

INTERMEDIATE EXAMINATION

(REVISED SYLLABUS - 2008)

GROUP - I

Paper-6 : COMMERCIAL AND INDUSTRIAL LAW AND AUDITING

SECTION - I

(Commercial and Industrial Law)

Q. 1. Comment on the following :

- (a) A offered to sell his car to B for Rs. 20000/-. B replied that he can accept for only Rs. 17000/-. A rejected B's counter offer to buy for Rs. 17000/-. B later changed his mind and was ready to buy the car for Rs. 20000/-. Is A bound to sell the car?
- (b) 'X' stands surety for 'Y' for any amount which 'Z' may lend to Y from time to time during the next three months subject to a maximum of Rs. 50,000. One month later X revokes the guarantee, when Z had lent to Y Rs. 5,000. Referring to the provisions of the Indian Contract Act, 1872 decide whether 'X' is discharged from all the liabilities to 'Z' for any subsequent loan. What would be your answer in case 'Y' makes a default in paying back to 'Z' the money already borrowed i.e. Rs. 5,000?
- (c) S delivered his car to M for repairs. M completed the work, but did not return the car to S within reasonable time, though S repeatedly reminded M for the return of car. In the meantime a big fire occurred in the neighborhood and the car was destroyed. Decide whether M can be held liable under the provisions of the Indian Contract Act, 1872.
- (d) Mr. SS a businessman has been fighting a long drawn litigation with Mr. RR another businessman. To support his legal campaign Mr. SS enlists the services of Mr. X a legal expert stating that an amount of Rs. 10 lacs would be paid, if Mr. X does not take up the brief of Mr. RR. Mr. X agrees, but at the end of the litigation Mr. SS refuses to pay. Decide whether Mr. X can recover the amount promised by Mr. SS under the provisions of the Indian Contract Act, 1872.
- (e) Mr. A of Delhi engaged Mr. S as his agent to buy a house in West Extension area. Mr. Singh bought a house for Rs. 30 lacs in the name of a nominee and then purchased it himself for Rs. 34 lacs. He then sold the same house to Mr. A for Rs. 36 lacs. Mr. A later comes to know the mischief of Mr. S and tries to recover the excess amount paid to Mr. S. Is he entitled to recover any amount from Mr. S? If so, how much? Explain.
- (f) X, a minor was studying in a college. On 1st June, 2010 he took a loan of Rs. 20,000 from B for payment of his college fees and to purchase books and agreed to repay by 31st December, 2010. X possesses assets worth Rs. 5 lacs. On due date X fails to pay back the loan to B. B now wants to recover the loan from X out of his (X's) assets. Referring to the provisions of Indian Contract Act, 1872 decide whether B would succeed.
- (g) W parks his car at a parking lot, locks it, and keeps the keys with himself. Whether this constitutes a contract of 'Bailment' under the provisions of the Indian Contract Act, 1872?

- (h) In an agreement between P and G, there is a condition that they will not institute legal proceeding against each other without consent. Examine the validity of such agreement.
- (i) “Glamorous Toiletries Ltd” advertised that it would give a reward of Rs. 10000 who developed skin disease after using, “GLOW Compact” facepack of the company for a certain period according to the printed directions. Miss Roshni purchased the advertised “GLOW Compact” and developed skin disease in spite of using this face pack according to the printed instructions. She claimed reward of Rs. 10000. The company refused the reward on the ground that offer was not made to her and that in any case she had not communicated her acceptance of the offer. Decide whether Miss Roshni can claim the reward or not.
- (j) Ram proposed to sell his house to Shyam. Ram sent his acceptance by e-mail. Next day, Shyam sends a Fax withdrawing his acceptance. Examine the validity of the acceptance in the light of the following :
- (i) The Fax of revocation of acceptance was received by Ram before the email of acceptance.
 - (ii) The Fax of revocation and email both reached together.

Answers 1.

