

INTERMEDIATE EXAMINATION

(REVISED SYLLABUS - 2008)

GROUP - I

Paper-6 : COMMERCIAL AND INDUSTRIAL LAW AND AUDITING

SECTION - I

(Commercial and Industrial Law)

Q. 1. Comment on the following :

- (a) S induced R to buy his motorcycle saying that it was in a very good condition. After taking the motorcycle, R complained that there were many defects in the motorcycle. S proposed to get it repaired and promised to pay 40% cost of repairs. After a few days, the motorcycle did not work at all. Now R wants to rescind the contract.
- (b) P contracts with Q for a fixed price to construct a house for Q within a stipulated time. Q would supply the necessary material to be used in the construction. R guarantees P's performance of the contract. Q does not supply the timber as per the agreement. Is R discharged from his liability?
- (c) 'X' agreed to become an assistant for 5 years to 'Y' who was a Lawyer practicing at Delhi. It was also agreed that during the term of agreement 'X' will not practise on his own account in Delhi. At the end of one year, 'X' left the assistantship of 'Y' and began to practise on his own account. Referring to the provisions of the Indian Contract Act, 1872, decide whether 'X' could be restrained from doing so?
- (d) F sells the goodwill of his shop to G for ₹ 6,00,000 and promises not to carry on such business forever and anywhere in India. Comment on the validity of the contract.
- (e) X lends a sum of ₹ 10,000 to Y, on the security of five shares of a Limited Company on 1st April 2011. On 15th September, 2011, the company issues bonus shares. Y returns the loan amount of ₹ 10,000 with interest but X returns only five shares which were pledged and refuses to give the bonus shares. Advise Y in the light of the provisions of the Indian Contract Act, 1872.
- (f) P rents out his house situated at Kolkata to Q for a rent of ₹ 5000/- per month. A sum of ₹ 2 lac, the house tax payable in arrears, his house is advertised for sale by the Municipal Corporation. Q pays the Corporation, the sum due from P to avoid legal consequences. Referring to the provisions of Indian Contract Act, 1872, decide Q is entitled to get reimbursement of the said amount from P.
- (g) F, B and G jointly borrowed ₹ 500,000 from W. The whole amount was repaid to W by B. Decide in the light of the Indian Contract Act, 1872 whether :
 - (i) B can recover the contribution from F and G,
 - (ii) Legal representatives of F are liable in case of death of F,
 - (iii) B can recover the contribution from the assets, in case G becomes insolvent.
- (h) P contracted with Q to supply him (Q) 500 tons of iron-steel @ ₹ 6,000 per ton, to be delivered at a specified time. Thereafter, P contracts with R for the purchase of 500 tons of iron-steel @ ₹ 5500

per ton, and at the same time told 'R' that he did so for the purpose of performing his contract entered into with Q. R failed to perform his contract in due course. Consequently, P could not procure any iron-steel and Q rescinded the contract. What would be the amount of damages which P could claim from R in the circumstances? Explain with reference to the provisions of the Indian Contract, 1872.

- (i) M promises to gift his son N ₹ 1 lac if N clears Joint Entrance Exam in first attempt. N clears the exam in the first attempt, but M fails to pay ₹ 1 lac as promised. N files a suit for recovery of the amount. State N's position.
- (j) Z & Co. through a newspaper advertisement announced a season end sale of woollen garments and exhibited the articles in their showroom with the original and the reduced prices marked on them. H, who had read the advertisement, picks up a woollen sweater marked ₹ 500/- as original price and ₹ 200/- as reduced price. But when H offers ₹ 200/- at the counter, the salesman refuses to accept the amount and hand over the article to H. Discuss the rights of H against Z & Co.

Answers 1.

- (a) The aggrieved party, in case of misrepresentation by the other party, can avoid or rescind the contract [Section 19, Indian Contract Act, 1872]. The aggrieved party loses the right to rescind the contract if he, after becoming aware of the misrepresentation, takes a benefit under the contract or in some way affirms it. Accordingly in the given case R could not rescind the contract, as his acceptance to the offer of S to bear 40% of the cost of repairs impliedly amount to final acceptance of the sale [Long v. Lloyd, (1958)].
- (b) According to Section 134 of the Indian Contract Act, 1872, the surety is discharged by any contract between the creditor and the principal debtor, by which the principal debtor is released or by any act or omission for the creditor, the legal consequence of which is the discharge of the principal debtor. In the given case the Q omits to supply the timber. Hence R is discharged from his liability.
- (c) An agreement in restraint of trade/business/profession is void under Section 27 of the Indian Contract Act, 1872. But an agreement of service by which a person binds himself during the term of the agreement not to take service with anyone else directly or indirectly to promote any business in direct competition with that of his employer is not in restraint of trade. However in the given case X cannot be restrained by an injunction from doing so.
- (d) 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 goodwill, not to carry on same business. However, the conditions must be reasonable regarding the duration and the place of the business. Hence the agreement is void.
- (e) This is based on the provisions of Section 163(4) of the Indian Contract Act, 1872. As per the section, "in the absence of any contract to the contrary, the bailee is bound to deliver to the bailor, any increase or profit which may have accrued from the goods bailed."
- Applying the provisions to the given case, the bonus shares are an increase on the shares pledged by Y to X. So X is liable to return the shares along with the bonus shares and hence B the bailor, is entitled to them also (*Motilal v Bai Mani*).
- (f) As per provisions of Section 69 of the Indian Contract Act, 1872, Q is entitled to recover from P the amount paid to Municipal Corporation because of the following reasons :
- There is a contract between P and Q, viz. quasi contracts.
 - P is bound to to make payment of house tax to Municipal corporation.
 - Q is interested in such payment
 - Q himself is not liable for such payment.

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

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

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

As per the provisions of above sections,

- (i) B can recover the contribution from F and G because F, B, G are joint promisors.
 - (ii) Legal representative of F are liable to pay the contribution to B. However, a legal representative is liable only to the extent of property of the deceased received by him.
 - (iii) 'B' also can recover the contribution from G's assets.
- (h) This 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 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. The leading case in this point is *Hadley v Baxendale*.

In "*Hadley vs. Baxendale*" it was decided that if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.

In the instant case 'P' had intimated to 'R' that he was procuring iron steel from him for the purpose of performing his contract with 'Q'. Thus, R had the knowledge of the special circumstance. Therefore, 'P' is entitled to claim from 'R' ₹ 2,50,000 (difference between the procuring price of iron steel and contracted selling price to 'Q') being the amount of profit 'P' would have made by the performance of his contract with 'Q'. If P had not told R of Q'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.

- (i) As per Section 10 of the Indian Contract Act, 1872, there is no contract between father and son since there is no intention to create legal relations, as it is a domestic or social agreement. As such N cannot sue his father for recovery of ₹ 1 lac as there is no contract between his father and him.
- (j) Price quotations and price tags do not amount to an offer but are only an invitation to an offer. Therefore, H's picking up the woolen sweater with price tag of ₹ 200/- as reduced price amounts to an offer by H to purchase the same at that price. It remains to be accepted by the seller- the salesman of Z & Co. to result in a concluded contract. The sales man has every right to accept or refuse the offer. Thus H shall have no remedies.

Q. 2. (a) Explain the general rules of relating to "Acceptance" under the Indian Contract Act, 1872.

(b) What is the status of a "finder of goods" under the Indian Contract Act, 1872? What are his rights?

