

# Revisionary Test Paper\_Intermediate\_Syllabus 2008\_Jun2015

## Paper- 6 : COMMERCIAL AND INDUSTRIAL LAWS AND AUDITING

### SECTION – A

#### **Question:1**

**Comment on the following:**

- a) **Silence is fraudulent**
- b) **Sale made by pledgee without reasonable notice is void**
- c) **Some contracts without consideration are valid.**
- d) **Risks follows ownership.**
- e) **Limited Liability Partnership is distinct from limited partnership**

#### **Answer:**

- a) Mere silence on the part of proposer so as to affect willingness of the acceptor is not fraud as the general rule is buyer beware. However silence is fraudulent in certain cases as follows:
  - i. Where it is duty of the proposer to speak.
  - ii. Where silence is equivalent to speech.
- b) Sale made by pledgee without reasonable notice is not void. But he is liable to the pledgor for damages suffered.
- c) A contract without consideration is valid when-
  - i. it is in writing;
  - ii. it is registered;
  - iii. made on account of natural love and affection;[Sec 25(1)]
  - iv. the parties stand in near relation to each other.
- d) As per Sec. 26 of Sale of Goods Act the goods are at buyer's risk when the property in the goods passes to the buyer whether delivery has been made or not. So risk follows ownership unless otherwise agreed.
- e) The difference can be marked out as follows.

Limited liability partnership is granted to all partners .	Limited partnership is granted to a set of non managing partners only.
The law relating to partnership is not applicable.	The law relating to partnership is very much applicable.

#### **Question: 2**

**Comment on the following based on legal provisions:**

- a) **Aditya appoints his brother Abhishek who is 16 years 7months as his agent.**
- b) **C delivered furniture items to AB Transport Co. for transporting the goods from Asansol to Kolkata. On the way the truck carrying the items met with an accident due to rash driving on part of the driver and the goods got damaged. C sued the owner of the Co. for the loss.**
- c) **Discuss about the different kinds of contracts.**

#### **Answer:**

- a) As per Law of Contract , as an agent does not make contract on his own, he need not have contractual capacity. So a minor may be appointed as an agent. However a minor cannot be held responsible to his principal. So, nothing in law prohibits Abhishek from becoming an agent of Aditya. But he will not be responsible to Aditya
- b) The position of owner of the transport company is that of a bailee. He is responsible to take reasonable care of the goods.The goods got damaged due to negligence of his employed driver. So he is liable to pay C for the loss.
- c) Classification of Contract:

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Contracts can be classified in terms of their Enforceability or form or extent of performance.

### 1. Based on Enforceability:

(i) Valid Contract: An agreement enforceable by law is a valid contract. In other words it satisfies all the requirements of a valid contract as laid down in section 10. If any of the essential requirement is missing it becomes a void contract.

(ii) Void agreement: An agreement not enforceable by law is said to a void. A void agreement has no legal consequences.

(iii) Voidable contract: An agreement which is enforceable at the option of one or more parties thereto but not at the option of other or others is a voidable contract.

(iv) Void contract: A Contract which ceases to be enforceable by law becomes void when it ceases to be so enforceable. Void agreement and void contract are different. Void agreement is void ab-initio but void contract is a valid contract at the beginning but subsequently becomes void when it ceases to be enforceable.

(v) Unenforceable contracts: These are the contracts which can not be enforced in a court of law because of some technical defects, these contracts becomes fully enforceable if the technical defects are removed.

(vi) Illegal Contracts: An illegal agreement is destitute of any legal effect from the very beginning. All illegal agreements are void agreements but all void agreements are not illegal.

### 2. Based on method of formation:

(a) Formal contracts: This term is usually found in English laws. Validity of these contracts depends upon their form. They are valid even if they lack consideration. These contracts are of two types; Contract under seal and contract of Records. Contract under seal are in writing and signed by the parties to them. Contract of Records includes the court judgements and recognisance, obligations in such cases arise out of judgement and not under the contract.

(b) Simple Contract: All contracts other than formal are called simple contracts or parole contracts.

### 3. Based on extent of performance:

(a) Executed Contracts: An executed contract is one which has been completely completed by both the parties.

(b) Executory contracts: It is a contract which is wholly unperformed. If one party has performed his part of obligation but the other party has not yet completed his obligation on the contract, the contract still remains executory contract.

### 3. Based on Obligation:

(a) Unilateral contract: Under this type of contract there is an obligation only on the part of only one party when the contract is concluded.

(b) Bilateral Contract: Here there is an obligation on both the parties to the contract.

### **Question: 3**

**a) Arvind is 7 years old. Can he be a beneficiary to any contract?**

**b) G, the holder of an overdue bill of exchange drawn by P as surety for Q, and accepted by Q, contracts with X to give time to Q. Is P discharged from his liability?**

**c) When is a consent said to be free? Discuss in details.**

### **Answer:**

**a)** As per Indian Contract Act , 1872 an agreement with a minor is void ab initio. However there is nothing that debars him from becoming a beneficiary i.e. payee, endorsee or promisee in a contract. The law does not regard him incapable of accepting a benefit. It should be however remembered that his property is liable for meeting the liability arising out contracts to supply him his necessaries.

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- b) According to Section 136 of the Indian Contract Act, 1872, where a contract to give time to the principal debtor is made by the creditor with a third person and not with the principal debtor, the surety is not discharged. In the given question the contract to give time to the principal debtor is made by the creditor with X who is a third person. X is not the principal debtor. Hence P is not discharged.
- c) Consent is said to be free when it is not caused by—
- (1) coercion, or
  - (2) undue influence, or
  - (3) fraud, or
  - (4) misrepresentation, or
  - (5) mistake, subject to provisions of sec 20, 21 and 22.

Consent is said to be so caused when it would not have been given but for the existence of such coercion, undue influence, fraud, misrepresentation or mistake.

1. COERCION- "Coercion" is the committing or threatening to commit, any act forbidden by the Indian Penal Code (45 of 1860), or the unlawful detaining, or threatening to detain, any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement.

2. UNDUE INFLUENCE -

- i. A contract is said to be induced by "undue influence" where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other.
- ii. In particular and without prejudice to the generality of the forgoing principle, a person is deemed to be in a position to dominate the will of another—
  - (a) Where he holds a real or apparent authority over the other, or where he stands in a fiduciary relation to the other; or
  - (b) Where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness, or mental or bodily distress.
- iii. Where a person, who is in a position to dominate the will of another, enters into a contract with him, and the transaction appears, on the face of it or on the evidence adduced, to be unconscionable, the burden of proving that such contract was not induced by undue influence shall lie upon the person in a position to dominate the will of the other. Nothing in this sub-section shall affect the provisions of section 111 of the Indian Evidence Act, 1872 (1 of 1872).

There is presumption of undue influence in the following relationships:

- (i) Parent and child
- (ii) Guardian and ward
- (iii) Doctor and patient
- (iv) Solicitor and client
- (v) Trustee and beneficiary
- (vi) Religious advisor and disciple
- (vii) Fiance and fiancée

There is however no presumption of undue influence in case of relationship of— (i) landlord and tenant (ii) debtor and creditor (iii) husband and wife. The wife has to be *pardanashin* for such presumption. In these relationships undue influence has to be proved.

3. FRAUD

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“Fraud” means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract:—

- (i) The suggestion, as a fact, of that which is not true by one who does not believe it to be true;
- (ii) The active concealment of a fact by one having knowledge or belief of the fact;
- (iii) A promise made without any intention of performing it;
- (iv) Any other act fitted to deceive;
- (v) Any such act or omission as the law specially declares to be fraudulent.

#### **4. MISREPRESENTATION**

“Misrepresentation” means and includes—

- (1) The positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true;
- (2) Any breach of duty which, without an intent to deceive, gains an advantage to the person committing it, or any one claiming under him, by misleading another to his prejudice or to the prejudice of anyone claiming under him ;
- (3) Causing, however innocently, a party to an agreement to make a mistake as to the substance of the thing which is the subject of the agreement.

#### **5. MISTAKE**

Mistake means an erroneous belief about something.

Mistake can be -

- (a) Mistake of law, or
- (b) Mistake of fact.

##### (a) MISTAKE OF LAW

When a party enters into a contract, without the knowledge of law in the country, the contract is affected by such mistake but it is not void. A contract is not voidable because it was caused by a mistake as to any law in force in India. The reason here is that ignorance of law is not an excuse at all. However if a party is induced to enter into a contract by the mistake of law then such a contract is not valid.

##### (b) MISTAKE OF FACT

Where both the parties to an agreement are under a mistake as to a matter of fact essential to the agreement, the agreement is void.

#### **Question: 4**

- a) Q sent a consignment of goods worth ₹ 160,000 by railway and got railway receipt. He obtained an advance of ₹ 130,000 from the bank and endorsed and delivered the railway receipt in favour of the bank by way of security. The railway failed to deliver the goods at the destination. The bank filed a suit against the railway for ₹1 60,000. Decide in the light of provisions of the Indian Contract Act, 1872, whether the bank would succeed in the said suit?
- b) Will offered to sell his flat to Hell for ₹15 lacs. H replied purporting to accept the offer and enclosed a cheque for ₹8 lacs. He also promised to pay the balance of ₹7 lacs in 20 installments of ₹35000 each. Examine the validity of contract.
- c) ‘Agreements by way of Wager are void’. Discuss.
- d) Asha agrees to pay Bikram a sum of money if Bikram marries Chitra. Chitra marries Dev. Is the contract between Asha and Bikram valid?

#### **Answer:**

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- a) As per Sections 178 and 178A of the Indian Contract Act, 1872 the deposit of title deeds with the bank as security against an advance constitutes a pledge. As a pledge, a banker's rights are not limited to his interest in the goods pledged. In case of injury to the goods or their deprivation by a third party, the pledgee would have all such remedies that the owner of the goods would have against them. In *Morvi Mercantile Bank Ltd. vs. Union of India*, the Supreme Court held that the bank (pledgee) was entitled to recover not only the amount of the advance due to it, but the full value of the consignment. However, the amount over and above his interest is to be held by him in trust for the pledgor. Thus, the bank will succeed in this claim of ₹ 160,000 against Railway.
- b) According to Section 7 of the Indian Contract Act, 1872, acceptance must be unqualified and absolute, it must conform to offer. If the parties are not *ad idem* on all matters concerning the offer and acceptance, there is no contract. In the given case the acceptance is qualified and hence not a valid acceptance. As a result there is no valid contract.
- c) Agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or entrusted to a person to abide by the result of any game or other uncertain event on which any wager is made.  
Exception in favour of certain prizes for horse-racing.—This section shall not be deemed to render unlawful a subscription, or contribution, or agreement to subscribe or contribute, made or entered into for or toward any plate, prize or sum of money, of the value or amount of five hundred rupees or upwards, to be awarded to the winner or winners of any horse-race.  
Section 294A of the Indian Penal Code not affected.—Nothing in this section shall be deemed to legalize any transaction connected with horse-racing, to which the provisions of section 294A of the Indian Penal Code, (45 of 1860) apply.
- d) If the future event on which a contract is contingent is the way in which a person will act at an unspecified time, the event shall be considered to become impossible when such person does anything which renders it impossible that he should so act within any definite time, or otherwise than under further contingencies. The marriage of Bikram to Chitra must now be considered impossible, although it is possible that Dev may die and that Chitra may afterwards marry Bikram. Hence after Chitra marries Dev, the contract is void

### Question: 5

- a) **Ashish offered to purchase shares of Average Ltd on 1st May 2013. The company made allotment of shares on 30th November 2013. A refused to accept the shares. Can it do so?**
- b) **Write a note on 'Counter Offer'.**
- c) **Rajesh has agreed to sell to Pran 400 quintals of wheat out of a huge quantity of wheat stored in his godown. The price, however, was to be paid at a later date, as was specified under the contract of sale of goods. Under such circumstances, has the property in the wheat passed on from the seller to the buyer at the time when the contract was entered into between them? Give reasons for your answer.**

### Answer:

- a) According to Sec 6(2) of the Indian Contract Act, 1872 an offer is revoked by lapse of time prescribed in the proposal or by lapse of reasonable time without communication of acceptance. What is reasonable time is question of fact in each case. In the given case the offer lapsed as it was not accepted within reasonable time [*Ramsgate Victoria Hotel Co. vs Montefiore.*]
- b) Where the offeree, instead of unconditionally assenting to the terms of the offer, accepts subject to certain conditions, he is said to have made a counteroffer. Thus, where A offers his car to B for ₹ 1,00,000 and B accepts to buy A's car for ₹ 80,000, B has made a counter offer.