- (a) The offer of A was rejected by B in the first instance. The fact that B later changed his mind does not amount to acceptance but a counter offer of B. It is upto A whether to accept it or not.
- (b) The problem as asked in the question is based on the provisions of the Indian Contract Act 1872, as contained in Section 130 relating to the revocation of a continuing guarantee as to future transactions which can be done mainly in the following two ways:
1. **By Notice** : A continuing guarantee may at any time be revoked by the surety as to future transactions, by notice to the creditor.
 2. **By death of surety** : The death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee, so far as regards future transactions. (Section 131).

The liability of the surety for previous transactions however remains.

Thus applying the above provisions in the given case, X is discharged from all the liabilities to Z for any subsequent loan.

Answer in the second case would differ i.e. X is liable to Z for Rs. 5,000 on default of Y since the loan was taken before the notice of revocation was given to Z.

- (c) The problem asked in the question is based on the provisions of section 160 and 161 of the Indian Contract Act 1872. Accordingly, it is the duty of the bailee to return or deliver the goods bailed according to the bailor’s directions, without demand, as soon as the time for which they were bailed has expired, or the purpose for which they were bailed for any loss, destruction of the goods from that time (Section 161), notwithstanding the exercise of reasonable care on his part.
- Therefore, applying the above provisions in the given case, M is liable for the loss, although he was not negligent, but because of his failure to deliver the car within a reasonable time.
- (d) The problem as asked in the question is based on one of the essentials of a valid contract. Accordingly, one of the essential elements of a valid contract is that the agreement must not be one which the law declares to be either illegal or void. A void agreement is one without any legal effect. Thus any agreement in restraint of trade, marriage, legal proceedings etc., are void agreements. Thus Mr. X cannot recover the amount of Rs. 10 lakhs promised by Mr. SS because it is an illegal agreement and cannot be enforced by law.

- (e) The problem in this case, is based on the provisions of the Indian Contract Act, 1872 as contained in Section 215 read with Section 216. The two sections provide, that where an agent without the knowledge of the principal, deals in the business of agency on his own account, the principal may :
- (1) repudiate the transaction, if the case shows, either that the agent has dishonestly concealed any material fact from him, or that the dealings of the agent have been disadvantageous to him.
 - (2) claim from the agent any benefit, which may have resulted to him from the transaction.
- Therefore, based on the above provisions, Mr. A is entitled to recover Rs.6 lakhs from Mr. S being the amount of profit earned by Mr. S out of the transaction.
- (f) Yes, B can proceed against the assets of X. According to section 68 of Indian Contract Act 1872 "If a person, incapable of entering into a contract, or any one whom he is legally bound to support, is supplied by another person with necessaries suited to his condition in life, the person who has furnished such supplies is entitled to be reimbursed from the property of such incapable person." Since the loan given to X is for the necessaries suited to the conditions in life of the minor, his assets can be sued to reimburse B.
- (g) No. Mere custody of goods does not mean possession. For a bailment to exist the bailor must give possession of the bailed property and the bailee must accept it (Section 148, Indian Contract Act, 1872 is not applicable).
- (h) An agreement in restraint of legal proceedings is void as per Section 28 of the Indian Contract Act, 1872. Hence this is void agreement.
- (i) Yes, Miss Roshni can claim the reward of Rs.10000 because the advertisement issued by the company is an offer made to the public in general and hence any one can accept and do the desired act. Where a general offer is of continuing nature, it will be open for acceptance to any number of persons until it is retracted. The Contract Act states that performance of the conditions of a proposal is an acceptance of the proposal. So there is no need of actual and formal offer and the communication of an acceptance of an offer.
- (j) The problem is related with the communication and time of acceptance and its revocation. As per Section 4 of the Indian Contract Act, 1872, the communication of an acceptance is a complete as against the acceptor when it comes to the knowledge of the proposer.
- An acceptance may be revoked at any time before the communication of the acceptance is complete as against the acceptor, but not afterwards.
- Referring to the above provisions
- (i) Yes, the revocation of acceptance by Shyam (the acceptor) is valid.
 - (ii) If Ram reads the Fax first , the acceptance stands revoked. If he opens the email first and reads it, revocation of acceptance is not possible as the contract has already been concluded.