(c) Discuss the distinction between wagering agreement and contingent contract.

(d) (i) Is there presumption of undue influence in relationship of husband and wife?

(ii) Does threat to commit suicide amount to coercion?

(e) Discuss the various modes of creating an agency.

(f) Explain the rights of a surety .

Answer 2. (a)

Following are the general rules regarding acceptance under the Indian Contract Act, 1872:

- (i) Acceptance must be absolute and unqualified [Section 7(1)].
- (ii) Acceptance must be in the prescribed manner. If the offer is not accepted in the prescribed manner, then the offeror may reject the acceptance within a reasonable time.
- (iii) Acceptance must be communicated to the offeror. If acceptance is communicated to the person, other than the offeror, it will not create any legal relationship.
- (iv) Acceptance must be given by the party to whom the offer is made.
- (v) Acceptance must be given within the prescribed time or within a reasonable time.
- (vi) Acceptance cannot be given before communication of an offer.
- (vii) Acceptance must be made before the offer lapses or is withdrawn.
- (viii) Acceptance must show intention to fulfill the promise.
- (ix) Acceptance can not be presumed from silence.
- (x) Doing of desired act amounts to acceptance.

Answer 2. (b)

A person, who finds goods belonging to another and takes them into his custody is subject to the same responsibility as a bailee. He is bound to take as much care of the goods as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quality and value. He must also take all necessary measures to trace its owner. If he does not, he will be guilty of wrongful conversion of the property. Till the owner is found out, the property in goods will vest with the finder and he can retain the goods as his own against the whole world (except the owner, of course).

A finder of goods has the following rights under the Indian Contract Act, 1872.

1. **Right of lien** : The finder of goods has a right of lien over the goods for his expenses. As such he can retain the goods against the owner until he receives compensation for trouble and expenses incurred in preserving the goods and finding out the owner. But he has no right to sue the owner for any such compensation (Section 168).
2. **Right to sue for reward** : The finder can sue for any specific reward which the owner has offered for the return of the goods. He may also retain the goods until he receives the reward. (Section 168)
3. **Right of resale** : The finder has a right to sell the goods in the following cases:
 - (i) where the goods found is in danger of perishing;
 - (ii) where the owner cannot, with reasonable diligence, be found out;
 - (iii) where the owner is found out, but he refuses to pay the lawful charges of the finder; and
 - (iv) where the lawful charges of the finder, in respect of the goods found, amount to 2/3rd of its value.

Answer 2. (c)

Wagering Agreement	Contingent Contract
(i) The term 'wagering agreement' is not defined u/s 30 or any other section of the Indian Contract Act, 1872.	The term 'contingent contract' is defined u/s 31 of the Indian Contract Act, 1872.
(ii) A wagering agreement is a promise to give money or money's worth upon the determination of uncertain event.	A contingent contract is a contract to do or not to do something if some event collateral to such contract does or does not happen.
(iii) Uncertain event is the sole determining factor of agreement.	The event is only collateral in case of contingent contract.
(iv) The agreement is void.	The contract is valid.
(v) The parties to agreement have no interest (other than their betting stakes) in the outcome of the uncertain event.	The parties have real interest in outcome of uncertain event.
(vi) A wagering agreement is essentially of contingent nature.	A contingent contract may not be of wagering nature.

Answer 2. (d)

- (i) As per Section 16 of the Indian Contract Act, 1872 undue influence cannot be presumed in husband wife relationship unless the wife is a pardanashin woman (Howes v. Bishop, 1909, 2KB 390). The burden of proving pardanashin rests on the wife.
- (ii) As per Section 15 of Indian Contract Act, committing or threatening to commit any act forbidden by Indian Penal Code is coercion. As such 'threat to commit suicide' amounts to coercion as it is forbidden by the Code.

Answer 2. (e)**Agency may be created in the following ways:**

1. By express agreement either oral or in writing. (Sec.187)
2. By implied agreement arising out of conduct, situation or relationship of parties. (Sec.187)

Implied agency are of three types-

 - (i) Agency by Estoppel-(Sec 237) When a person by his conduct or statements creates a situation whereby a certain person is believed to be his agent, he is estopped from denying the fact subsequently.
 - (ii) Agency by holding out – An affirmative conduct on part of principal is necessary to create an agency by holding out.
 - (iii) Agency of necessity – (Sec 189) In this case there is no express or implied contract between the parties involved, but one is forced to act on behalf of another because of the circumstances.
3. By ratification (Sec 196-200) When an agent acts without the knowledge of his principal or exceeds its authority, the principal, if he so desires, ratify the act of the agent. Such ratification may be express or implied.

Answer 2. (f)

A surety has right against :

1. The creditor :

- (a) Before payment of guaranteed debt –may require the creditor sue the principal debtor. However he has to bear the expenses arising therefrom.
- (b) Right to set-off or counter claim that debtor has against creditor.
- (c) On payment of guaranteed debt, right to benefit of creditor's securities. In fact he steps into the shoes of creditor.

2. The debtor :

- (a) Right to be relieved of his liability before payment has been made.
- (b) Right to indemnity.

3. The co-sureties :

- (a) In absence of any contract to the contrary, the co-sureties are liable to contribute equally.
- (b) When sureties are bound by different sums they have to contribute equally subject to maximum sum guaranteed.
- (c) Release by creditor of one of the sureties, does not release him of the responsibility towards co-sureties.

Q. 3. Comment on the following :

- (a) **Mr. X was shopping in a selfservice 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. Decide, under the Sale of Goods Act, 1930, whether Mr. X would succeed in his claim?**
- (b) **B buys goods from A on paymentbut leaves the goods in the possession of A. A then pledges the goods to C who has no notice of the sale to B. State whether the pledge is valid and whether C can enforce it. Decide with reference to the provisions of the Sale of Goods Act, 1930.**
- (c) **P purchased from Q 5000 tins of canned fruit to be packed in cases, each containing 50 tins but Q supplied cases containing 25 tins. Does P have right to rejects the goods?**
- (d) **W contracted to erect machinery on Vs 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?**

Answer 3. (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.

Answer 3. (b)

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

Answer 3. (c)

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

Answer 3. (d)

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.

Q. 4. (a) Point out the differences between conditions and warranties under the Sale of Goods Act, 1930.

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

(c) "Nemo Dat Quod Non Habet" — No one can give a better title than he himself has. State the exceptions to the rule.

(d) State difference between lien and stoppage in transit.

Answer 4. (a)

The points of differences are as follows :

Condition	Warranty
(i) A condition is a stipulation which is essential to the main purpose of the contract.	A Warranty is a stipulation which is collateral to the main purpose of the contract.
(ii) The aggrieved party can repudiate the contract of sale in case there is a breach of a condition.	The aggrieved party can claim damages only in case of breach of a warranty.
(iii) A breach of condition may be treated as a breach of a warranty. This would happen where the aggrieved party is contented with damages only.	A breach of a warranty, can not be treated as a breach of a condition.

Answer 4. (b)

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 effected by doing anything which parties agree to be treated as delivery. Thus delivery of goods may be :

(i) **Actual or physical delivery** : Physical possession of goods is handed over to buyer from seller.

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

Answer 4. (c)

The exceptions to the rule are given vide Sections 27 to 30 of Sale of Goods Act, 1930.