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A counter offer has the effect of terminating the original offer. If in the aforesaid illustration, B later accepts to pay ₹ 1,00,000 for the car, it shall amount to a fresh offer by B which A may or may not accept.

Similarly, where an offeree agreed to accept half the quantity of goods offered by the offeror on the same terms and conditions as would have applied to the full contract, it was held that there was no contract as there was a counter offer to the original offer.

- c) No; the property in the wheat has not passed on from the seller to the buyer at the time when the contract was entered into between them. This is so because the property in the wheat will be passed on from the seller to the buyer only after the required quantity of wheat is segregated from the huge quantity of wheat stored in the seller's godown. This is so because it will be only then that the required quantity of wheat would be deemed to have been ascertained, and only thereafter the property in the wheat will pass on from the seller to the buyer. Until then it will remain in the nature of unascertained or future goods, because, under Section 18 of the Sale of Goods Act, in the case of a contract of sale of 'unascertained or future goods', the property in the goods will not be transferred from the seller to the buyer unless the goods become ascertained.

### **Question: 6**

- a) **When is communication of revocation complete?**
- b) **Avinash is sixteen years of age. He lends ₹ 1 lac to Bijay on the strength of a mortgage executed in his favour. Is the borrower liable to repay the money? Give reasons.**
- c) **Ten cows were 'exchanged; at an agreed price of ₹ 8,000 each (i.e. aggregating ₹ 80,000). The payment, however, was to be settled partly against the delivery (exchange) of 2,000 kgs of sugar at the rate of ₹ 30 per kg, and the balance amount of ₹ 20,000 was to be paid in cash. Do you think that this will be deemed to be a valid agreement of sale or a case of barter, as the payment is to be made not fully in terms of money but partly in terms of money and partly in kind (i.e. sugar in the instant case). Give reasons for your answer.**
- d) **A student was induced by his teacher to sell his brand new car to the later at less than the purchase price to secure more marks in the examination. Accordingly, the car was sold. However, the father of the student persuaded to sue his teacher. State whether the student can sue the teacher.**
- e) **Where there are two debts one for ₹ 1,000 and another for ₹ 1,200 falling due on the same day and if the debtor pays ₹ 800, whether the appropriation can be made pro-rata for the two debts?**

### **Answer:**

- a) According to section 4 of The Indian Contract Act, 1872, the communication of a revocation is complete,—
- i) as against the person who makes it, when it is put into a course of transmission to the person to whom it is made, so as to be out of the power of the person who makes it;
  - ii) as against the person to whom it is made, when it comes to his knowledge.
- Example: P revokes his proposal by email. The revocation is complete as against P when the email is sent. It is complete as against Q when Q opens his mail box and receives it.
- b) Yes, Avinash can recover the money from Bijay. Though a contract with a minor is void ab initio, he is allowed to be a beneficiary in a transaction and enforce his claim. The basic logic is that a contract with a minor has been kept void only to protect his interest and not to prejudice his interest.
- c) This will be deemed to be a valid agreement of sale (and not a case of barter) as the payment is to be made not fully in terms of exchange of goods but partly in terms of money and partly in kind (i.e. sugar in the instant case). This is so because, as per the provisions made in the Sale of Goods Act, in case of a sale of any (property in) goods, in consideration of a certain amount of money (cash or cheque or bank draft), and such settled price is paid

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partly in terms of money and partly by way of some goods (i.e. in kind), such transaction will also be deemed to be a valid sale in the eye of law.

- d) A contract is said to be induced by undue influence where the relations subsisting between the parties are such that

- (i) One of the party is in a position to dominate the will of the other and
- (ii) Uses that position to obtain an unfair advantage over the other.

Undue influence means improper or unfair use of one's superior power in order to obtain the consent of a person who is in a weaker position.

When consent to agreement is obtained by undue influence, the agreement is a Contract Voidable at the option of the party whose consent was so obtained. Any such contract may be set aside either absolutely, or if the party has received any benefit under the contract, upon such terms and conditions as the court may deem fit.

So, in the given case the student can sue his teacher on the ground of Undue Influence.

- e) When a debtor owes several distinct debts to a creditor and makes a payment insufficient to satisfy the whole indebtedness a question arises about the appropriation of the payment. Section 59 to 61 lay down the following three rules in this regard:

- (i) **Where the debtor intimates (Sec 59)** – If the debtor expressly intimates at the time of actual payment that the payment should be applied towards the discharge of a particular debt, the creditor must do so.
- (ii) **Where the debtor does not intimate and the circumstances are not indicative (Sec 60)** – Where the debtor does not expressly intimate or where the circumstances attending on the payment do not indicate any intention, the creditor may apply it at his discretion to pay lawful debt actually due and payable to his from the debtor.
- (iii) **Where the debtor does not intimate and the creditor fails to appropriate (Sec 61)** – Where the debtor does not expressly intimate and where the creditor fails to make any appropriation, the payment shall be applied in discharge of the debts in chronological order, i.e., in order of time. If the debts are of equal standing, the payment shall be applied in discharge of each proportionately.

So, the given case, as per section 61, the appropriation can be made proportionately, if neither party appropriates specifically.

### Question: 7

- a) **Adarsh obtains possession of a motorcycle under hire-purchase agreement. He then sells the same to Bhavesh who purchased the same in good faith and for value. Meanwhile Adarsh defaults in paying the hire charges and the owner wants his motorcycle back. Bhavesh pleads ignorance of the defective title. Discuss**
- b) **'A stipulation may be a condition though called warranty in a contract.'**
- c) **No one can give a better title than he himself has. State the exceptions to the rule.**
- d) **A bill of exchange is payable to Sunder on order. At maturity another person of the same name wrongfully gets possession of the bill and presents it to the acceptor for payment. After being satisfied that the person presenting is Sunder, the acceptor makes payment on it in due course. Is the acceptor discharged?**

### Answer:

- a) As Adarsh possesses a defective or no title to the motorcycle, he cannot give a better title as sale involves transfer of ownership. So Bhavesh cannot claim a good title to the motorcycle and the owner has right to get it back.
- b) How a contract is constructed decides whether a stipulation is a condition or warranty in a contract. For example, when a person buys a particular Pressure Cooker which is warranted to cook rice in just 5 minutes. In case it doesn't the only remedy to the buyer is to claim damages. But if the buyer insists on buying a Pressure Cooker that cooks rice in just 5 minutes, the stipulation is a Condition and the buyer may reject the offer.

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- 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 the Indian Contract Act.
  - viii. Sale by pawnee or pledgee u/s 176 of the Indian Contract Act.
  - ix. Sale made by Official Receiver or Official Assignee or Liquidator.
- d) "Payment in due course" means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof. The payment to the person in possession of the instrument must be under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount mentioned in the instrument. If, under suspicious circumstances, the person making the payment does not make the necessary inquiry, the payment is not a payment in due course.
- In the given case, if the acceptor does not make the necessary inquiry before making the payment, it is not a payment in due course. So, he is not discharged.

### **Question: 8**

- a) **P purchased from Q 5000 tins of canned fruit to be packed in cases, each containing 50 tins but Q supplied cases containing 25 tins. Does P have right to reject the goods?**
- b) **R buys goods from S on payment but leaves the goods in the possession of S. S then pledges the goods to T who has no notice of the sale to R. State whether the pledge is valid and whether T can enforce it. Decide with reference to the provisions of the Sale of Goods Act, 1930.**
- c) **Modern Furniture, a partnership firm, was getting the supplies of its finished goods from Saharanpur from several suppliers on credit. But, after some time, the firm started facing some financial problems, and thereby its dues to its suppliers had accumulated to a substantial amount over a period of time. Thereupon, an agreement was reached between the partnership firm and its various suppliers to the effect that the firm will pay its due to its creditors out of the profit it would earn from time to time. It was further agreed upon that the firm's business from now onwards will be run under the supervision of the creditors, till such time all their dues were fully paid.**
- Do you think that, under the aforementioned arrangement, the various creditors of the firm will now be deemed to be the partners of the firm on the ground that they were being paid their dues by the firm out of its profits? Give reasons for your answer.**
- d) **Zeeshan, an agent of a buyer, had obtained goods from the Railway organization and loaded the goods on his truck. In the meantime, the Railway organization received a notice from Y, a seller, for stopping goods in transit as the buyer had become insolvent. Referring to the provisions of the Sale of Goods Act, 1930 decide whether the Railway organization can stop the goods in transit, as instructed by the seller?**

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### Answer:

- a) This is based on the provisions of Section 15 of the Sale of Goods Act, 1930. P is entitled to reject the goods because the goods were not packed according to the description. It is to be noted that if the goods do not correspond with the description but such goods are fit for buyer's purpose, even then the buyer may reject the goods and the seller cannot take defense by saying that the goods will serve buyer's purpose.
- b) The problem 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, the pledgee who obtains the goods in good faith from R without notice of the previous sale, gets a good title. Thus the pledge is valid.
- c) Under the aforementioned arrangement, the various creditors of the firm will not be deemed to be the partners of the firm in any manner, despite the fact that they were now being paid their dues by the firm out of its profits. This is so because, Section 6 has amply clarified that, though the sharing of profit in the business of the partnership firm happens to be one of the most essential elements in any partnership firm, none of the persons will be deemed to be the partners of the firm, just because they are being paid out of the profits earned by the firm. That is, in addition to the element of profit-sharing, the various other essential ingredients of a partnership must also be present, to consider such group of persons as a partnership. Such contention is based on the judgement delivered by the House of Lords in the case titled Cox vs Hickman (1860) 8 HLC, 268.
- d) The right of stoppage of goods in transit can be exercised only so long as the goods are in the course of transit. In the given case the transit was at an end as soon as the agent of the buyer obtained goods from the Railway Organisation. Therefore Railway Organisation cannot act as instructed by the seller, who has lost the right of stoppage of the goods in transit as provided in Section 30 of the Sale of Goods Act, 1930.

