumstances of corporate planning deficiencies, organization's structured defects, ineffective management control system etc. warrants the necessity of management audit.
4. 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.
5. 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.
6. 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.
7. 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.
8. Financial institutions conduct the management audit, while participating in equities of a company to avoid possible losses arising from inefficient management.

9. Company itself feels the need of management audit to assess its managers' performances and link an incentive system to the results of such assessment.
10. While advancing loans, banks like to get the management audit conducted.

(b) Advantages of Management Audit:

1. The company's personnel know the organizational policies, plans, personnel operations, personalities and working relationships, the political climate, the functional importance, and some of the problems themselves.
2. The audit team need not spend an unduly long time for familiarizing themselves with the background information for study.
3. It may be easier to get the support of the higher management, because such audit in the form of self appraisal apparently involves no extra cost.
4. The acceptance of the findings may be comparatively easier because the concerned personnel may readily accept the recommendations from the internal management audit team (consisting of co-workers) than from the external management auditors (or consultants).
5. The implementation of the new method of operation or organizational arrangement may be easier because the personnel who designed and advised it are on the premises. The constant co-operation necessary in the implementation phase are greatly facilitated.
6. The experience and expertise gained by the company personnel in the conduct of management by self appraisal could be gainfully utilized for subsequent audits.

Limitation of Management Audit:

1. The company personnel possess experience limited only to their organization. The company might have faced difficulties and constraints due to limited experience of the company personnel.
2. They are more likely to take facts for granted and may not probe into the details to unearth problems.
3. There may be a tendency to suppress unfavorable facts relating to some of the fellow personnel.
4. The company may not have the talent necessary to conduct such management audit involving complicated studies.
5. It may not be possible for the company to spare personnel for the studies as these may take long time.
6. It may be possible, due to conflicting interests that the audit work may be prolonged and as a result, the action on findings and recommendations may be delayed.
7. The vested interests of the operational executives may prevent the management audit team from being objective.

8. In a management audit scheme, the areas of investigation should fruitfully cover the entire management system, and so the situation demands the audit team to complete the studies under a time constraint which may result in not covering some of the important appraisal areas.