These are as follows :

- (i) Sale by a mercantile agent who is in possession of the goods with consent of the seller and sells the goods in ordinary course of business.
- (ii) Sale by a joint owner in possession of goods with consent of other joint owners. (Sec 28)
- (iii) Sale by a person in possession of goods under a contract which may be voidable on the ground of fraud, misrepresentation, coercion or undue influence provided sale is made before voidable contract is avoided. (Sec 29)
- (iv) Sale by seller who is in possession of the goods after sale but not in capacity of buyer's bailee. The subsequent buyer must buy in good faith and for value. (Sec 30)
- (v) Sale by buyer who is in possession of the goods before actual purchase if the subsequent buyer buys bona fide and for value. (Sec 30(2))
- (vi) Sale made by unpaid seller exercising his right of lien and stoppage in transit. (Sec 54(3))
- (vii) Sale made by finder of lost goods u/s 169 of Indian Contract Act.
- (viii) Sale by pawnee or pledge u/s 176 of Indian Contract Act.
- (ix) Sale made by Official Receiver or Official Assignee or Liquidator.

Answer 4. (d)

Lien	Stoppage-in-transit
(1) Applicable only when goods are in possession of the seller.	Applicable only after the seller has parted with the goods.
(2) Applicable even if the buyer is solvent.	Applicable only when the buyer becomes insolvent.
(3) This is a right to retain possession of goods.	This is a right to regain possession of goods.
(4) The right can be exercised by seller only.	The right can be exercised by seller through carrier or bailee who is in possession of the goods.

Q. 5. Comment on the following :

- (a) **Safety officers in any factory are optional and not mandatory.**
- (b) **'X' joined BE Engineering Works (P) Ltd. on 5.3.2011. On 8th December, 2011 he was laid off as the management wanted to slow down due to shortage of power. 'X' was not allowed lay-off compensation on the ground that his period of service was less than one year.**

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

Answer 5. (a)

As per Sec 40-B of The Factories Act, 1948 in every factory (i) wherein 1000 or more workers are ordinarily employed, or (ii) wherein, in opinion of the State Government, any manufacturing process or operation is carried on, which involves any risk or bodily injury, poisoning or any other hazard to health, to persons employed in factory, the occupier shall if so required by State Government by notification in Official Gazette, employ such number of safety officers as specified in the notification [Sec 40B(1)]. The duties, qualifications and conditions of service of Safety Officers are to be prescribed by State Government. [Sec.40 B(2)].

Answer 5. (b)

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

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

Answer 5. (c)

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

- Q. 6. (a)** The employer of TGH Ltd made certain alteration in wage structure as a result of which certain allowances were discontinued. However the total salary of an employee remained unchanged. Will an application under Sec 15(2) of the Payment of Wages Act, 1936 lie for this?

- (b) XYZ Ltd is running into losses and is unable to pay minimum rates of wages to its employees. The employees pleaded that employer is under obligation to pay the wages at minimum rates. XYZ Ltd. Intends to go to the court challenging the constitutional validity of the Minimum Wages Act, 1948. Will the company succeed?

- (c) P is an employee in a XYZ Ltd. The following payments were made to him during the previous year :

- (i) Piece rate wages
- (ii) Productivity bonus
- (iii) Additional dearness allowance
- (iv) Value of Puja gift.

Examine as to which of the above payments form part of "Basic Wage" of P under the Employees Provident Fund and Miscellaneous Provisions Act, 1952.

Answer 6. (a)

The discontinuance of allowance does not amount to 'deduction'. As such no application will lie under Sec. 15(2) of the Payment of Wages Act, 1936.

Answer 6. (b)

Minimum wages are required to be paid whether the company is in profit or loss. Section 3 of the Minimum wages Act, 1948 lays down that appropriate Government shall fix minimum wage and Section 22 says that employer is liable for penalty if minimum wages are not paid as per provisions of the Act. (Kamani Metals vs workers 1967 AIR 1175, 1967 SCR(2) 463).

Answer 6. (c)

As per Section 2 of the Employees Provident Fund and Miscellaneous Provision Act, 1952, the "Basic Wages" means all emoluments which are earned by an employee while on duty or on leave or on holidays with wages in either case in accordance with the terms of the contract of employment and which are paid or payable in cash to him, but does not include :

- (i) the cash value of any food concessions;
- (ii) any dearness allowance (that is to say all cash payments, by whatever name called, paid to an employee on account of rise in the cost of living), house rent allowance, overtime allowance, bonus, commission or pay and other similar allowance payable to the employee in respect of his employment or of work done in such employment; or
- (iii) any presents made by the employer.

Applying the above provisions of the Act to the given problem, the Basic wages of P will include only piece rate wages but it excludes the Productivity bonus, additional dearness allowance and value of puja gift.

Q. 7. (a) K works in a social welfare organization. Examine whether the Payment of Bonus Act, 1965 is applicable to him.

(b) H retired from services on attaining the age of superannuation. After his retirement, it was noticed that he had misappropriated amount from travelling allowance drawn by him. The employer wants to deduct the misappropriated amount from gratuity payable to him. Is the action of the employer legally tenable?

(c) G 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?

Answer 7. (a)

As per the provisions contained in Section 32 (v) (c) of the Payment of Bonus Act, 1965, 'K' is not entitled to any bonus as the said Act is not applicable to social welfare organization.

Answer 7. (b)

Section 4(6) of the Payment of Gratuity Act, 1972 provides that –

- (A) The gratuity of an employee, whose services have been terminated for any act, willful omission or negligence causing any damage or loss to, or destruction of, property belonging to the employer, shall be forfeited to the extent of the damage or loss so caused.
- (B) The gratuity payable to an employee may be wholly or partially forfeited—
 - (i) if the services of such employee have been terminated for his riotous or disorderly conduct or any other act of violence on his part, or
 - (ii) if the services of such employee have been terminated for any act which constitutes an offence involving moral turpitude, provided that such offence is committed by him in the course of his employment.

In the present case the employee has attained the age of superannuation and has retired. His misappropriation was noticed after his retirement. The employer wants to deduct misappropriated amount after his retirement. The decision of the employer is not tenable as H's services has not been terminated.

Answer 7. (c)

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.

Q. 8. (a) Discuss 'Hazardous process' under the Factories Act, 1948.

(b) Have the Government employees a fundamental or statutory right to go on strike under the Industrial Disputes Act, 1947?

Answer 8. (a)

As per section 2(cb) of the Factories Act, hazardous process means any process or activity in relation to an industry specified in the First Schedule to the Act where, unless special care is taken, raw materials used therein or the intermediate or finished products, by products, wastes or effluents thereof would –

- (i) cause material impairment to the health of the persons engaged in or connected therewith, or
- (ii) result in the pollution of general environment.

The State Government may, by notification in the Official Gazette, amend the First Schedule by way of addition, omission or variation of any industry specified in the said Schedule.

Answer 8. (b)

There is no statutory right to Government employees to go on strike. Where there is any injustice done to the employee in a democratic welfare State, they should resort to the machinery provided under statutory provisions for redressal of their grievances as held by the apex court in T.K. Rangarajan vs Government of Tamil Nadu and others.

Q. 9. (a) Explain the term 'arising out of employment and in course of employment' in relation to the Employees' Compensation Act, 1923.

(b) State the rules regarding fixation of wage periods under the Payment of Wages Act, 1936.

Answer 9. (a)

An accident arising out of employment implies a causal connection between the injury and the accident and the work done in the course of employment.