### Question: 9

- a) What would constitute as 'Delivery' in relation to Sale of Goods Act, 1930.
- b) Mohan introduced Kabir to Seikh as a partner in his firm named Mohan and Friends. But, in fact, Kabir is not a partner in the firm named. However, despite not being a partner in the firm, Kabir not contradicted the aforementioned statement of Mohan, and had preferred to keep quiet, instead. After a couple of days, Seikh had given a loan of ₹ 1,25,000 to the firm. But, as the firm was not paying back the loan amount, Seikh had approached Kabir for repayment of the loan. At this point of time, Kabir refused to repay the loan on the ground that he was never a partner in the firm, and therefore, he cannot be held responsible for the repayment of the loan given not to him but to the firm of Mohan. Do you think that the contention of Kabir in the instant case is legally justified? Give reasons for your answer.
- c) The seller had sold to the buyer 1,200 tonnes of stainless steel sheets of a specific quality, which was required under the contract for sale of goods, to be shipped at 100 tonnes per month and in equal installments each month. But after 400 tonnes of the total quantity of 1,200 tonnes delivered to and also paid for by the buyer, it was found that the goods which were supplied were not of the agreed quality, and accordingly, he had refused to take any further delivery of the goods. Do you think that the buyer was rightfully entitled to refuse to take any further delivery of the goods? Give reasons for your answer.

### Answer:

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1. '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.
- b) No, the contention of Kabir in the instant case is not legally justified. This is so because, Kabir, in the instant case, will be considered as partner of the firm by virtue of being a 'partner by holding out', also referred to as a 'partner by estoppel', as per the provisions of Section 28, based on the following circumstances of the case :
- (i) That, Kabir had knowingly permitted himself to be represented, to be a partner of the firm;
  - (ii) That, such representation was made by him by his conduct; and
  - (iii) That, the other party had given the credit to the firm, based on the faith of such representation.
- Accordingly, Kabir cannot be allowed to plead that, in fact, he was not a partner in the firm. Instead, he will have to compensate Seikh by virtue of his being a 'partner by holding out', also referred to as a 'partner by estoppel'.
- c) Yes, the buyer was rightfully entitled to refuse to take any further delivery of the goods, because he was not bound to take the risk of accepting any further delivery of the goods which did not conform to the quality that was contracted for. This is so because though, under the provisions of the Sale of Goods Act, usually, the failure on the part of the seller to deliver any one of the installments to the buyer, or the failure on the part of the buyer to pay for any of the instalments to the seller, does not amount to the repudiation of the contract as a whole, in the cases where the breach is of such a nature that it could be reasonably inferred that a similar breach is most likely to be committed by the defaulting party even in the cases of future transactions, the other party will be entitled to treat the whole contract as repudiated. This contention is also confirmed in a similar case titled Robert A. Munso & Co. vs Meyer [(1930) 2 K.B. 312].

### **Question: 10**

- a) **"Minimum wage rate may vary". Discuss with the provisions of The Workmen Compensation Act, 1923.**
- b) **Vishal (P) Ltd. imposed a fine on Divya, one of its employees for regularly reporting late for work. The fine was imposed on 4th April, 2013. The management wanted to recover the amount in September, 2013 during half yearly increment.**
- c) **A company, employing 50 persons, has been incurring losses right from the commencement of its business. Accordingly, it has made an application to the appropriate Government to exempt it from the application of all the provisions of the Payment of Bonus Act. Do you think that the appropriate Government will exempt from the application of all the provisions of the Payment of Bonus Act, and if so, on what grounds? Give reasons for your answer.**
- d) **DEF Ltd discontinued deduction towards contribution to provident fund from its employees salary and stopped remitting contribution of its share of provident fund when**

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**the number of its employees on its roll fell to thirteen. Do the provisions of the Employees Provident Fund and Miscellaneous Provisions Act, 1952 cease to be applicable under such circumstances?**

**Answer:**

- a)** As per Sec.3(3)(a) of Minimum Wages Act, 1948 minimum wage rate may vary depending on different variables like:
- 1) Scheduled employment
  - 2) Classes of work in same scheduled employment
  - 3) Locality
- b)** As per Sec. 8(7) of The Payment of Wages Act, 1936 no fines can be recovered after expiry of 90 days from the date on which it is imposed. So Vishal (P) Ltd. will not be able to recover the fine from Divya in September, 2013 as the gap exceeded 90 days.
- c)** As per Section 36 of the Payment of Bonus Act, the appropriate Government may, having regard to the financial position and other relevant circumstances of any establishment or class of establishments, exempt, by notification in the Official Gazette, such establishment or class of establishments from all or any of the provisions of the Payment of Bonus Act. It may do so if it is of opinion that it will not be in public interest to apply all such establishment or class of establishments from the application of such provisions of the Act for such period as may be specified in the notification and impose such conditions as it may think fit to impose. As in the given case the company has been incurring losses right from the commencement of its business, goes to indicate that its financial position is weak enough, and accordingly, the appropriate Government is most likely to consider that it would be in the public interest to exempt this company from the application of all or any of the provisions of the Act. However, the appropriate Government, according such exemption, may impose such conditions on the company, as it may consider fit.
- d)** According to sec 5(1) of the Employees Provident Fund and Miscellaneous Provisions Act, 1952, an establishment to which this Act applies shall continue to be governed by this Act notwithstanding that the number of persons employed therein at any time falls below twenty. As such the provisions of the Employees Provident Fund and Miscellaneous Provisions Act, 1952 continue to be applicable to DEF Ltd.

**Question: 11**

- a) Who is a 'occupier' under Factories Act, 1948?**
- b) Arvind is the owner of a concern manufacturing cigars. 20 persons are employed in the concern. Of these 20 employees, one is a graduate for supervising the work and another apprentice learning work. The remaining 18 are employed not on the time wage system, but on the piece work system. Is the concern 'A Factory' within the meaning of that term under the Factories Act, 1948 ?**
- c) ABC Ltd bought ghee from various sources. Ghee so bought were sampled chemically, analysed and packed in tins for transportation to various stock points to be sold in market. Does this amount to manufacturing process under the Factories Act, 1948?**
- d) Distinguish between an 'agent' and a 'servant'.**

**Answer:**

- a)** 'Occupier' of Factory implies the person who has ultimate control over the affairs of the factory. Provided that:
- i. In case of a firm or AOP any partner or member shall deemed to be occupier.
  - ii. In case of a company, the directors are occupiers.
  - iii. In case of a factory owned by Central or State Government or Local Authority, the persons employed to manage the affairs of the factory will deemed to be the occupiers.

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In short, an occupier may be owner, lessee or licensee but he should have the right to occupy the property and dictate terms of management. An employee charged with specific machinery, workers or office is not an occupier.

- b)** As per Section 2 (m) factory means any premises including the precincts thereof -
- Whereon 10 or more workers are working or were working on any day of the preceding 12 months, and in any part of which a manufacturing process is being carried on with the aid of power, or is ordinarily so carried on, or
  - Whereon 20 or more workers are working or were working on any day of the preceding 12 months, and in any part of which a manufacturing process is being carried on without the aid of power, or is ordinarily so carried on.

For computing the number of workers, all the workers in different groups in a day shall be taken into account.

So, in the given case, as per section 2(m) the concern is a factory within the meaning of that term under the Factories Act, 1948.

- c)** As per section 2(k) of The Factories Act, 1948, manufacturing process means any process for-
- Making, altering, repairing, ornamenting, finishing, packing, oiling, washing, cleaning, breaking up, demolishing, or otherwise treating or adapting any article or substance with a view to its use, sale, transport, delivery or disposal, or
  - Pumping oil, water, sewage or any other substance; or;
  - Generating, transforming or transmitting power; or
  - Composing types for printing, printing by letter press, lithography, photogravure or other similar process or book binding;
  - Constructing, reconstructing, repairing, refitting, finishing or breaking up ships or vessels; (Inserted by the Factories (Amendment) Act, 1976, w.e.f. 26-10-1976.)
  - Preserving or storing any article in cold storage;

The process of sampling, analyzing and packing of ghee for sale in market is a manufacturing process as per the definition under the Factories Act, 1948. [Shri Laxmi Das Premji Ghee Merchant v. R. Inspector of Factories(1960) 1 LLJ]

- d)** There is too much of similarity between an agent and a servant as both are employed to act for and on behalf of principal. However, there is a lot of difference between the two. An agent has the authority to create contractual relationship between the principal and a third party, but a servant ordinarily has no such authority. A servant usually serves only one master but an agent may work for several principals at the same time. A servant is generally paid salary or wages, whereas an agent may be paid on commission basis. Thus, we find that an agent is not a servant though a servant may be authorized to serve as an agent.

### **Question: 12**

- a)** The services of a woman worker who had completed 4 months' continuous service in a factory were terminated.
- To what leave is she entitled?
  - To what leave will she be entitled if she were below 15 years of age ?
- b)** 'Dinesh' joined AB Chemical Works (P) Ltd. on 5.3.2013. On 8<sup>th</sup> December, 2013 he was laid off as the management wanted to slow down due to shortage of Chemical 'A'. Dinesh was not allowed lay-off compensation on the ground that his period of service was less than one year. Is the claim of management valid under the Industrial Disputes Act, 1947?
- c)** Write short note on Agency by estoppels.
- d)** Lay off and retrenchments have same legal implication under Industrial Dispute Act. Discuss

### **Answer:**

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- a) As per section 79 every worker who has worked for a period of 240 days or more in a factory during a calendar year shall be allowed during the subsequent calendar year leave with wages for a certain number of days. These days of leave shall be calculated at the rate of –
- i. If an adult, one day for every 20 days of work performed by him during the previous calendar year.
  - ii. If a child, one day for every 15 days of work performed by him during the previous calendar year.
- So, in the given case, she is entitled to
- i. 6 day's leave, and
  - ii. 8 day's leave.
- 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.  
Dinesh has worked for 273 days before he was laid off. So he is entitled to lay-off compensation and can claim the same.
- c) The doctrine of estoppel states that when a person by his words, spoken or written or by his conduct willfully leads another person to believe about a certain state of affairs, and induces the person to act in a particular manner, he is estopped from denying that state of affairs subsequently.  
Sec. 237 deals with agency by estoppel. According to it, if a person by his conduct leads another to believe that a certain person is his agent or his agent is authorized to incur the particular obligation, the principal is bound by acts of the person posing as his agent or where the agent has exceeded his authority.  
For e.g. A terminates the services of B, his agent but forgets to give notice of the same. C contracts with B. A is bound by the contract.
- d) Lay off and retrenchment carry different meanings under the Industrial Disputes Act as follows:

Lay off	Retrenchment
i) Means failure, refusal or inability of an employer to give employment to a workman whose name appears in the master rolls of his establishment and who has not been retrenched.	It is termination of service of a workman for any reason other than as a punishment by way of disciplinary action but does not include: a) VRS b) Retirement on reaching the age of superannuation. c) Termination due to non-renewal of contract. d) Termination on the ground of illness.
ii) U/s 2(kkk) of Industrial Disputes Act	U/s 2(oo) of Industrial Disputes Act
iii) Worker is entitled to compensation which is 50% of Basic + DA payable to him in case he was not laid off for all days of lay-off excluding weekly holidays.	Compensation is 15 days average pay for each year of completed service or part thereof in excess of six months.