Q. 2. (a) Explain the concept of 'misrepresentation' in matters of contract.

- (b) What do you understand by "Agency by Ratification"? What is the effect of ratification?
- (c) Explain the concept of 'Supervening impossibility' under the Indian Contract Act, 1872. State the circumstances where under a party to a contract may be exempted from the performance of contract on the ground of 'Supervening impossibility'.
- (d) Under what circumstances can a non-owner create a valid pledge?
- (e) Distinguish between void and illegal agreement.
- (f) State the grounds upon which a contract may be discharged under the provisions of Indian Contract Act, 1872.

Answer 2.

- (a) According to Section 18 of the Indian Contract Act, 1872, misrepresentation is there :
- (i) When a person positively asserts that a fact is true when his information does not warrant it to be so, though he believes it to be true.
 - (ii) When there is any breach of duty by a person, which brings an advantage to the person committing it by misleading another to his prejudice.
 - (iii) When a party causes, however, innocently, the other party to the agreement to make a mistake as to the substance of the thing which is the subject of the agreement.

- (b) A person may act on behalf on another without his knowledge or consent. Later on such another person may accept the act of the former or reject it. If he accepts the act of the former done without his consent, he is said to have ratified that act and it places the parties in exactly the same position in which they would have been the former had later's authority at the time he made the contract. Likewise, when an agent exceeds the authority bestowed upon him by the principal, the principal may ratify the unauthorised act.

The effect of ratification is to tender the acts done by one person (agent) on behalf of another (principal), without his (principal's) knowledge or authority, as binding on the other person (principal) as if they had been performed by his authority (Section 196: Indian Contract Act, 1872).

Further, ratification relates back to the date when the act was done by the agent. This means the agency comes into existence from the moment the agent first acted and not from the time when the principal ratified the act.

- (c) When performance of a promise becomes impossible or illegal by occurrence of an unexpected, event or a change of circumstances beyond the contemplation of parties, is called supervening impossibility. In case of supervening impossibility the contract becomes void.

A party to a contract may be excused from the performance of his promise on the ground of 'supervening impossibility' under the Indian Contract Act, 1872 in the following circumstances.

- (i) **Accidental destruction of the subject matter of the contract** : If the subject matter of the contract is destroyed by an accident both the parties are excused from the performance of the contract.
- (ii) **Non-existence or non occurrence of a particular state of things** : Non-existence or non occurrence of a particular state of things of the contract exempts the parties from the performance of the contract.
- (iii) **Incapacity to perform a contract of personal services** : In case of contract of personal service, disability or incapacity to perform, caused by the act of God e.g. illness, constitutes lawful excuse for non-performance of the contract.
- (iv) **Change in law** : Performance of a contract may also become impossible due to a subsequent change in the law. The law passed after the contract may prohibit performance of some act, which may be very basis of the contract. As such the contract is discharged due to subsequent impossibility and the parties become free from their mutual obligations.
- (v) **Outbreak of war** : Contracts may be affected by war in a variety of ways, viz., (A) by emergency legislation controlling prices or otherwise relating to restriction of trade; (B) by prohibiting or restraining transaction with alien enemy.

(d) A non-owner can create a valid pledge in the following situations :

(I) Pledge by mercantile agent (Sec 178):

- A mercantile agent who is in possession of goods or document of the title to goods, with the consent of owner, can pledge them while acting in the ordinary course of business as a mercantile agent.
- Such pledge shall be valid as if it were made with authority of the owner of goods.
- The pledge shall be valid only if the pawnee — (i) acts in good faith, and (ii) has no notice at the time of pledge that the pawner had no authority to pledge.

(II) Pledge by a person in possession under voidable Contract (Sec 178 A) :

When the pawner has obtained possession of goods under a voidable Contract u/s 19 or 19 A i.e by way of fraud, coercion, etc. but the Contract is not rescinded at the time of pledge is valid. The pawnee obtains a good title to such goods provided that he acted in good faith and had no notice of the defective title of the pawner.