'In course of employment' refers to time during which the employment continues. This includes not only the actual period of work but also the time when the employee is at a place where he would not be but for his employment.

Compensation under the Act is payable only in those injury/diseases where the employment is the immediate and proximate cause of the said injury/disease or in other words 'arising out of employment and in course of employment'.

Answer 9. (b)

This is discussed under Section 4 of the Payment of Wages Act, 1936. As per Section 4 of the said Act :

- (i) Every person responsible for the payment of wages under section 3 shall fix periods (in this Act referred to as wage-periods) in respect of which such wages shall be payable;
- (ii) No wage-period shall exceed one month.

Q. 10. (a) Explain 'committee method' and 'notification method' for fixation of minimum wages under the Minimum Wages Act, 1948.

(b) Explain the provisions of the Employees Provident Fund and Miscellaneous Provisions Act, 1952 relating to the liability of an employer in case of transfer of the establishment to another person.

Answer 10. (a)

According to Section 5(1)(a) of the Minimum Wages Act, 1948 the appropriate government may appoint as many committees and sub-committees as it considers necessary to hold enquiries and advise it in respect of such fixation or revision as the case may be. This method is called Committee method.

As provided in Section 5(1)(b) of the said Act, the appropriate Government by notification in the Official Gazette, fix or as the case may be revise the minimum rates of wages in respect of each scheduled employment and unless such notification otherwise provides it shall come into force on the expiry of three months from the date of its issue. This method is known as Notification method.

Answer 10. (b)

According to Section 17B of the Employee's Provident Fund and Miscellaneous Provisions Act 1952, where an employer in relation to an establishment, transfer that establishment in whole or in part by sale, gift, lease or licence or in any other manner whatsoever, the employer and the person to whom the establishment is so transferred shall jointly or severally be liable to pay the contribution and other sum due from the employer under any provision of this Act of the Scheme or the pension scheme, as the case may be, in respect of the period up to the date of such transfer. The liabilities of the transferee shall be limited to the value of the assets obtained by him by such transfer. The liability of transferor and transferee in relating to all the money due under the Act or the Scheme or pension scheme in case of the transfer of the establishment.

Q. 11. (a) Explain the provisions of the Payment of Bonus Act, 1965 relating to adjustment of customary bonus against bonus payable under the Act.

(b) Explain the concept of 'continuous service' under the Payment of Gratuity Act, 1972.

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

Answer 11. (a)

Adjustment of customary bonus against bonus payable: The Payment of Bonus Act, 1965 provides that if in any accounting year, an employer has paid any customary bonus to an employee, then the former shall be entitled to deduct the amount of bonus so paid from the amount of bonus payable by him to employee under the Act in respect of that accounting year. The employee shall be entitled to receive only the balance. The employer can do the same thing even in a case where he has paid off the bonus payable under the Act to an employee before the date on which such bonus payable becomes payable. (Section 17)

Answer 11. (b)

Section 2A of the Payment of Gratuity Act, 1972 deals with this provision. For the purposes of this Act,—

- (1) an employee shall be said to be in continuous service for a period if he has, for that period, been in uninterrupted service, including service which may be interrupted on account of sickness, accident, leave, absence from duty without leave (not being absence in respect of which an order treating the absence as break in service has been passed in accordance with the standing order, rules or regulations governing the employees of the establishment), lay off, strike or a lock-out or cessation of work not due to any fault of the employee, whether such uninterrupted or interrupted service was rendered before or after the commencement of this Act.
- (2) where an employee (not being an employee employed in a seasonal establishment) is not in continuous service within the meaning of clause (1), for any period of one year or six months, he

shall be deemed to be in continuous service under the employer—

- (a) for the said period of one year, if the employee during the period of twelve calendar months preceding the date with reference to which calculation is to be made, has actually worked under the employer for not less than—
 - (i) one hundred and ninety days, in the case of an employee employed below the ground in a mine or in an establishment which works for less than six days in a week; and
 - (ii) two hundred and forty days, in any other case;
- (b) for the said period of six months, if the employee during the period of six calendar months preceding the date with reference to which the calculation is to be made, has actually worked under the employer for not less than—
 - (i) ninety-five days, in the case of an employee employed below the ground in a mine or in an establishment which works for less than six days in a week; and
 - (ii) one hundred and twenty days, in any other case;

Explanation : For the purpose of clause (2), the number of days on which an employee has actually worked under an employer shall include the days on which—

- (i) he has been laid-off under an agreement or as permitted by standing orders made under the Industrial Employment (Standing Order's) Act, 1946 (20 of 1946), or under the Industrial Disputes Act, 1947 (14 of 1947), or under any other law applicable to the establishment;
 - (ii) he has been on leave with full wages, earned in the previous year;
 - (iii) he has been absent due to temporary disablement caused by accident arising out of and in the course of his employment; and
 - (iv) in the case of a female, she has been on maternity leave; so, however, that the total period of such maternity leave does not exceed twelve weeks.
- (3) where an employee employed in a seasonal establishment, is not in continuous service within the meaning of clause (1), for any period of one year or six months, he shall be deemed to be in continuous service under the employer for such period if he has actually worked for not less than seventy-five per cent of the number of days on which the establishment was in operation during such period.

Answer 11. (c)

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.

Q. 12. (a) A Limited Liability Partnership is a body corporate, so shall have perpetual succession and can carry on business with any number of partners under the Limited Liability Partnership Act, 2008. Do you agree?

(b) Certain categories of information have been exempted from disclosure under the Right to Information Act, 2005. Comment.

Answer 12. (a)

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

- (1) Every limited liability partnership shall have at least two partners.
- (2) If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that

it so carries on business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

Answer 12. (b)

As provided in section 8 of the Right to Information Act, 2005, there shall be no obligation to give following information to any citizen :

- (i) information, disclosure of which would prejudicially affect the sovereignty and integrity of India, the security, strategic, scientific or economic interests of the State, relation with foreign State or lead to incitement of an offence;
- (ii) information which has been expressly forbidden to be published by any court of law or tribunal or the disclosure of which may constitute contempt of court;
- (iii) information, the disclosure of which would cause a breach of privilege of Parliament or the State Legislature;
- (iv) information including commercial confidence, trade secrets or intellectual property, the disclosure of which would harm the competitive position of a third party, unless the competent authority is satisfied that larger public interest warrants the disclosure of such information;
- (v) information available to a person in his fiduciary relationship, unless the competent authority is satisfied that the larger public interest warrants the disclosure of such information;
- (vi) information received in confidence from foreign Government;
- (vii) information, the disclosure of which would endanger the life or physical safety of any person or identify the source of information or assistance given in confidence for law enforcement or security purposes;
- (viii) information which would impede the process of investigation or apprehension or prosecution of offenders;
- (ix) cabinet papers including records of deliberations of the Council of Ministers, Secretaries and other officers :
 Provided that the decisions of Council of Ministers, the reasons thereof, and the material on the basis of which the decisions were taken shall be made public after the decision has been taken, and the matter is complete, or over :
 Provided further that those matters which come under the exemptions specified in this section shall not be disclosed;
- (x) information which relates to personal information the disclosure of which has no relationship to any public activity or interest, or which would cause unwarranted invasion of the privacy of the individual unless the Central Public Information Officer or the State Public Information Officer or the appellate authority, as the case may be, is satisfied that the larger public interest justifies the disclosure of such information :
 Provided that the information which cannot be denied to the Parliament or a State Legislature shall not be denied to any person.