### Question: 13

- a) Define 'disablement' under The Workmen Compensation Act, 1923.
- b) A qualified Allopathic Physician treated a patient with ayurvedic medicine and the patient died. Can the said physician be guilty of negligence under Consumer Protection Act, 1986?

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- c) X, had undertaken a piece of work in course of his ordinary business. He sub- contracted a part of his work to Y who in turn sub-contracted a part to Z. F a employee of Z got killed in an accident while working at a machine. The widow of F applied to the Commissioner for an order on X under the Workmen's Compensation Act, 1923 to deposit the amount of compensation for the death of her husband. Comment.

**Answer:**

- a) Disablement implies loss of capacity to work or move. Disablement leads to loss or reduction in earning capacity of workman. Disablement may be partial or total. Further it may be temporary or permanent.  
Partial disablement reduces the earning capacity of workman as a result of some accident. It may be temporary or permanent. Temporary partial disablement reduces the earning capacity of workman in any employment in which he was engaged at the time of employment.  
Permanent partial disablement reduces the earning capacity in every employment the worker was capable of doing at the time of employment.  
Total disablement u/s 2(1) (I) means worker becomes incapable in performing any work which he could perform before accident. Total disablement is deemed to result from every injury specified in Part I of Schedule I or combination of injuries specified in Part II resulting in loss of earning capacity to the extent of 100% or more.
- b) Since a qualified allopathic physician treated with ayurvedic medicine which is not his area of specialization/knowledge, this physician would be held guilty of negligence on the death of a patient. This is a fault also on the part of the physician.
- c) As per Sec. 12, where an employer (known as principal) takes help of a contractor in order to engage some workmen, a workman is entitled to claim compensation from principal if he satisfies the following conditions :
- (i) The principal must have contracted with contractor for execution by latter of whole or any part of work of the principal.
  - (ii) Such work must ordinarily be a part of the trade or business of the principal.
  - (iii) The workman employed in the execution of work must have been injured by accident arising out of and in course of his employment.
  - (iv) Injury must have been caused to the workman within or about the vicinity of the employer's premises.
- Where the principal is liable to pay compensation, he is entitled to be indemnified by the contractor.  
Further, nothing in this section shall be construed as preventing a workman from recovering compensation from the contractor instead of the principal.  
In the given case, X is liable to pay compensation but he can recover it from Y or Z. If X recovers the amount from Y, Y can recover the same from Z.

**Question: 14**

- a) K earns a salary ₹9000/- per month. Bonus declared by the establishment is 12% of salary. Bonus received by K is ₹ 5040. Discuss
- b) X met with an accident while returning from work . He was travelling by bus provided by his employer. He filed a civil suit against the employer for claim of compensation.
- c) Define an "Establishment in public sector". What are the circumstances when the Payment of Bonus Act, 1965 becomes applicable to such an establishment?
- d) What is not included in 'wages' as per the Employees' State Insurance Act, 1948 ?

**Answer:**

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- a) As per Sec. 12 of The Payment of Bonus Act, where the salary /wage of an employee is more than ₹ 3500/- per month , for the purpose of calculation of bonus salary should be taken as ₹ 3500/-.
- b) X is not entitled to compensation under Workmen's Compensation Act , 1923 as he has filed a civil suit against the employer.
- c) Section 2(16) of the Payment of Bonus Act, 1965 defines 'establishment in public sector' to mean an establishment owned, controlled or managed by:
- a Government company as defined in Section 617 of the Companies Act, 1956;
  - a Corporation in which not less than 40% of its capital is held (whether singly or taken together) by -
    - the Government; or
    - the Reserve Bank of India; or
    - a Corporation owned by the Government or the Reserve Bank of India.
- The provisions of the Payment of Bonus Act, 1965 do not ordinarily apply to an establishment in public sector. However, if the following two conditions are satisfied by such establishment in any accounting year, the provisions of the Act shall apply to such establishment as they apply to an establishment in the private sector:
- If in any accounting year, an establishment in the public sector sells goods produced or manufactured by it or renders any services, in competition with an establishment in private sector; and
  - the income from such sale or services is not less than 20% of the gross income of the establishment in public sector in that year. (Section 20)
- d) 'Wages' does not include
- Any contribution paid by the employer to any pension fund or provident fund under the Act;
  - Any travelling allowance or value of any travelling concession;
  - Any sum paid to the person employed to defray special expenses entailed on him by the nature of his employment; or
  - Any gratuity payable on discharge

### **Question: 15**

- a) **"Predatory price" is sale of goods or provision of services at cost plus nominal profit for purposes of Section 4 of Competition Act, 2002.**
- b) **Binod fraudulently induces Chirag and obtains a Bill of Exchange from Chirag in his own favour. Later, he endorses the same to Asim under a commercial deal as a consideration. Asim gets the bill as holder in due course. Asim subsequently endorses it back to Binod for some other deal and for value. On maturity Chirag refuses to pay up and Binod sues him for recovery of money. With reference to the provisions of the Negotiable Instruments Act, should Binod succeed in the case?**
- c) **X has balance of ₹ 3000/- in YZ Bank. He draws a cheque of ₹ 10,000/- in favour of C knowing fully that he has no O/D facility. The cheque is dishonoured. Is 'notice of dishonour' to X necessary?**
- d) **What is 'information' under RTI Act?**
- e) **When is a LLP not bound by act of its members?**

### **Answer:**

- a) For the purposes of the above mentioned section of the said Act, "predatory price" is sale of goods or provision of services at a price below cost, as may be determined by regulations ,of production of goods or provision of services, with a view to reduce competition or eliminate the competitors.
- b) The problem stated in the question is based on the provisions of the Negotiable Instruments Act as contained in Section 53. The section provides: 'Once a negotiable instrument passes

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through the hands of a holder in due course, it gets cleansed of its defects provided the holder was himself not a party to the fraud or illegality which affected the instrument in some stage of its journey. Thus any defect in the title of the transferor will not affect the rights of the holder in due course even if he had knowledge of the prior defect provided he is himself not a party to the fraud. (Section 53).

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

- c) Notice of dishonour is not necessary when the party charged could not suffer damage for want of notice. As such notice of dishonour to X is not necessary.
- d) 'Information' means any material in any form, including records, documents, file notings, memos, emails, opinions, advices, press releases, circulars, orders, log books, contracts, reports, papers, samples, models, data, material held in any electronic form and any information relating to a private body which can be accessed by a Public Authority under any law.
- e) A limited liability partnership is not bound by any act of a member in dealing with a person if:
  - i) the member in fact has no authority to act for the limited liability partnership by doing that thing;
  - ii) the person knows that the member has no authority or does not know or believe him to be a member of limited partnership.

### **SECTION – B**

#### **Question: 16**

- a) **State the importance of vouching and the important points to be considered while vouching.**
- b) **Write a short note on Auditing Technique.**

#### **Answer:**

- a) The most important step in all types of audit is vouching of business transactions as a voucher is a foundation stone on which whole of the accounting structure stands. The importance of vouching can be explained as under –
  - i) Detection of Errors & Frauds – Careful vouching assists the auditor to detect errors & frauds.
  - ii) Reduce liability of Auditor – An efficient vouching reduces the auditors liability to considerable extent.
  - iii) Moral check on employees – Detailed vouching also acts as a moral check on employees.
  - iv) Back Bone of Auditing – Vouching, done with care and caution makes an auditor to proceed well further in his work as it helps in carrying out further scrutiny with ease to satisfy him that the financial books reveal the true position of the business.
  - v) Compliance with Law – Auditor gets satisfied that the transactions are complying with the provisions of different laws, in particular the Companies Act.
  - vi) Capital & Revenue Expenditure – Vouching ensures the proper allocation of expenditure into Capital and Revenue.
  - vii) Genuineness of Transactions – Auditor ascertains that no dummy transactions are recorded.
  - viii) Nature of Transactions – Auditor ascertains that the transactions are related to the nature of the business carried on by the client.

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- ix) Accounting period – It enables auditor to verify the transactions related to other periods other than the period under audit.
- x) Accounting – Auditor can verify whether whole accounting work is properly carried through.
- xi) Easy conduct of Audit – The efficient vouching creates a picture regarding organizational frame work in the mind of auditor facilitating easy conduct of audit.

### Important points to be considered while vouching –

- i) All the vouchers are serially numbered & filed in order of the entries in the accounts.
  - ii) Attention should be paid to the dates which must correspond to the audit period.
  - iii) The auditor should see whether the voucher is in the name of client.
  - iv) He should see whether the amount written in figures and words is correct.
  - v) He should ensure whether the account head is properly written or not.
  - vi) He should also see whether the voucher is signed by the recipient of the amount.
  - vii) He should ensure whether the voucher is properly authenticated.
  - viii) Auditor also see whether the expenditure shown is reasonable or not.
  - ix) He should see whether the expenditure is for the cause of the business.
  - x) In case of expenditure exceeding ₹5,000/- auditor should ensure whether the revenue stamp is affixed on the voucher or not.
  - xi) Auditor should see whether the voucher is properly accounted in the books or not.
- b)** Effective auditing is the outcome of systematic audit procedures applied to trade and examine audit evidence with the help of audit techniques. According to Moyer, audit techniques are the devices or methods available to the auditor for obtaining competent evidential matter. While according to statement on audit standards, audit procedure is the act to be performed, such as reviewing, inspecting and confirming. Practice refers to the application of principles and techniques in various situations to get the expected results, on the same line auditing practice means the use of auditing principles, as were already established and notified by professional pronouncements from time to time, in different auditing situations.

### Audit Techniques:

As explained above, audit techniques are the tools used to get reliable evidence while conducting an audit. According to Prof. Mautz, basically there are following ten techniques available—

- i) Physical Examination
- ii) Confirmation
- iii) Comparing Documents with the Records (Vouching)
- iv) Computation
- v) Re-tracking Book-keeping
- vi) Scanning
- vii) Inquiry
- viii) Examining Subsidiary Records
- ix) Co-relation with the related information
- x) Observation of pertinent activities

### **Question: 17**

- a) How would the following be verified?**
- i) Wages**
  - ii) Income Tax**

### iii) Plant and Machinery

#### Answer:

#### i) Wages:

1. Auditor should satisfy himself about the efficiency of the internal check system in operation.
2. Compare the current year's total wages, monthly wages, wages of each dept., ratio of wages to Sales, ratio of wages to cost of production, ratio of P.F. Contribution and E.S.I. contribution to wages etc., to that of previous year.
3. Check selected entries in the wages sheet with attendance record.
4. Check different deductions for I. Tax, P.F. E.S.I. etc., with the challans or returns submitted to the concerned departments.
5. Examine the agreement with trade union, specific awards of courts, provisions of different labour laws to ascertain their compliance.
6. Examine the sanction of Casual Labour by a competent authority; check the attendance record, and also the terms of appointments.
7. See that retired, expelled and resigned workers are not included in the wages sheet and for that get a list of such workers.
8. See that the preparation of wages sheet and payment of wages sheet is not done by the same person.
9. Disown his liability if he finds any loophole in the system of payment of wages.
10. Check the totals, sub totals of wages sheet.
11. Check the calculations of few items at random.
12. Compare the total amount payable per wages sheet and the cheque drawn for the purpose to see that more money is not drawn than required.
13. See that the amount of unpaid wages is paid into bank immediately.
14. Compare the names of some workers, appearing in the wages sheet with the Time Cards, Job Cards, Foreman's Register and find out whether dummy workers are included in wages sheet.
15. Verify whether the wages sheet is authenticated by the persons who prepared it.
16. If possible he may pay surprise visit at the time of actual disbursements of wages and see whether internal check is followed properly and whether wages are paid to the workers on presentation of their identity cards.
17. Compare the sanctioned strength of workers with the wages sheet. If the numbers of workers in wages sheet found are more, he should enquire into by verifying the respective files of personnel department.
18. Detect ghost workers appearing in wages sheet by comparing it with ESI Cards, P.F. deductions etc.
19. Compare the current month's wages sheet with that of last month, if increase in number of workers found enquiry must be made.
20. Signatures or attested thumb impression etc., be checked.
21. Examine the leave register to find out whether leave is sanctioned with pay or without pay.
22. To examine the genuineness of the workers signatures, compare them with Past two-three wages sheets and if required ask few workers to sign before the auditor.
23. See that wages are properly allocated and accounted.