(III) Pledge where pawner has limited interest (Sec 179) :

Where the pawner has only limited interest in the goods pledged, the pledge shall be valid only to the extent of such interest.

(e) Distinction between void and illegal agreement :

Void agreement	Illegal agreement
An agreement not enforceable by law is void.	An agreement is illegal where either consideration or object is illegal besides being void.
It affects only immediate parties and has no further consequences.	It is void not only between immediate parties has effect of tainting the collateral transactions also.

(f) A Contract may be discharged either by an act of parties or by an operation of law which may be enumerated as follows :

- (i) Discharge by performance which may be actual performance or tender of performance. Actual performance is said to have taken place, when each of the parties has done what he had agreed to do under the agreement. When the promisor offers to perform his obligation, but the promisee refuses to accept the performance. It amounts to attempted performance or tender :
- (ii) **Discharge by mutual agreement** : Section 62 of the Indian Contract Act, 1872 provides if the parties to a contract agree to substitute a new contract for it or to refund or remit or alter it, the original contract need not to be performed. Novation, Rescission, Alteration and Remission are also the same ground of this nature.
- (iii) **Discharge by impossibility of performance** : The impossibility may exist from its initiation. Alternatively, it may be supervening impossibility which may take place owing to (a). unforeseen change in law (b). The destruction of subject matter (c). The non-existence or non-occurrence of particular state of things d). the declaration of war (Section 56).
- (iv) **Discharge by lapse of time** : A contract should be performed within a specific period as prescribed in the Law of Limitation Act, 1963. If it is not performed the party is deprived of remedy at law.
- (v) **Discharge by operation of law** : It may occur by death of the promisor, by insolvency etc.

- (vi) **Discharge by breach of contract** : Breach of contract may be actual breach of contract or anticipatory breach of contract. When a person repudiates a contract before the stipulated time, for its performance has arrived, it is an anticipatory breach. If one of the parties to a contract breaks the contract the party injured thereby has a right of action for damages as well as he is also discharged from performing his part of the contract (Section 64).
- (vii) A promisee may dispense with or remit the performance of the promise made to him or may accept any satisfaction he thinks fit. In the first case, the contract will be discharged by remission and in the second it is accord and satisfaction (Section 63).
- (viii) When a promisee neglects or refuses to afford the promisor reasonable facilities for the performance of the promise, the promisor is excused by such neglect or refusal (Section 67).

Q. 3. Comment on the following :

- (a) **With a view to boost the sales HM Automobiles sells a motorcar to Mr. X on trial basis for a period of three days with a condition that if Mr. X is not satisfied with the performance of the car, he can return back the car. However, the car was destroyed in a fire accident at the place of Mr. X before the expiry of three days. Decide whether Mr. X is liable for the loss suffered.**
- (b) **A contracts to sell B, by showing sample, certain quantity of sunflower oil described as 'foreign refined sunflower oil'. The oil when delivered matches with the sample, but is not foreign refined sunflower oil. Referring to the provisions of Sale of Goods Act, 1930 advise the remedy, if any, available to B.**
- (c) **X, 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?**
- (d) **X, Y and Z were joint owners of a bus and possession of the said bus was with Y. P purchased the bus from Y without knowing that X and Z were also owners of the bus. Decide in the light of provisions of the Sale of Goods Act, 1930, whether the sale between Y and P is valid or not?**

Answer 3. (a)

The problem as asked in the question is based on the provisions of the Sale of Goods Act, 1930 as contained in Section 8. Accordingly, the contract becomes void if the goods are destroyed or do not answer to the description in the agreement before the risk passes on to the buyer. In the given case that the subject matter of the contract i.e Motorcar was destroyed before the transfer of property from the seller to the buyer. Thus the risk passes only when the ownership is transferred to the buyer. Therefore, in the present case Mr. X is not liable for the loss suffered due to the fire accident over which X has no control. Thus M/s. HM Automobiles will have to bear whatever loss that has taken place due to the fire accident.