Q. 13. (a) FBG 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?

(b) Comment on the following statement with reference to the provisions Negotiable Instruments Act. 1881: "Once a bearer instrument always a bearer instrument."

Answer 13. (a)

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.

Answer 13. (b)

A bearer instrument is one, which can change hands by mere delivery of the instrument. The instrument may be a promissory note or a bill of exchange, or a cheque. It should be expressed to be so payable or on which the last endorsement is in blank. (Explanation 2 to Section 13 of the Negotiable Instrument Act 1881).

Under Section 46 where an instrument is made payable to bearer, it is transferable merely by delivery, i.e. without any further endorsement thereon. But this character of the Instrument can be subsequently altered. Section 49 provides that a holder of negotiable instrument endorsed in blank (i.e. bearer) may, without signing his own name, by writing above the endorser's signature, direct that the payment of the instrument be made to another person. Thus the character of the instrument is changed and the instrument cannot be negotiated by mere delivery.

But in the case of a Cheque, however, the law is a little different from the one stated above. According to the provisions of Section 85 (2) where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, despite any endorsement whether in blank or full appearing thereon not with standing that any such instrument purported to restrict or exclude further negotiation. In other words, the original character of the cheque is not altered so far as the paying bank is concerned, provided the payment is made in due course. Hence the proposition that once a bearer instrument always a bearer instrument.

Q. 14. (a) List the circumstances under which an LLP formed under the Limited Liability Partnership Act, 2008 may be wound up by tribunal?

(b) What is the manner in which requests may be made by a citizen to the authority for obtaining information under the Right to Information Act, 2005.

Answer 14. (a)

A limited liability partnership may be wound up by the Tribunal,—

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

Answer 14. (b)

(1) A person, who desires to obtain any information under this Act, shall make a request in writing or through electronic means in English or Hindi or in the official language of the area in which the application is being made, accompanying such fee as may be prescribed, to—

- (i) the Central Public Information Officer or State Public Information Officer, as the case may be, of the concerned public authority;

(ii) the Central Assistant Public Information Officer or State Assistant Public Information Officer, as the case may be, specifying the particulars of the information sought by him or her :

Provided that where such request cannot be made in writing, the Central Public Information Officer or State Public Information Officer, as the case may be, shall render all reasonable assistance to the person making the request orally to reduce the same in writing.

(2) An applicant making request for information shall not be required to give any reason for requesting the information or any other personal details except those that may be necessary for contacting him.

(3) Where an application is made to a public authority requesting for an information,—

(i) which is held by another public authority; or

(ii) the subject matter of which is more closely connected with the functions of another public authority, the public authority, to which such application is made, shall transfer the application or such part of it as may be appropriate to that other public authority and inform the applicant immediately about such transfer :

Provided that the transfer of an application pursuant to this sub-section shall be made as soon as practicable but in no case later than five days from the date of receipt of the application.

Q. 15. (a) ABC 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.

(b) When is presentment of an instrument not necessary under the Negotiable Instruments Act?

Answer 15. (a)

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

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

- (A) products manufactured, processed or mined;
- (B) debentures, stock and shares after allotment;
- (C) 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.

Answer 15. (b)

According to Section 76 of the Negotiable Instruments Act 1881, no presentment to payment is necessary in any one of the following cases :

- (i) if the maker, drawee or acceptor intentionally prevents the presentment of the instrument, or
- (ii) if the instrument being payable at his place of business, he closes such place on a business day during the usual business hours, or
- (iii) if the instrument being payable at some other specified place, neither he nor any other person authorised to pay it attends at such place during the usual business hours, or
- (iv) if the instrument not being payable at any specified place, if he (i.e. maker etc) cannot after due search be found;
- (v) as against any party sought to be charged therewith, if he (i.e maker, etc.) has engaged to pay notwithstanding non-presentment;
- (vi) as against any party if after maturity, with knowledge that the instrument has not been presented — he makes a part payment on account of the amount due on the instrument, or promises to pay the amount due thereon in whole or in part, or otherwise waives his right to take advantage of any default in presentment for payment; as against the drawer, if the drawer could not suffer damage from want the of such presentment.

SECTION - II (Auditing)

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

- (a) Inventory turnover ratio is calculated by the auditor to obtain evidence concerning management's assertion about valuation of inventory.
- (b) The first auditors of a public limited company appointed by the Board of Directors hold office till the conclusion of its statutory meeting.
- (c) The auditor examines debit notes to vouch sales return.
- (d) Working Papers of the audit are to be returned to his client after audit since these are the property of the client.
- (e) Non-adjusting events of a material nature, need not be adjusted in accounts and can be disclosed by way of explanatory notes to the accounts.
- (f) Reclassification of long term investment as short term investment is made at cost as on the date of classification.
- (g) Efficiency audit examines whether the transactions have been done in conformity with established rules, principles and some established standards.
- (h) As per Indian GAAP, R & D costs can be capitalised unconditionally.
- (i) Where the accounts of the company do not present a 'true and fair' view, the auditor of the company can give a qualified opinion.
- (j) In the Balance Sheet of the Company, Debenture to be redeemed during the subsequent year are shown under the head "Current Liabilities and Provisions".
- (k) The overall objective and scope of audit do not change in EDP audit.
- (l) While designing audit sample, auditor should consider only on the specific audit objectives and none else.
- (m) For calculating minority interest there is a need to distinguish between capital and revenue profits of the subsidiary.
- (n) Internal check is part and parcel of internal control.
- (o) Management Audit emphasizes on problem identification rather than problem solving.

Answer 16.

- (a) The statement is true. Calculation of inventory turnover ratio and its comparison with those of previous year's ratio will provide an evidence on correct valuation of slow-moving, defective and obsolete items included in inventories.
- (b) The statement is false. Section 224(5) of the Companies Act, 1956 has laid down the tenure of the first auditors appointed by the Board of Directors, as until the conclusion of the first annual general meeting. The statutory meeting of a public limited company is one held under Section 165 of the Companies Act, 1956 and cannot be equated as the first annual general meeting.
- (c) The statement is false. The auditor examines purchase return transactions with reference to copies of debit notes issued to suppliers and outward return notes to vouch purchase return.