#### ii) Income Tax

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1. Check the calculations of Income Tax paid and provided and its disclosure in accordance with AS 22.
2. Verify whether appropriate Provision is made for MAT, FBT etc.,
3. Check the adjustments relating to assessment completed upto the audit.
4. Verify whether the accounting treatment and disclosure of disputed tax liability is made with reference to the concerned accounting standards.
5. Check the accounting treatment relating to the Pending tax matter.
6. Verify the challans of Income Tax paid.
7. Check the accounting year for which Income Tax is paid.
8. Verify the assessment order.
9. See the interest and / or penalty for late payment of tax and filling return of Income is also accounted properly.
10. Check the calculations & Payments of advance tax with challans and last year's liability and instruct the client accordingly.
11. See whether tax audit is applicable and done accordingly.
12. Also see that the provisions regarding TDS, payment of Advance Tax, submission of ITR etc are complied with.

### **iii) Plant and Machinery**

As in case of industrial concern out of total assets 20% to 50% cost is that of Plant & Machinery and hence the auditor is required to take much more precaution while verifying the Plant and Machinery and for this he should give attention to following points –

1. He should get the detailed list of all Plant and Machineries and asset wise accumulated depreciation.
2. He should trace the opening balance in the Plant & Machinery register with the help of last year's audited balance sheet.
3. He should verify quotations, invoices, cost etc., in connection with Purchase of Plant & Machinery.
4. If there are sales of Plant & Machinery in audit period he should verify the invoice to that effect.
5. He should check the Board Resolution authorizing Purchases of Plant & Machinery.
6. If any machinery is disposed off and sold as scrap during the audit period, he should check the authorization and valuers report in that connection.
7. He should check the rates and calculation of depreciation and ensure these are according to the provision of Section 205 of the Companies Act, 1956.
8. He should check whether related expenses incurred on purchases of machinery are duly capitalized.
9. He should check whether proper accounting of profit earned or loss suffered on Sale of Machinery, during the audit period, is done.
10. If any machine is manufactured by the client itself, auditor should verify that capitalization of material, labor and other expenses is properly done.
11. He should obtain from the Company management certificate about the verification of all items as required.
12. He should scan the Plant register and physically inspect some of the major plants by visiting to the works.
13. He should, finally, ensure appropriate disclosure of all information on the balance sheet as required by the Companies Act.
14. He should obtain a certificate from the local auditor to that effect, if Plant and Machinery is kept abroad at a distant place.

### **Question: 18**

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- a) "Auditors to attend general meeting". Is it necessary?  
b) Write a note on 'Role of evidence in Auditing'

**Answer:**

(a) The rights and duties of an auditor with respect to attending general meetings of the company are explained as follows:

**1. Right of the auditor to receive notices of general meeting**

All notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company.

**2. Duty of the auditor to attend general meeting**

- The auditor shall attend the general meetings.
- The auditor may attend the general meeting -  
(a) himself; or  
(b) through his authorised representative, who shall also be qualified to be an auditor.
- The company may exempt an auditor from attending the general meeting.

**3. Right of the auditor to be heard at general meetings**

The auditor shall have a right to be heard at a general meeting on any part of the business which concerns him as the auditor.

b) The concept of evidence is fundamental to auditing. All auditing techniques and procedures are derived from it. It helps the auditor in perceiving the types of evidence available in an audit situation, collecting it through the various audit techniques and evaluating its sufficiency and competency to support accounting data. Development of this concept is therefore, basic to the understanding of the audit process. Mautz and Sharaf list the following five steps in the process of Judgment formation in auditing.

1. Recognition of the propositions to be proved.
2. Evaluation of the proposition in terms of materiality or significance.
3. Collection of evidence within given limits of time and costs.
4. Evaluation of evidence obtained as valid or not valid.
5. Formation of judgment as to the propositions at issue.

According to Indian Accounting Standards (AS) and their interpretations (ASI):

The auditor is required to obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions there from on which his opinion on financial statements be based.

**Question: 19**

- a) What is the remedy available to the company where the auditor refuses to carry out the audit?  
b) How would you fix the remuneration of a Statutory Auditor of your company?

**Answer:**

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(a) The provisions relating to removal, resignation and giving of special notice are explained as follows:

### 1. Removal of auditor before expiry of his term [Section 140(1)]

(a) **Resolution.** Such removal requires a special resolution.

(b) **Approval.** Previous approval of the Central Government must be obtained in the manner prescribed.

(c) **Procedure for obtaining approval of the Central Government and passing Special Resolution (Rule 7).**

(i) An application shall be made to the Central Government in Form ADT-2. The application shall be accompanied with the prescribed fees.

(ii) The application shall be made to the Central Government within 30 days of passing of the Board resolution.

(iii) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

(d) **Opportunity of being heard.** Before taking any action for removal, the auditor shall be given a reasonable opportunity of being heard.

### 2. Resignation by Auditor [Section 140(2) and 140(3)]

(a) **Duty of auditor.** When an auditor resigns, he is required to file a Statement in the prescribed form.

(b) **Contents of Statement.** The Statement shall indicate the reasons and other facts as may be relevant with regard to his resignation.

(c) The Statement shall be filed with -

- the company
- the Registrar
- CAG (in the case of a Government company).

(d) **Time limit for filing.** The Statement shall be filed within 30 days from the date of resignation.

(e) **Fine for non-filing.**

- Minimum: ₹ 50,000
- Maximum: ₹ 5,00,000.

### 3. Special Notice for not reappointing the retiring auditor [Section 140(4)]

(a) **Requirement of special notice.**

- (i) At an AGM, special notice shall be required for -

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- appointing as auditor a person other than the retiring auditor; or
  - providing expressly that the retiring auditor shall not be re-appointed.
- (ii) However, special notice shall not be required if the retiring auditor has completed consecutive tenure of 5 years / 10 years, as provided under Section 139(2).
- (b) Copy to be sent to the retiring auditor. On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- (c) Right of auditor to make a representation and to get it circulated.
- (i) The retiring auditor is entitled to make a representation against his removal. The representation (not exceeding a reasonable length) shall be in writing and shall be sent to the company.
- (ii) He may request the company to circulate the representation to the members of the company.
- (d) Duties of the company w.r.t. representation.
- (i) The company shall state the fact that the retiring auditor has made a representation against his removal, in any notice of the resolution that is given to the members of the company.
- (ii) The company shall send a copy of the representation to every member of the company to whom notice of the meeting is sent (unless the representation's received by the company too late).
- (iii) If a copy of the representation is not sent because it was received too late or because of the company's default, then -
- the auditor may require that the representation shall be read out at the meeting;
  - a copy of the representation shall be filed with the Registrar.
- (b) The provisions relating to remuneration of auditors are explained as follows:**
- 1. Remuneration to be fixed in general meeting**  
The remuneration of the auditor of a company shall be fixed -
    - (a) in the general meeting; or
    - (b) in such manner as may be decided in the general meeting.
  - 2. Remuneration to be fixed by the Board**  
In case, the first auditor is appointed by the Board, the remuneration of the first auditor shall be fixed by the Board.
  - 3. Certain sums to be included in remuneration**
    - The remuneration shall, in addition to the fee payable to an auditor, include -
      - (a) the expenses, if any, incurred by the auditor in connection with the audit of the company; and
      - (b) any facility extended to the auditor.
    - However, the remuneration shall not include any remuneration paid to the auditor for any other service rendered by him at the request of the company

## **Question: 20**

**Discuss the rights and duties of a company auditor as per Companies Act, 2013.**

### **Answer:**

Section 143 of the Companies Act, 2013 casts certain duties on the auditor and gives him certain powers to discharge the duties efficiently. These duties and rights cannot be limited in any manner, whether by way of a resolution of the company or by a provision in the articles [Newton v Birmingham Small Arms Company (1895) 2 Ch. 166]. An auditor has the following rights and duties:

#### **1. Rights and duties as per Section 143(1)**

##### **(a) Right of access to books.**

- The auditor shall have access, at all times, to the books of account and vouchers of the company.
- His right extends to all the books, whether kept at the registered office of the company or at any other place.
- The auditor shall also have access to the records of all the subsidiaries of the company, in so far as access to the books of subsidiaries is required for the purpose of consolidation of financial statements of the company with its subsidiaries.

##### **(b) Right to require information**

The auditor shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

##### **(c) Duty to make inquiries**

- (i) The auditor shall inquire as to whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members.
- (ii) The auditor shall inquire as to whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company.
- (iii) Where the company is not an investment company or a banking company, the auditor shall inquire as to whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.
- (iv) The auditor shall inquire as to whether loans and advances made by the company have been shown as deposits.
- (v) The auditor shall inquire as to whether personal expenses have been charged to revenue account.
- (vi) Where it is stated in the books and documents of the company that any shares have been allotted for cash, the auditor shall inquire as to whether cash has actually been

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received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

### 2. Duty to make Report [Section 143(2)]

- The auditor shall make a report to the members of the company.
- In his audit report, the auditor shall report on -
  - (a) the accounts examined by him; and
  - (b) financial statements which are required to be laid before the company in general meeting.
- The auditor shall state in his report as to whether the accounts examined by him and financial statements give a true and fair view of-
  - (a) the state of the company's affairs as at the end of its financial year;
  - (b) the profit or loss for the year; and
  - (c) cash flow for the year.
- The auditor shall state in his report such other matters as may be prescribed.
- The auditor shall prepare his report after taking into account the provisions of this Act and the accounting and auditing standards.