Answer 3. (b)

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

Answer 3. (c)

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.

Answer 3. (d)

This problem is based on Section 28 of the Sale of Goods Act, 1930 which lays down an exception to the general rule that a person cannot transfer a better title than that he himself possesses. A person who is one of joint owners may transfer a better title than he possesses. Section 28 provides that – “if one of several joint owners of goods has the sole possession of them by permission of the co-owners, the property in goods is transferred to any person who buys them of such joint owner in good faith and has not at the time of the contract of sale notice that the seller has not authority to sell”.

The given problem fulfills all such requirements. X, Y and Z are joint owners of the bus. Y had sole possession of it. In such a case if P has purchased the bus from Y in good faith without notice at the time of sale that Y had no authority to sell, then P acquires good title and becomes full owner although Y was not the full owner.

Q. 4. (a) What do you understand by the term “unpaid seller” under the Sale of Goods Act, 1930? Explain the provisions of law relating to unpaid seller’s ‘right of lien’.

(b) “There is no implied warranty or condition as to quality or fitness for any particular purpose of goods supplied under a contract of sale. “Discuss the significance and state exceptions, if any.

(c) When shall a ‘breach of condition’ be treated as ‘breach of warranty’ under the provisions of the Sale of Goods Act, 1930? Explain.

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

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

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

Answer 4. (a)

According to Section 45 of the Sale of Goods Act, 1930 the seller of goods is deemed to be an ‘Unpaid Seller’ when-

- (i) the whole of the price has not been paid or tendered.
- (ii) a bill of exchange or other negotiable instrument has been received as conditional payment, and it has been dishonoured.

The legal provisions regarding the right of lien of an unpaid seller has been stated from Sections 47 to 49 of the Sale of Goods Act, 1930 which may be enumerated as follows :

- (i) According to Section 47 the unpaid seller of the goods who is in possession of them is entitled to retain possession of them until payment or tender of the price in the following cases namely :
 - (A) where the goods have been sold without any stipulation as to credit.
 - (B) where the goods have been sold on credit, but the term of credit has expired; or
 - (C) where the buyer becomes insolvent.

The seller may exercise his right of lien notwithstanding that he is in possession of the goods as agent or bailee for the buyer.

- (ii) Section 48 states that where an unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless such part delivery has been made under such circumstances as to show an agreement to waive the lien.

- (iii) According to Section 49 the unpaid seller loses his lien on goods :
- (A) when he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the goods.
 - (B) when the buyer or his agent lawfully obtains possession of the goods ;
 - (C) by waiver thereof

The unpaid seller of the goods, having a lien thereon, does not lose his lien by reason only that he has obtained a decree to the price of the goods.

Answer 4. (b)

The statement given in the question is the fundamental principle of law of sale of goods, sometime expressed by the maximum 'Caveat Emptor' meaning thereby 'Let the buyer be aware'. In other words, it is no part of the seller's duty in a contract of sale of goods to give the buyer an article suitable for a particular purpose, or of particular quality, unless the quality or fitness is made an express terms of the contract. The person who buys goods must keep his eyes open, his mind active and should be cautious while buying the goods. If he makes a bad choice, he must suffer the consequences of lack of skill and judgement in the absence of any misrepresentation or guarantee by the seller.

There are, however, certain exceptions to the rule which are stated as under :