- (d) The statement is false. Working Papers are the property of the Auditor. He may, at his discretion, take portions or extracts from his working papers and make available to his client. However, the auditor should take reasonable care for custody and keep confidentiality of his working papers and retain for a necessary period of time to meet future needs, if any.
- (e) The statement is true. Non-adjusting events are those which do not provide any additional evidence with regard to the conditions existing on the Balance Sheet date and hence do not merit any financial adjustment. However, such events may be dealt with the Directors in their report under Section 217, or by way of explanatory notes to the accounts, if material.
- (f) The statement is false. As per AS-13, 'Accounting for Investments' the transfer should be at lower of cost and carrying amount of the investment at the date of reclassification of long term as short term investment.
- (g) The statement is false. Efficiency audit involves review of adequacy of the effectiveness of working personnel to attain business objective as also of the tools and techniques adopted . Propriety audit examines whether the transactions have been done in conformity with established rules, principles and some established standards.
- (h) The statement is false. As per Indian GAAP, capitalisation is not unconditional. R&D costs can be capitalised subject to the conditions of the criteria of technical feasibility of the production, resource availability and existence of market etc.
- (i) The statement is false. An adverse opinion is appropriate where the reservations or the objections are so substantial that the auditor feels, that the accounts do not give a 'True and Fair' view. Qualified opinion would imply that the financial statement project a 'True and Fair' view subject to certain reservations.
- (j) The statement is false. The amount should be shown under the first sub- head under "Secured Loans" irrespective of the due date of redemption as per Part – I, Schedule VI of the Companies Act, 1956.
- (k) The statement is true. The principal objective of an auditor is to ensure that the financial statement reflect 'True and fair view'. This would involve assessment of reliability and sufficiency of information contained in the accounting records and other source data by study and evaluation of accounting system and internal control in operation. This overall objectives and scope of an audit does not change in an EDP environment. However, the use of a computer changes the processing and storage of financial information and may affect the organization and procedure employed by the entity to achieve internal control.
- (l) The statement is false. Specific audit objective is only one of the consideration. Other items to be considered are data from which sample is drawn, size of sample, risk and assurance, tolerable error and expected error in population.
- (m) The statement is false. Minorities are concerned with their stakes in the holding company. Their right consists of capital and reserves & surplus. To ascertain minority interests, neither capital profit nor revenue profit is necessary.
- (n) The statement is true. Internal control is a plan of organisation and covers all methods and procedures adopted by management to assist its objectives of ensuring the orderly and efficient conduct of business. It includes financial and physical control and covers internal check and internal audit also. Hence internal check is part of internal control.
- (o) The statement is true. Management audit emphasizes on areas requiring management attention, evaluates the existence of well defined objectives and examines whether policies are consistent with objectives and understood properly at all functional levels. So it tries to identify source of problem rather than solution.

**Q. 17. (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 17. (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.

Answer 17. (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 :

- (i) **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.

- (ii) 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.
- (iii) 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.

Q. 18. As an auditor, how will you vouch and /or verify the following?

- (a) Recovery of Bad Debts written off.**
- (b) Borrowing from Banks**
- (c) Trade Marks and Copyrights.**
- (d) Sales Return.**
- (e) Expenditure on Foreign Travelling.**

Answer 18. (a)

Recovery of Bad Debts written off :

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

Answer 18. (b)

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

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

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

Answer 18. (c)

Trade Marks and Copyrights :

- (i) 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.
- (ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trade marks and copyrights have been duly registered.
- (iii) Verify existence of copyright by reference to contract between the another and noting down the terms of payment of royalty.
- (iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trade marks and copyrights have been capitalized.
- (v) Verify existence of copyright by reference to contract between the author and the entity and to check the payments of royalty made to author.
- (vi) Ascertain that the legal life of the trade marks and copyrights have not expired.
- (vii) Ensure that amount paid for both the intangible assets is properly amortized having regard to appropriate legal and commercial considerations.

Answer 18. (d)

Sales Return :

- (i) Examine the accounting basis for such transactions with reference to corresponding Debit Note. The relevant correspondence may also be examined.
- (ii) 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.
- (iii) 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.
- (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.

Answer 18. (e)

Expenditure on foreign travelling:

It is to be vouched with reference to following :

- (i) Air ticket
- (ii) Visa entries on passport
- (iii) Foreign currency drawer from authorized dealer for expenses abroad.
- (iv) On the basis of enquiries, tour report (if any) and other evidences it should be ensured that it was for business purpose only.

Q. 19. As an auditor, comment on the following situations :

- (a) One of the debtors of ABC Ltd. from whom ₹ 6 lacs is recoverable for credit sales gives a motor car in full settlement of dues. The directors estimate that the market value of the car transferred is ₹ 6.50 lacs. As on date of Balance Sheet, the car has not been registered in the name of ABC Ltd.
- (b) M/s DF Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2011-12 it received a communication from an Insurance Company informing that premium

amount for the accounting year 2010-11 was less charged by ₹ 95 lacs on account of arithmetical error on the part of Insurance Company. M/s DF Ltd. Paid the said sum of ₹ 95 lacs during the accounting year 2011-12 by debiting the same to Prior period expenses.

Answer 19. (a)

According to AS-10, Accounting for Fixed Assets, when fixed asset is acquired in exchange or in part exchange for another asset, the cost of asset acquired should be recorded either at fair market value or net book value of the asset given up. In present case book value is more evident than fair value of car estimated by the directors. Hence, Debtor's A/c should be credited with ₹ 6 lacs and motor car recorded at the same amount.

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

Answer 19. (b)

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

In the given case –

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

Q. 20. Comment on the following statements :

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

Answer 20. (a)

It is a quite normal that in any on going 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.

Answer 20. (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.

Q. 21. As an auditor, how will you verify the following?

- (a) Sale Proceeds of Junk Materials**
- (b) Assets Abroad**
- (c) Capital work-in-progress**
- (d) Contingent Liabilities**

Answer 21. (a)

Sale Proceeds of Junk Materials:

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

Answer 21. (b)**Assets Abroad :**

- (i) Examine the title deeds of immovable properties abroad.
- (ii) Ensure that the immovable properties abroad have been properly classified and disclosed.
- (iii) Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document.
- (iv) Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.

Answer 21. (c)**Capital Work-in-Progress :**

Capital Work-in-Progress denotes assets under installation. This could either be plant or machinery under construction, or that construction project for establishment of a new factory is under progress. The auditor should take the following steps to verify the same.

- (i) Ensure that the capital project is authorised by the Board. See the relevant Board Minutes for the purpose.
- (ii) Obtain the break up in details of the amount shown in the Balance Sheet under this head.
- (iii) Check purchase cost of plant machinery or other assets with reference to the contract with, and amount paid to the suppliers.
- (iv) Examine the allocation of common costs to the Capital Work-in-Progress in case such items have been constructed internally.
- (v) Ensure that the assets already put to commercial use are not included under Capital Work-in-Progress.
- (vi) Verify that only expenses incurred up to pre commissioning stage are capitalised under this head.
- (vii) Obtain the certificate of the engineering department to ascertain the quantum of the Capital Work-in-Progress, and whether the value is correctly represented in the Balance Sheet, and its transfer to Fixed Assets on completion of the project or installation of the plant.
- (viii) See that Capital Work-in-Progress is properly disclosed in the Balance Sheet under the head Fixed Assets.

Answer 21. (d)**Contingent liabilities :**

A contingent liability will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events. The uncertainty as to whether there will be any legal obligation that distinguishes a contingent liability from an actual liability. An obligation may be a contingent liability when the very basis of the obligation is contested. For example, when a claim is made against a company in respect of infringement of a patent and the suing company does not possess a legitimate title. Schedule VI to the Companies Act, 1956 requires that contingent liabilities to be disclosed as a foot note to the balance sheet. Some examples of contingent liabilities include claims against the company not acknowledged as debts, arrears of fixed cumulative dividends, etc. AS-4 requires that in case there is a probability that a loss may be incurred and a reasonable estimate of the amount can be made, then such contingent liability must be adjusted in the financial statements. Otherwise, disclosure will have to be made describing nature of the event, uncertainties affecting the event and estimate of the financial effect or a statement that such an estimate cannot be made. In such circumstances, the auditor may take following steps :

- (i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.

- (ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.
- (iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.
- (iv) Examine bank letters in respect of bills discounted and not matured.
- (v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
- (vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.
- (vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.
- (viii) Ensure that proper disclosure has been made as per Schedule VI to the Companies Act, 1956 and AS-4, "Contingencies and Events Occurring after the Balance Sheet Date".