### 3. Report on principal assertions [Section 143(3)]

- (a) The report of the auditor shall state as to whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements
- (b) The report of the auditor shall state as to whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him
- (c) The report of the auditor shall state as to whether the report on the accounts of any branch office of the company audited by a person other than the company's auditor has been sent to him and the manner in which he has dealt with it in preparing his report
- (d) The report of the auditor shall state as to whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns
- (e) The report of the auditor shall state as to whether, in his opinion, the financial statements comply with the accounting standards
- (f) The report of the auditor shall state the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company
- (g) The report of the auditor shall state as to whether any director is disqualified from being appointed as a director under sub-section (2) of section 164
- (h) The report of the auditor shall state any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith
- (i) The report of the auditor shall state as to whether the company has adequate internal

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financial controls system in place and the operating effectiveness of such controls  
(j) The report of the auditor shall state such other matters as may be prescribed.

#### **4. Other matters to be included in auditor's report (Rule 11)**

The auditor shall include in his report, his views and comments on the following matters:

- (a) Whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement.
- (b) Whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts.
- (c) Whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

#### **5. Reasons to be given (Section 143(4))**

Where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons thereof.

#### **Question: 21**

- a) What are the points that an auditor should keep in mind while issuing the Audit Certificate.**
- b) When can a auditor issue a 'Qualified Audit Report'**
- c) State the differences between an Audit Report and an Audit Certificate**

#### **Answer:**

- a)** Sometimes an auditor is called upon to give a certificate for special purpose. The points that an auditor should keep in mind while issuing the same are the following:
  - i) Auditor should see that there is a suitable declaration by the management about the subject matter.
  - ii) Auditor should give the certificate on his letter head or on stationary carrying his name and address to avoid misunderstanding.
  - iii) Auditor should clearly state his limitations and indicate the extent to which he has relied upon a technical expert if any.
  - iv) Auditor should indicate the specific record covered by the certificate.
  - v) Auditor should mention the manner in which the audit was conducted.
  - vi) Auditor should indicate in the certificate if he has made certain fundamental assumptions.
  - vii) Auditor should make a reference to the information and explanations obtained.
  - viii) Auditor should give clear title to it, indicating whether it is a report or a certificate.
  - ix) Auditor should mention whether he has used any general purpose statement like Profit & Loss Account for his investigation and also, state whether that general purpose statement has been audited by other auditors.
  - x) Auditor should be careful while interpreting any law related matter, he should clearly mention that he is expressing merely his own opinion.
  - xi) Auditor should see that the certificate should be self contained documents.
  - xii) Auditor should clearly mention the responsibility assumed by him.

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- xiii) Auditor should, if he has referred the audited statements, clearly mention that the figures are used from the audited statements and relied upon.
- xiv) Auditor should address the certificate to the client or the Public Authority or the person requiring it as the case may be. In appropriate circumstances it may be issued by using the words as "to whom so ever it may concern".

b) When auditor gives his report with certain reservations, then the report is called a qualified audit report. In following circumstances the auditor has to qualify his report.

- i) He cannot conduct audit satisfactorily due to non availability of certain books of accounts or records, information or explanations necessary for conduct of his audit.
- ii) He finds that the Balance Sheet and Profit & loss Account have not been prepared in accordance with accepted accounting principles.
- iii) He detects that provisions for Bad & Doubtful Debts, Depreciation etc. are not adequate.
- iv) He detects that the company has created certain secret reserve.
- v) The stock in trade has been valued at market price which is more than cost price.
- vi) He finds that the contingent liability for bills discounted has not been disclosed.
- vii) If in his opinion provision for taxation made is not proper.
- viii) When he finds any embezzlements of cash or misappropriation of goods or manipulation of accounts which considerably affects the financial position of the company.

c) Difference between Audit Report and Audit Certificate

- i) **Meaning:** Audit Report is a statement of collected and considered information so as to give a clear picture of the state of affairs of the business to the persons who are not in possession of the full facts. While Audit Certificate is a written confirmation of the accuracy of the information stated there in.
- ii) **Opinion:** Audit Report contains the opinion of the auditor on the accounts, while Audit Certificate does not contain any opinion but only confirms the accuracy of the figures with the books of accounts.
- iii) **Basis:** Audit Report is made out on the basis of information obtained & books of account verified by the auditor, while Audit Certificate is made out on the basis of the particular data capable of verification as regards accuracy.
- iv) **Guarantee:** Audit Report may not guarantee correctness of financial statement in absolute terms, while Audit Certificate guarantees absolute correctness of the figures & information mentioned in the certificate.
- v) **Coverage:** Audit Report always covers entire accounts of the concern, while Audit Certificate covers only certain part of the accounts of the concern.
- vi) **Responsibility:** Audit Report does not hold auditor responsible for anything wrong in the accounts, while Audit Certificate makes an auditor responsible if anything mentioned in the certificate found as wrong later on.
- vii) **Suggestion:** Audit Report may provide certain suggestions for improvement while Audit certificate does not provide any such suggestion.

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- viii) **Nature:** Audit Report is based on the vouching & verification of books of accounts, voucher, assets & liabilities, while Audit Certificate is based on checking arithmetical accuracy of the facts.
- ix) **Scope:** Audit Report covers all transactions done during the year, while the Audit Certificate is very specific.
- x) **Characteristics:** Audit Report is subjective as it is opinion oriented, while Audit certificate is objective as it is fact oriented.
- xi) **Form:** Audit Report is required to be presented in the prescribed format, while Audit Certificate, except in few cases, is not required to be presented in any standard format.
- xii) **Address:** Audit report is addressed to the members of the company at large or appointing authority, while Audit Certificate is addressed to particular person or sometimes may include the words like "To Whom so ever it may concern".

### **Question: 22**

- a) Discuss the necessity and scope of internal audit.**
- b) What are the functions of financial audit and Operation audit?**

### **Answer:**

#### Necessity of Internal Audit

Internal Audit has become an important managerial tool for the following reasons:-

- i) It ensures compliance of legal formalities and provisions.
- ii) Internal Auditing is a specialized service to look into the standards of efficiency of business operation.
- iii) Internal Auditing can evaluate various problems independently in terms of overall management control and suggest improvement.
- iv) Internal Audit's independent appraisal and review can ensure the reliability and promptness of MIS and the management reporting on the basis of which the top management can take firm decisions.
- v) Internal Audit system makes sure the internal control system including accounting control system in an organization is effective.
- vi) Internal Audit ensures the adequacy, reliability and accuracy of financial and operational data by conducting appraisal and review from an independent angle.
- vii) Internal Audit is an integral part of "Management by System".
- viii) Internal Audit can break through the power ego and personality factors and possible conflicts of interest within the organization.
- ix) It ensures compliance of accounting procedures and accounting policies.
- x) Internal Auditor can be of valuable assistance to management in acquiring new business, in promoting new products and in launching new projects for expansion or diversification of business.

#### Scope of Internal Auditing

The Institute of Internal Auditors defines scope of internal auditing as "The examination and evaluation of the adequacy and effectiveness of organization's system of internal control and the quality of actual performance.

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Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance.

According to The Institute of Internal Auditors, internal audit involves five areas of operations, which can be discussed as follows:-

- i) Reliability and Integrity of Financial and Operating Information: - Internal Auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.
- ii) Economical and Efficient Use of Resources: - Internal Auditor should ensure the economic and efficient use of resources available.
- iii) Compliance with Laws, Policies, Plans, Procedures, and Regulations: - Internal Auditor should review the systems established to ensure compliance with those policies, plans and procedures, law and regulations which could have a significant impact on operations and should determine whether the organization is in compliance thereof.
- iv) Accomplishment of Established Goals for Operations: - Internal Auditor should review operations, programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.
- v) Safeguarding of Assets :- Internal Auditor should verify the existence of assets and should review means of safeguarding assets.

**b)** The functions can be enumerated as follows.

### Financial Audit

- i) To see that established systems and procedure are complied with.
- ii) To see that proper records have been maintained for the fixed assets of the concern.
- iii) To look into the correctness of financial data and records alongwith correctness of the accounting procedure/standards followed.
- iv) To see whether scrap, salvage and surplus materials have been properly accounted for etc.
- v) To see the Internal Control System has been working properly.
- vi) To see that any abrupt variation in sales, purchases etc. with respect to immediate previous year are not due to any irregularity.
- vii) To see that the credit control has been strictly followed.
- viii) To see that all payments have been made with proper authorization and approval.
- ix) To see that preparation of salary and wage payroll has been properly done.
- x) To see that all statutory obligations have been complied with.

### Operational Audit

- i) To examine whether the accounting operational functions have been true with the management objectives.
- ii) To see that internal control system has been working properly.
- iii) To see that the financial accounting records have been properly designed and maintained to furnish management with timely information to help them of judging to what extent the profitability goals have been achieved.
- iv) To study whether scrap/loss of materials have remained within the permitted limits.
- v) To see the Internal Control System has been working properly.
- vi) To study the reasons for unfavorable variances.
- vii) To study the credit control system for suggesting better means where considered necessary.
- viii) To study whether the expenditure has remained within budgetary provisions.

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- ix) To see that the payments are well within budgeted amounts and there is proper utilization of manpower.

### **Question: 23**

- a) Explain the rights of the Comptroller and Auditor General of India with respect to conduct of audit of government companies.  
b) "Auditor not to render certain services". Comment

### **Answer:**

- (a) Section 143 of the Companies Act, 2013 confers upon CAG certain rights with respect to conduct of audit of government companies, as explained below:

#### **1. Directions by CAG to the auditor [Section 143(5)]**

- In the case of a Government company, CAG shall direct the auditor the manner in which the accounts of the Government Company are required to be audited.
- The auditor shall submit a copy of his audit report to CAG.
- The audit report shall, among other things, include the directions, if any, issued by CAG, the action taken thereon and its impact on the accounts and financial statement of the company.

#### **2. Right of CAG to conduct supplementary Audit or supplement the audit report [Section 143(6)]**

CAG shall, within 60 days from the date of receipt of the audit report, have the following rights:

##### **(a) Supplementary audit**

- CAG may order conduct of a supplementary audit of the financial statement of the company.
- Supplementary audit shall be conducted by such person(s) as CAG may authorise in this behalf.
- CAG may authorise such person(s) to obtain such information as may be required for conduct of supplementary audit.

##### **(b) Supplement / comment**

- CAG may comment upon the audit report.
- CAG may supplement the audit report.
- Any such comments or supplement shall be sent by the company to every person entitled to copies of audited financial statements.
- Any such comments or supplement shall also be placed before the members in the AGM at the same time and in the same manner as the audit report.

#### **3. Test Audit | Section 143(7)]**

CAG may, by an order, cause test audit to be conducted of the accounts of a Government company

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- (b) Section 144 of the Companies Act, 2013 prohibits rendering of certain services by an auditor. These provisions are explained as under:

### 1. Services to be approved [Section 144]

An auditor shall provide to the company only such other services as are approved by -

- (a) the Board of Directors or
- (b) the audit committee, as the case may be.

### 2. Prohibited Services [Section 144]

An auditor shall not provide any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company):

- (a) Accounting and book keeping services
- (b) Internal audit
- (c) Design and implementation of any financial information system
- (d) Actuarial services
- (e) Investment advisory services
- (f) Investment banking services
- (g) Rendering of outsourced financial services
- (h) Management services
- (i) Any other kind of services as may be prescribed (No service has been prescribed so far).

### 3. Discontinuation of existing non-audit services [Proviso to Section 144]

An auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

### 4. Meaning of directly and indirectly' [Explanation to Section 144]

For the purposes of this sub-section, the term 'directly or indirectly' shall include rendering of services by the auditor -

- (a) In case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual;
- (b) In case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners.