- (i) Where the buyer expressly or by implication, makes known to the seller the particular purpose for which he needs the goods and depends on the skill and judgement of the seller whose business is to supply goods of that description, there is an implied condition that the goods shall be reasonably fit for that purpose;
- (ii) If the buyer purchasing an article for a particular use is suffering from an abnormality and it is made known to the seller at the time of sale, implied condition of fitness will apply.
- (iii) If the buyer purchases an article under its patent or other trade name and relies on seller's skills and judgement which he makes known to him, the implied condition that are articles are fit for a particular purpose shall apply.
- (iv) If the goods can be used for a number of purposes the buyer must tell the seller the particular purpose for which he required the goods otherwise implied condition of fitness of goods for a particular purpose will not apply.
- (v) Where the goods are bought by description from a seller who deals in goods of that description whether he is the manufacturer or producer or not, there is an implied condition that the goods are of merchantable quality.
- (vi) An implied condition as to quality or fitness for a particular purpose may be annexed by the usage of trade or custom;
In a sale by sample there is an implied condition that
 - (A) The bulk shall correspond with the sample in quality;
 - (B) The buyer shall have reasonable opportunity of comparing the bulk with the sample; and
 - (C) The goods shall be free from any defect, rendering them unmerchantable;
- (vii) In the case of eatables and provisions in addition to the implied condition of merchantability, there is an implied condition that the goods shall be wholesome.

Answer 4. (c)

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

- (i) Where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition,

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

Answer 4. (d)

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

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

Q. 5. Comment on the following :

- (a) Daily working hours in a factory cannot be more than 8 hours on any day considering ceiling of 48 working hours in a week as per *the Factories Act 1948*.
- (b) An individual dispute is not an industrial dispute under the *Industrial Disputes Act, 1947*.
- (c) W, a heart patient worked for four hours in a factory premises. He profusely sweated during the recess and died of heart failure which resulted on account of severe stress and strain inside the factory premises. Is the employer liable to pay compensation under the *Employees Compensation Act, 1923*?

Answer 5. (a)

As per Sec . 51 of the Factories Act, 1948 no adult employee is required to work more than 48 hours in any week. Subject to this rule, no adult employee shall be required to work for more than 9 hours in any day. But in order to facilitate the change of shift, this limit may exceeded. This can, however, be done with the previous approval of the Chief Inspector of Factories.

Answer 5. (b)

Where any employer discharges, dismisses, retrenches or otherwise terminates the services of an individual workman, any dispute or difference between that workman and his employer connected with, or arising out of, such discharge, dismissal, retrenchment or termination shall be deemed to be an industrial dispute notwithstanding that no other workman nor any union of workmen is a party to the dispute. [Sec 2-1]

Answer 5. (c)

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

Q. 6. (a) C failed to give details of travelling expenses on account of tour inspite of several reminders. His company deducted the amount of tour advance from C's salary after expiry of 3 months. Is the company justified under the *Payment of Wages Act, 1936* ?

- (b) X is engaged in two types of job in a factory, that of a mechanic and watchman. The wage rates are different for two different jobs. The employer calculates his minimum wage at an average rate.
- (c) The payment of contribution to provident fund of an employee, to be made by his employer, who has become insolvent, a preferential payment as per the provisions of the *Employees Provident fund and Miscellaneous Provisions Act, 1952*.

Answer 6. (a)

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

Answer 6. (b)

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

Answer 6. (c)

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

Q. 7. (a) WX is working as a marketing personnel in a company. The following payments were made to him by the company during the previous financial year –

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

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

(b) It is illegal to pay Gratuity in excess of the limits prescribed in the *Payment of Gratuity Act, 1972*.

(c) K booked a ticket from Mumbai to Los Angeles by Lufthansa Airlines. The authorities at Delhi Airport did not find any fault in his visa and other documents. However, at Frankfurt Airport, the authorities instituted proceedings of verification because of which X missed the flight to L.A. He had to take the next flight. The airline authorities tendered apology to X for inconvenience but X wants to institute proceedings against Lufthansa Airlines for deficiency of services. Will he succeed under the *Consumer Protection Act, 1986*?