Q. 22. Comment on the following situations :

- (a) At the Annual General Meeting of DEF Ltd., Mr. Q is appointed as the auditor which later is held to be void ab initio. The company holds another general meeting and appoints Mr. R as new auditor.**
- (b) One of the directors of UVW Ltd. is attracted by the disqualification under Section 274(1)(g).**
- (c) The auditor of a company wanted to see the minutes book of Directors meetings. The Chairman of the company refused for the same on the ground that matters of confidential nature were contained therein.**
- (d) The Financial Controller of GH Limited refuses to provide for proposed dividend in books of accounts for the year ended 31.3.2012 on the ground that it is pending approval of shareholders in Annual General Meeting to be held on 17th October 2012.**

Answer 22. (a)

Section 224 of the Companies Act, 1956, lays down the necessary details of appointment of an auditor. Accordingly, it is necessary that requirements of Section 224A with regard to passing of special resolution or ceiling on number of audits as laid down in Section 224(1B) amongst others have to be complied with. In case a company fails to adhere to statutory provisions laid down in the Companies Act, 1956, then in such cases, the appointment of any person as the auditor at the Annual General Meeting would be void *ab initio*. Under the circumstances in view of the fact that the company failed to appoint an auditor, the provisions of Section 224(3) would be attracted and the appointment of the auditor can be made by the Central Government only.

Accordingly, the appointment of a new auditor at the subsequent general meeting will not be valid.

Answer 22. (b)

Section 227(3)(f) as inserted by the Companies (Amendment) Act, 2000 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as directors under Section 274(1)(g) of the Companies Act, 1956. To this end, the auditor has to ensure that written representation have been obtained by the Board from each director that one is not hit by Section 274(1)(g). Since in this case, one of the director is attracted by disqualification u/s 274(g) of the Act, the auditor shall state in his report u/s 227 about the disqualification of the particular director.

Answer 22. (c)

Under Section 227(1) of the Companies Act, 1956, the auditor of a company has the right of access at all times to books and accounts and vouchers of the company whether kept at the head office of the company or elsewhere.

Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties. Therefore, he has a statutory right to inspect the directors' minutes book.

The refusal by Chairman to provide access to Directors' Minutes Book shall constitute limitation of scope as far as the auditor's duties are concerned. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

Answer 22. (d)

Normally, the dividend is proposed first by Board before adoption of the accounts in AGM. It is the shareholders in AGM who may approve the dividend proposed by BOD. It is also correct that as on the date of balance sheet or subsequent to it, but before approval of the financial statements in AGM, the dividend declaration is a contingent one.

But according to AS-4, Contingencies and Events occurring after the Balance Sheet date, even though certain events occur after balance sheet date, they are included/provided in the accounts because of their special nature or statutory requirement. Schedule VI to the Indian Companies Act, 1956 requires disclosure of proposed dividend specifically.

According to AS-4, the proposed dividend pertaining to the period covered by the financial statements, should be included in the financial statements although they are declared after the approval of the accounts.

In the circumstances, applying the above provisions, the contention of the Financial controller of AS Ltd. is wrong. Hence proposed dividend should be provided in the books of accounts for the year ended 31-03-2012, as the same is a statutory requirement of the law.

Q. 23. As a Company Auditor, how would you deal with the following situations?

- (a) ₹ 10 lacs paid by HGH Pharmaceuticals Ltd. to the legal advisor defending the patent of a product treated as Capital Expenditure.
- (b) Sale value of scrap items adjusted against Miscellaneous Expenditure.
- (c) The company had subscribed to shares of associate companies amounting to ₹ 15 crores. These associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The company does not want to make any provision for the fall in the value of the investments.
- (d) In the books of accounts of M/s BCS Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accounts Officer informs that this is common due to huge volume of business done by the company during the year.

Answer 23. (a)

Legal expenses of ₹ 10 lacs incurred to defend the patent of a product of the HGH Pharmaceuticals Ltd is revenue expenditure pertaining to the asset since by this expenditure neither any enduring benefit can be obtained in future in addition to what is presently available nor the capacity of the asset would be increased.

Payment of legal fees is normally revenue expenditure irrespective of the amount involved unless same is incurred to bring any new asset into existence. Hence, treating such expenditure as capital expenditure is incorrect. This would result in overstatement of the value of asset and profit and calls for qualification in the audit report.

Answer 23. (b)

Sale value of scrap is an item of miscellaneous income and adjusting such income against miscellaneous expenditure is not proper.

AS-5 on, "Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies" requires that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Therefore, requirements in regard to the profit and loss account of a company, it should disclose clearly credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

The auditor should see that the revenue has been disclosed properly in the financial statement since such an adjustment would fail to explain the performance of the company.

Answer 23. (c)

AS-13 on "Accounting for Investments" requires investments to be classified as long term and current investments distinctly in its financial statements. The investments in shares of associate companies can very well be considered as trade investments since they would not be intended to be liquidated within a period of one year from its acquisition. Hence they would be classified as long term investments.

AS-13 states, "long-term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually". In the instant case, these associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The net worth of these companies would have been wiped out resulting in a fall in the value of the investments. Therefore, such fall cannot be merely temporary as the companies could take a long time to turn around (if at all) and again have a positive net worth. The auditor would therefore have to qualify his report by saying that no provision for diminution for fall in the value of investments as required by AS-13 has been made and to that extent the profits and reserves have been overstated.

Answer 23. (d)

The huge differences found between control accounts and subsidiary records in the books of M/s BCS Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accounts Officer cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these difference indicate the possibility of some kind of material misstatements. As per SA-240(AAS 4), "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" when the auditor encounters circumstances that there is material misstatement, the auditor should perform procedures to determine whether the financial statements are materially misstated. If as a result of such examination the auditor comes across any material information involving fraud or gross irregularity the same shall be reported by him appropriately.

Q. 24. (a) SAFA organised a three-day International Conference of Accountants in Bangalore. You are asked to audit the accounts of the conference. Draft the audit programme for audit of receipt of participation fees from delegates to the conference.

(b) What do you understand by Audit Note Book?

Answer 24. (a)**Audit of Receipts of Participation Fees**

The organization of three-day International Conference of Accountants in Bangalore by SAFA is a one-time event. Normally, in view of mega-size of the event, a special cell is made in the organization to handle the entire event. Since few people would be handling the event, the internal controls may not be that strong and, thus, more emphasis is required to be given on substantive procedure. Audit of receipt of participation fees should be under the following areas :

(I) Internal Control System

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

(II) Rate of Participation Fees

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

(III) Receipts of Participation Fees

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

(IV) Overall Checking

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

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

(VI) Special Issues

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

Answer 24. (b)

An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. Audit note books form part of audit working papers and for each year a fresh audit note book is maintained. In case an auditor classifies his working paper into permanent and current, then audit note book shall form part of the current file. It is in any case a part of the permanent record of the auditor available for reference later on, if required.

The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily. It is also used for recording the various queries raised in the course of the work and their state of disposal. In respect of disposed queries, explanation obtained and evidence seen would be recorded in the said book, while queries remaining undisposed of would be noted for follow up.

Q. 25. (a) State the reporting requirements of Company Auditor in respect of the following under CARO-2003?

- (i) Deposit of Statutory Dues.
- (ii) Transactions in which Directors are interested.