## **Question: 24**

- (a) How is an auditor required to design his audit sample.**  
**(b) What are the different methods adopted in designing an audit sample.**

## **Answer:**

- (a)** Auditor should consider the following important factors at the time of designing the audit sample–
- (i) Audit objective
  - (ii) Population
  - (iii) Risk and Assurance
  - (iv) Tolerable error
  - (v) Expected Error in the Population

### **1. Audit Objective**

First of all the auditor should think about the specific audit objective he is going to achieve, which will enable him to decide upon audit procedure. When, according to him, audit sampling is appropriate, the nature of audit evidence to be gathered and positive error conditions etc., relating to that evidence will help him in what population be selected for sampling as well as what constitute as error.

### **2. Population**

The population is the entire set of data from which sample is drawn to reach a conclusion. He should be careful while selecting sample that the population is appropriate to reach his audit objective.

### **3. Risk and Assurance**

Auditor, while planning the audit uses his skill and judgment in assessing the level of audit risk, which include inherent risk, control risk and detection risk. Inherent risk and control risk remain irrespective of audit sampling procedures. He should consider detection risk arising from the uncertainties due to sampling. Sampling risk arises from the possibility that the auditors' conclusion may be different from the conclusion based on entire population.

### **4. Tolerance Error**

Tolerance error is the maximum error in the population which auditor accepts and still concludes that the results from the sample have achieved his audit objectives. For minimizing the tolerance error auditor has to select the larger sample size.

### **5. Expected error in the population**

When auditor expects the presence of error, normally he examines a larger sample. Smaller sample sizes are justified in the case when the population is expected to be error free. To determine the expected error in population, the error levels found in previous audits, changes in accounting and other procedures adopted by the auditee and evidence available from evaluation of internal control system etc., proves useful.

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- (b) The sample selected should represent the population and for all items in the Population must have an equal opportunity of being selected.

The following are the common methods used for selecting the samples –

- (i) Random Number Selection
- (ii) Systematic Selection Method
- (iii) Haphazard Selection Method
- (iv) Stratified Selection Method
- (v) Cluster Selection Method

### 1. Random numbers Selection Method

In this method, all items in the population have equal opportunity of being selected. Under this method random number tables or computer generated random numbers are used.

### 2. Systematic random selection Method

This method embraces the characteristic of both Random selection and Systematic selection. Under this method, the first number is selected at random and then other numbers are selected systematically using uniform interval for e.g. every ₹ 50,000/- in the cumulative value of the population is selected. This method is sometimes called interval sampling as there is uniform gap, interval between each item selected. Suppose if a systematic sample of 500 items is to be drawn for verification from a total population of 5000 items, then the interval or gap between two items selected will be  $5000/500 = 10$ . To have systematic random selection all the items will be assigned sequential number 1 to 5000. Now the first item will be selected randomly. Let it happens to be item no marked 54, then the next item will be  $54 + 10 = 64, 74$  -so on.

### 3. Haphazard Selection Method

This method is an alternative to random selection method, here auditor draws a representative sample with no intention to either include or exclude specific items.

### 4. Stratified Selection Method

One of the drawbacks of simple random or systematic random selection method is that when the population consists of various heterogeneous groups it is quite possible that the sample drawn may not represent a few groups of the population. This problem can be solved by dividing the entire population into some homogeneous groups and then sample from each group is drawn following either simple random selection or systematic random selection. Under this method the population is subdivided into sub population and all items in each sub-population have same characteristics and from each sub population samples may be drawn but auditor direct his effort toward the items which contains greater monetary error.

### 5. Cluster Selection Method

At times it becomes quite expensive or impracticable to spread sample across the entire population. To reduce administrative cost at time cluster sampling is used. In this method division of total items is made into sub groups and then at random few subgroups are selected entirely as samples. Care is to be taken that no item from the non-selected cluster are included in the sample. The method is different from the stratified sampling in which samples are drawn from each strata, whereas in cluster sampling a particular cluster is selected in its entirety.

**Question: 25**

**Discuss how Internal audit and Investigation of frauds are related.**

**Answer:**

In the minds of the public at large and of many clients, the discovery of frauds is the principal function of the auditor, overshadowing his other duties entirely, and although this is far from correct, there can be no question that it is of great importance.

Fraud may be divided broadly into two classes –

1. Defalcation, involving either misappropriation of money or goods.
2. The fraudulent manipulation of accounts not involving defalcation.

As regards the first, where accounting staff are not subjected to any form of check, the opportunities of committing fraud are so frequent, and the methods necessary to conceal it so comparatively simple, that it is safe to say that no business of any size could be carried on under such conditions for very long without the risk of fraud taking place. In small business where the individual proprietor is in touch with the whole of the detail, and is able to supervise it effectively, the possibilities of concealing fraud may be remote. As soon, however, as the business increases in size and the proprietor is no longer able to do this a check is to be carried out by members of the staff themselves assisted by an independent auditor. Where the staff is sufficiently large to enable the whole of the work to be sub-divided, the auditor should examine carefully the system in force and ascertain its deficiencies, if any.

The auditor should pay particular attention to those classes of transactions which offer scope for fraud, the principal of which are cash transactions of one kind or another.

As general principles only are under consideration here, the actual way in which these transactions should be verified will be dealt with in due course but it may be noted that there are two methods by means of which the misappropriation of money may be concealed, the first is by the inclusion of fictitious payments, and the second by the omission of cash received, the latter class being much more difficult to detect.

The second class of fraud entailing the falsification of accounts without corresponding defalcations, is naturally considerable less frequent than the class of fraud above mentioned, but when it does occur it may involve very large amount. It may be done for the purpose of bolstering up a business which is in an insecure condition, in order to maintain the confidence of shareholders, creditors or the public; or it may be done by a manager for the purpose of increasing the apparent profit of the business, thus showing that he has been successful in his management, and possibly increasing the commission on results payable to him; or by directors for the purpose of enabling them to pay dividends which would otherwise not have been possible. Several notable cases of this sort of falsification have occurred. It need only be pointed out here that this form of fraud is often very ingeniously and skillfully concealed, and is in many cases carried out by persons holding positions of the highest trust, and having the entire confidence of directors and shareholders.

The Internal Audit Department has a big role to play in preventing fraud in different organizations, as a part of protective functions. Every big organization has an internal audit manual and such a manual usually outlines the internal audit function in detail vulnerable areas where loss through fraudulent means may arise frequently. Examples of vulnerable areas are

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stores receipt/consumption, Cash expenditure, sizeable receipts of cash, civil maintenance jobs etc. The internal audit manual prescribes in detail the manner and procedure as to how internal audit function would be carried out in these areas. The manual also directs the frequency of such audit. If internal audit of such areas is done accordingly, the possibility of occurrence of both visible and invisible frauds get eroded.

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

### **Question: 26**

- a) Write a note on – “Audit in Online System Environment”**
- b) Explain the relation between Computer Information System and Internal Controls**

### **Answer:**

**a)** In online computer system the data stored on a central computer can be used by number of persons through the number of terminals. In some organizations distribution system is used where in computers are distributed throughout the network and data processed at various stages. In some online systems, computer files are updated to give immediate effect to the transactions entered through terminals; this is called as online real-time system. The controls used in such systems depend upon the specific hardware and software used.

The auditor, while auditing in such environment should consider the following points –

1. He should get acquainted with the computer network, entry points from other organizations and for collecting the network diagram.
2. He should review the network control system.
3. He should verify whether proper control measures are in use to avoid unauthorized transactions, unauthorized changing in the data or program.
4. He should review the internal controls as source documents are not available for every transaction, processing results are not available in printed form, and the reports required by the auditor are many times not available in printed form.
5. He should see into the procedures to ensure proper authorization of data fed into the computer.
6. He should insist upon the retaining of important links in audit trails.
7. He should verify the effectiveness of separating the transactions accounting period wise to avoid confusion in the situation of overflow of online transactions.
8. He should see that proper measures like establishment of appropriate controls to detect and correct line errors, cryptographic controls etc. are introduced in the system effectively to avoid the loss of data by accident or corruption.

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9. He should test the sample transaction derived at random from the addition of audit instructions to the programs used in data processing for continuous monitoring the system.

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

Some of these controls are as under -

1. **Password** - This control is used to identify the person before the computer information system starts processing the task. This control assures that the data fed into and the processing done by the computer information system are authorised.
2. **Edit Test** - Edit test, Financial control test etc. help in correct data entry and the accurate processing by the computer information system.
3. **Batch Cancellation Stamp** - This control keeps check on the processing of data only once and the repetition is avoided.
4. **Financial Control Total** - Along with edit test, this control helps in saving of the data and complete processing of the data.
5. **File Libraries** - File libraries, locks on computer installation etc. are used to safeguard the computer information system from destruction and corruption.
6. **Audit Trails** - Ensures that all those record and process are maintained within the system from which financial statement are derived.
7. **General Control** - These control establish overall control of the activities of computer information system. These controls include:
  - a. Organisational Control
  - b. System & Documentation Control
  - c. Access Control
  - d. Hardware Control
  - e. Procedural Control etc.
8. **Application Controls** - Over and above general control, control over the application of the computer information system is very important. These controls include:
  - a. Input control
  - b. Processing control and
  - c. Output control

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

## Question: 27

State the provisions relating to reporting of fraud by an auditor as contained in the Companies Act, 2013.

## Answer:

The provisions relating to reporting of frauds by an auditor are explained as follows:

### **1. When is reporting required:**

If an auditor has reason to believe that an offence involving fraud has been committed or is being committed against the company by officers or employees of the company, the auditor is required to report such fraud.

### **2. Report to whom:**

The auditor shall report the matter to the Central Government.

### **3. Time and manner of reporting**

The auditor shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

### **4. No liability of auditor**

An auditor shall not be deemed to be guilty for breach of any of his duties by reason of his reporting any matter to the Central Government if such reporting is done in good faith.

### **5. Provisions applicable to other auditors**

The provisions w.r.t. reporting of fraud shall mutatis mutandis apply to -

- (a) the cost accountant in practice conducting cost audit under section 148; or
- (b) the company secretary in practice conducting secretarial audit under section 204.

### **6. Punishment for non-compliance**

- (a) Minimum Fine: ₹ 1,00,000
- (b) Maximum Fine: ₹ 25,00,000.

### **7. Time and manner of reporting of fraud by auditor (Rule 13)**

- (i) When a fraud comes to the knowledge of the auditor, the auditor shall immediately forward his report to the Board / Audit Committee.
- (ii) The Board is required to submit its reply or observations within 45 days.
- (iii) Within 15 days of receipt of such reply or observations, the auditor shall forward to the

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- Central Government -
- (a) his report; and
  - (b) the reply or observations of the Board / Audit Committee along with his comments.
- (iv) In case the auditor fails to get any reply or observations from the Board / Audit Committee within 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board / Audit Committee.
- (v) The report shall be sent - to the Secretary, Ministry of Corporate Affairs IN a sealed cover by Registered Post with Acknowledgement Due or by Speed post
- (vi) After the report is sent, an e-mail shall also be sent to the Secretary, Ministry of Corporate Affairs in confirmation of the report sent.
- (vii) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number.
- (viii) The report shall be signed by the auditor with his seal and shall indicate his Membership Number.
- (ix) The report shall be in the form of a statement as specified in Form ADT-4.
- (x) These provisions shall also apply, mutatis mutandis, to -
- (a) a cost auditor during the performance of his duties under section 148; and
  - (b) a secretarial auditor during the performance of his duties under section 204.

### **Question: 28**

**Mr. Ayush has recently joined a manufacturing company. Since he has joined, there has been pilferage in some expensive input units. How would you audit for the same being the internal auditor of the company.**

### **Answer:**

#### Audit of Inventory

Purchases – See whether there is a purchase manual. The Internal Auditor should then, jot down the important factors that has been prescribed in respect of purchase of raw materials etc.

Normally purchases are based on five important factors given below:-

- (1) Right Price.
- (2) Right quantity
- (3) Right quality
- (4) Right delivery and
- (5) Right supplier

The auditor therefore, has to see that these principles have been duly followed. Based on the above principles the audit steps would be generally as follows :-

#### (1) Inventory Control Receiving:

- (i) Examine the systems and procedures of receiving, checking and recording of stores, materials and the authority and responsibility of the persons involved in the process.
- (ii) Examine the procedure of inspection of materials – see whether there is proper coordination between the Inspection Department and the Receiving Section of the Stores Department.

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(iii) Examine the procedure of preparing Material Report – How many copies of the report are prepared? To whom these are endorsed? Are all necessary? What is the time lag between receipt of material and its inspection?

(iv) Has any demurrage been paid to the railways for late clearance of materials?

(v) What is the procedure of receipt of materials returned from the Production Department?

### (2) Keeping of Stock

(i) See whether the physical condition of the stores in stock is periodically verified.

(ii) Study the arrangement to facilitate receiving, storing and issue of stores

(iii) Study whether heavy materials / materials for immediate consumption are delivered directly to the work- sites.

(iv) Study the arrangements and precautions taken in respect to hazardous handling, safety measures to prevent theft, fire, deterioration etc.

(v) See whether any sub-stores / site-stores exists.

(vi) See whether facilities exist in storing materials in well-arranged bins etc.

### (3) Procedure of issue and recording

(i) Examine the procedure of issue and records maintained in the stores section.

(ii) What is the time lag between placing the issue requisition and actual issue to the consuming department?

(iii) Review the frequency of issues to the consuming departments. Is it possible to reduce the frequency?

(iv) Has there been issue without properly authorized requisition? If so, ascertain the reasons thereof.

(v) Does the person drawing the material signs the issue voucher? Similarly does the assistant issuing the materials from stores similarly sign the issue voucher? Examine the authority and responsibility of the persons involved in the process.

(vi) Review the issue procedure and documentation in respect to issue to contractor engaged in construction/ maintenance jobs.

(vii) Did the production suffer due to non availability of materials from stores? Ascertain the reasons therefore.

(viii) Has there been any sale of stores materials to employees? If such system exists, review the systems and procedures in issues, recording, accounting and realization of money from the employees.

(ix) Examine the procedure and documentation in respect to materials returned. Is any Stores Return Note issued for the purpose? Are the information adequate for the purpose of accounting and receipt of materials in the stores?

(x) Review the procedure of recording and return of empty containers.

(xi) In case a stores manual exists, see, whether instructions contained therein have been followed in issuing the materials and their documentation etc.

### (4) Physical Verification

(i) Review the procedure of physical verification of stores? Is it done in the year end? Or the physical verification is done on perpetual inventory system basis.

(ii) If a system of perpetual inventory exists, see whether the stores are covered at least once in a year and important stores are covered more than once.

(iii) Does an independent stock verification wing carry out physical verification of stores?

(iv) What records are prepared in respect to recording of stores found short / surplus?

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- (v) What is the procedure in making adjustment of stores records / financial records on the basis of shortage / surplus report?
- (vi) Under whose authority this discrepancy report is issued.
- (vii) To whom physical verification department reports?

### (5) Stores Accounting

- (i) Is there any Stores- Accounting Manual duly approved by the management?
- (ii) Who maintains the stores ledger? If maintained by the stores people in addition to bin cards, is it periodically reviewed and reconciled with accounts by some accountants working in the Accountants' Offices?
- (iii) Examine whether accounting/recording of stores received/stores returned from production department, stores issued for consumption has been done as per procedure of the Stores Manual.
- (iv) See whether the stores ledger/bin cards contain all the required information like unit price, maximum, minimum, reorder, economic order quantity etc.
- (v) Examine whether the system of receiving / issuing of stores etc. ensure that only the authorized transactions are recorded.

### (6) Inventory Control and Management

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

### (7) Some General Aspects

- (i) Sometimes used materials are returned to stores. In such cases procedure for recording would be the same as followed in case of unused materials except that these may or may not be priced. Usually separate stores ledger / bin cards are opened. See whether the procedure in this regard has been observed.
- (ii) Review whether any study has been made in regard to mechanization in stores receipt/issue, store accounting.
- (iii) Review whether proper numerical accounts have been kept in respect to stand by spares.
- (iv) See whether there are any Material Receiving Report pending disposals – recording valuation in stores ledger/bin card, accounting the accounts records etc.
- (v) Review the mode of valuation of closing stock.
- (vi) How soon the stores schedule is prepared for annual accounts purpose ?
- (vii) Are the stores materials adequately covered by insurance against loss from fire and other risks ?

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(viii) Is there proper coordination between –

- (a) Central Purchase Department
- (b) Local Purchase Department
- (c) Stores Department
- (d) Stock – verification Department

(ix) In case there are number of factories producing same / similar products make comparative study regarding –

- (a) Surplus materials
- (b) Obsolete/slow-moving materials.
- (c) Finished/work-in-progress stock
- (d) Opening/closing stock of raw material, etc.

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

### **Question: 29**

- a) “Field work is a managerial control which functions by measuring and evaluating the effectiveness of other controls”. Discuss.**
- b) What are the objects of Audit Working papers**

### **Answer:**

**a)** The internal auditors' duty is to collect, classify and appraise information so that he is able to form an opinion and to make necessary recommendations for effective improvement in operation of the business. This job would consume a larger part of the auditor's time.

Two factors are mainly involved in this work:-

- (a) Measurement
- (b) Evaluation

First the concept of measurement needs to be discussed. The internal auditor would be able to examine any operation in the company if he is able to grasp this concept.

He must examine the operations in terms of units of measurement and standards applicable in such cases. The units of measures would be some discreet elements e.g. the rupees, days, degrees, documents, machines and some other quantifiable material. So the units of measurement would be such by which success or failure of the operation can be judged objectively. The standards on the other hand are those quantities of acceptability with which the measured things may be compared.

Hence each audit job would have to be approached with the idea that it can be dealt with by:-

- (a) Determining its size, extent or other quality in terms of some units of measurement.
- (b) Comparison of the results with acceptable standards. Then only the auditor would be able to carry out the audit objectively and intelligently. If however, the audit job is such that it cannot be approached as above, it would not be possible for the auditor to make an objective observation. In such cases perhaps he would be able to produce only some subjective observations. It should be remembered that measures is only one aspect of the field work. After making the measures the internal auditor would have to evaluate the results. The auditor would have to evaluate the data obtained through measurements to form his opinion and recommendations. Evaluation would mean arriving at correct judgment and to express such judgment in terms of what is known. In a few cases monetary worth of something may be determined.

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## Measurement Standard

The auditor must be able to evaluate the standard as they are applied in the field work. The auditor may need some modification in the light of future changes. Standards which are developed yesterday might not be applicable today. There may be some changes in the statutes, procedures, contracts etc For these reasons the standards have to be changed. The adequacy of the standards must be assessed. The measures of standards by the auditor should be done from the point of view of quality, cost and time schedule.

## Interviews

The internal auditor has to send his report to the management on the assigned areas. The report to be meaningful, informative and effective, has to be definite in every observation it contains. To have definiteness and authentication, sometimes the internal auditor "interviews" the functional people in an honest endeavor to have elucidation in respect of facts collected by him or his representative during the course of audit. In his report, the internal auditor would point out the facts observed by him during audit and would also mention the facts revealed during the interview for explaining the real position to the management. Internal Audit Report is precious informative reports to aid the management in deciding the right course of action. Memoranda are often found very useful in passing some additional information to the internal auditor, in making his reports more informative and purposeful.

## **b) OBJECTS OF WORKING PAPERS:**

1. In order to support the auditor's report these papers show in detail the work performed by the audit clerks
2. The auditor can form an opinion about the efficiency or otherwise of the audit clerks.
3. As the working papers remain with the auditor, as we shall see later on, they are the permanent record and therefore, in case of any suit against him for negligence, he can defend himself on the basis of these working papers.
4. The preparation of the working papers is a means to give training to audit clerks as to how to summarise the work done by them.
5. The working papers enable the auditor to point out to the client the weaknesses of the internal control system in operation, and deficiency of the accountancy system. He may therefore, be in a position to advice his client as to how to avoid such pitfalls.
6. The working papers help the auditor to plan for the succeeding year.
7. The working papers enable the auditor to prepare the report to be issued without much waste of time.
8. He can know that his assistants had followed his instructions.
9. If changes and transfer of staff are very frequent and in case such working papers exist the audit work can be assigned to others with minimum of dislocation with least possibility of duplication and omission of any work.
10. Future audit work can be carried on in the same sequence on the basis of the previous working papers.
11. Items left outstanding during the previous year, e.g. any document not produced, may be paid particular attention in the future.

## **Question: 30**

- a) 'Audit in an e-commerce environment', how it would be undertaken.
- b) Discuss the need for 'Management Audit'

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### **Answer:**

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

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

### **b) Need of Management Audit:**

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

1. To overcome the human limitations of Top Management.
2. To improve the management's production.
3. Circumstances of corporate planning deficiencies, organization's structured defects, ineffective management control system etc. warrants the necessity of management audit.
4. In the circumstances of acquisition of another business entity, the acquiring organization needs to evaluate financial aspects, technical aspects and management aspects and analysis of these aspects takes the form of management audit.
5. Society at large likes to be assured that the top and middle level management discharge their functions efficiently and to the best advantage to the society, the management audit satisfy the different interest of groups like customers, employees, citizens, government etc. of the society and also guide the management in the application of scientific methods of business management for social well being.
6. The statutory financial audit is generally annual and concerned with the past without having any forward approach. Statutory financial audit and internal audit along with statutory cost audit are essentially legalistic in terms of time given for its completion and

nature of certification fails to provide the insight to the management in regard to unsuitability of structure to meet the entity's needs, poor leadership, inability to make decisions, poor vision and the enlightened managers realizes this fact and feels the need of management audit to identify the problems and guidance to overcome them.

7. Foreign collaborators, while investing in other organizations feel the necessity of management audit to ensure that the funds invested are to be used properly for growth and expansion.
8. Financial institutions conduct the management audit, while participating in equities of a company to avoid possible losses arising from inefficient management.
9. Company itself feels the need of management audit to assess its managers' performances and link an incentive system to the results of such assessment.
10. While advancing loans, banks like to get the management audit conducted.