(b) Explain the significance of Auditors Report to the shareholders under Section 227 of Companies Act, 1956.

Answer 25. (a)

(i) The Company Auditor has to report that –

- (I) Is the company regular in depositing undisputed statutory dues including Provident Fund, Employees State Insurance, Income Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of arrears of outstanding statutory dues as at the last date of the financial year concerned for a period of more than six months from the date they seem payable, shall be indicated by the auditor.
- (II) In case dues of Income Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, Cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may be mentioned, but he should, while reporting, remember that a mere representation to the department should not constitute a dispute.

(ii) Auditors statements are required on the following :

- (a) Whether transactions that need to be entered into register in pursuance of Section 301 of the Companies Act, have been so entered.
- (b) Whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time.

These should be commented only in the cases of transactions exceeding the value of ₹ 5 lakhs.

Answer 25. (b)

Section 227 of the Act lays down powers and duties of the auditor. Sub-sections (2), (3), (4) and (4A) of Section 227 deal with reporting requirements. Sub-section (2) states that the auditor of a company shall make a report to the members on the accounts examined by him and on every balance sheet and profit and loss account which are laid before company in general meeting during the tenure of his office. The significance of the report lies in the fact that it requires that the report shall state whether in his opinion and to the best of his information and according to the explanations given to him the said accounts give the information required by the Act in the manner so required and give a true and fair view.

The functional approach by the auditor for making a report u/s 227 of the Act, requires him to perform compliance and substantive audit procedures to verify the information contained in the financial statements. Having regard to the materiality of the items involved, the auditor also determines whether the relevant information is properly disclosed in the financial statements.

Q. 26. (a) In PQR LTD, N a junior accountant was given additional responsibility of making recoveries from the debtors. On one occasion, when an insurance claim of ₹ 75,000 was received, he credited the same to the account of a debtor and misappropriated the cash which he had recovered from the said debtor. Pinpoint weaknesses in the internal control system which led to this situation.

(b) "Surprise Checks" help the auditors to ascertain whether the internal control system is operating effectively in a Company or not. Discuss.

Answer 26. (a)

Following two essential features of internal control are relevant here :

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

Weakness in internal control system in the instant case:

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

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

Answer 26. (b)

The Standards on Auditing 400(AAS 6), "Risk Assessment and Internal Control", prescribes that "the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgment to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level." The understanding of the accounting and internal control system can be obtained in several ways including inspection of documents making inquires of appropriate management, observation of activities, etc. It is in this context, surprise checks intend to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. Particularly, the observation of the entity's activities and operations including observation of the organisation of computer operations, personnel performing control procedures and the nature of transition processing on a surprise visit would reveal the exact manner in which the activities are being performed in the manner prescribed by the management. It has often been found that manipulations and frauds are facilitated under a system of book-keeping, which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

Surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit. If this surprise check reveals any weaknesses in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the

management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Thus "surprise checks" help the auditors, during the course of their audit, to ascertain whether the internal control is operating effectively in a company or not.

Q. 27. (a) When can a company be said to have 'Not maintained' proper books of account? What is the role of the statutory auditor for the same?

(b) What do you understand by the term 'Sufficient Appropriate Audit Evidence'?

Answer 27. (a)

Section 209(1) of the Companies Act, 1956 requires that every company shall keep proper books of account with respect to the following items:

- (i) all sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place;
- (ii) all sales and purchases of goods by the company;
- (iii) the assets and liabilities of the company; and
- (iv) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account.

Proper books of account shall not be deemed to be kept if such books of accounts are not kept on accrual basis of accounting and according to double entry system of accounting.

In case proper books of account are not kept, the auditor is required to specifically refer to violation of the Companies Act, 1956 in the auditor's report and shall also state that in his opinion proper books of account as required by law have not been kept by the company so far as appears from his examination of those books and, he has to further give either qualified opinion or disclaimer of opinion.

Further, the books also have to be maintained under accrual system. If the statutory auditor finds the books are not maintained accordingly, he will have to modify his report.

Answer 25. (b)

Standards on Auditing 200(AAS 1) on basic principles governing an audit states "the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedure, to enable him to draw a reasonable conclusion therefrom on which to base his opinion on the financial information". Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained; appropriateness relates to its relevance and reliability. The auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The evidence should, in total, enable the auditor to form an opinion on the financial information.

Q. 28. (a) Discuss various factors that render manual audit method ineffective in IS audit.

(b) Briefly explain the uses of test packs while conducting examination of accounts in the absence of audit trail.

Answer 28. (a)

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

- (i) **Electronic evidence** : Essential evidence is not physically retrievable by most auditors, and it is not readable in its original electronic form.
- (ii) **Terminology** : The tools and techniques used in automated applications are described in terms that are difficult for the non-EDP auditor to understand.
- (iii) **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.
- (iv) **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.
- (v) **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.

Answer 28. (b)

“Test Packs” contain simulated transactions of all sorts of error conditions which can be used to test all the program controls. It consists of test data which will be processed in the same way as actual or live data. The data may either be fictitious as invented by the auditor or genuine data selected prior to processing. The essence of a test pack is that data will be chosen to test the workings of each control upon which reliance is to be placed. Data will include both that which falls outside the control parameters (and therefore should be printed out as an error or exception), and that which falls within the parameters (and therefore should be processed normally). For example; assume that stock numbers range from 0 to 10,000, and that any stock movements with a number outside this range should be printed out as an error. So test data with numbers of 9,999 and 10,001 might be chosen. The latter should be printed out as an error, the former should be processed normally. Assume further that all debts over 90 days old should be printed out as exceptions on account of their being overdue. So a debt at 89 days, and one at 91 days might be chosen as the test data. The latter should be printed out as an exception, whereas the former should not appear on the exception report.

The results of the test data can be predetermined, and these anticipated results can then be compared with the error or exception reports produced by the computer. If this compliance testing reveals that the program controls can be relied upon, then it means that the resulting error and exception reports can be regarded as reliable. For example, if a program control can be proved to work properly, it may be assumed that it will continue to work, unless fraudulently interfered with. And the chances of this will have been assessed during the examination of administrative controls.

The auditor will then have to satisfy himself that the appropriate action is taken on all error and exception reports. This would be determined by appropriate compliance testing, such as the review of a sample of error reports, to ensure that all errors have been actioned, and, if necessary, reprocessed. If the results of this compliance testing are satisfactory, the auditor may then be satisfied that the chances of material error existing in the system are small, and may accordingly reduce the quantity of substantive testing for error, on the basis of reliable internal control.

The exception reports will be an important part of management controls over assets and liabilities, especially, in relation to concealed defalcations. And as such, the auditor will want to ensure that they are reliable. But they can also be of considerable audit benefit in substantive testing, particularly at the verification stage. For, the exceptions are often exactly those items which the auditor himself would wish to examine. And he would otherwise have to extract such figures by hand.

Q. 29. (a) Elaborate the principles of internal check system that should be followed with regard to cash payments.

(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.

Answer 29. (a)

The principles to be followed are enumerated below :

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

Answer 29. (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 :

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

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

Q. 30. (a) Draft a Management Audit questionnaire for Audit of Inventory.

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

Answer 30. (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?
- 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 :
 - (i) obsolescence?
 - (ii) deterioration?
 - (iii) pilferage?

- Is inventory control integrated with :
 - (i) economic order quantities?
 - (ii) 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?

Answer 30. (b)

The management auditor should possess the following qualities :

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