Answer 7. (a)

According to Section 2(21) of the Payment of Bonus Act, 1965 salary and wages means all remuneration other than remuneration in respect of overtime work, capable of being expressed in terms of money, which would if the terms of employment, express or implied, were fulfilled, be payable to an employee in respect of his employment, or of work done in such employment. It includes dearness allowance, i.e. all cash payment by whatever name called, paid to an employee on account of a rise in the cost of living. But the term excludes :

- (i) Any other allowance which the employee is for the time being entitled to;
- (ii) The value of any house accommodation or of supply of light, water, medical attendance or other amenities of any service or of any concessional supply of food grains or other articles;

- (iii) Any traveling concession;
- (iv) Any contribution paid or payable by the employer to any pension fund or for benefit of the employee under any law for the time being in force.
- (v) Any retrenchment compensation or any gratuity or other retirement benefit payable to the employee or any ex-gratia payment made to him; and
- (vi) Any commission payable to the employee.

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

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

Answer 7. (b)

As per Sec 4(3) of the Payment of Gratuity Act, the amount of gratuity payable to an employee shall not exceed ten lacs rupees. However an employee may sometimes be entitled to receive better terms of gratuity under any award or agreement or contract with the employer. In such a case nothing in Sec 4 shall affect the right of the employee to receive better terms. [Sec 4(5)].

Answer 7. (c)

In the given case, Lufthansa Airlines cannot be held guilty of deficiency in service. Although X has been subjected to harassment, it is equally true that none of the respondents would be held guilty of deficiency in service. The airline authorities tendered apology to X. Deficiency of service cannot be alleged without attributing fault, imperfection or shortcoming or inadequacy in the quality, nature and manner of performance which is required to be performed by a person in pursuance of a contract or otherwise in relation to any service. So, X will not succeed if he institutes proceedings under the Consumer Protection Act.

Q. 8. (a) Does the Factories Act, 1948 apply to factories belonging to the Central Government?

(b) Distinguish as per provisions of the Industrial Disputes Act, 1947.

- (i) Strike and lockout.
- (ii) Award and settlement.

Answer 8. (a)

The Act extends to the whole of India including the State of Jammu and Kashmir. Unless, otherwise provided, it also applies to factories belonging to the Central and any State Governments. (Sec.116)

Answer 8. (b)

(i) Differences between :

Strike	Lockout
(i) Acts as weapon in hands of employees.	Is a weapon in hands of employers.
(ii) It is cessation of work by a body of persons employed in any industry acting in combination.	Temporary closing of the place of employment or suspension or withholding of work by employers in some form.

(ii)

Award	Settlement
(i) U/s 2(b)	U/s 2(p)
(ii) It means an interim or final determination of any industrial dispute or any question relating thereto by any Labour Court, Industrial Tribunal, or National Tribunal. Also includes arbitration award u/s 10-A.	It is arrived in course of conciliation proceedings and includes written agreement between employer and employee arrived in course of conciliation signed by both parties and copy sent to authorized officer.

Q. 9. (a) When is compensation not payable under the *Employees's Compensation Act, 1923*?

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

Answer 9. (a)

Compensation under this Act is not payable when:

- (i) The disablement due to injury is less than 3 days
- (ii) The employee was under the influence of drugs/alcohol at the time of accident.
- (iii) Employee willfully disobeys any safety rule.
- (iv) Employee willfully removes/disregards any safety guard/ equipments.
- (v) Employee has filed a Civil suit against the employer for claim of compensation.
- (vi) Employee has refused to get himself medically examined cost of which is borne by the employer.

Answer 9. (b)

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

Q. 10. (a) Under the *Minimum Wages Act, 1948*, state what constitutes the minimum rate of wages?

(b) Explain the concept of "Basic Wages" under the provisions of the *Employees' Provident Funds and Miscellaneous Provisions Act, 1952*.

Answer 10. (a)

The minimum rate of wages is described under Section 4 of the Minimum Wages Act, 1948.

- (1) Any minimum rate of wages fixed or revised by the appropriate government in respect of scheduled employments under section 3 may consist of –
- (i) a basic rate of wages and a special allowance at a rate to be adjusted at such intervals and in such manner as the appropriate government may direct to accord as nearly as practicable with the variation in the cost of living index number applicable to such workers (hereinafter referred to as the "cost of living allowance"); or
 - (ii) a basic rate of wages with or without the cost of living allowance, and the cash value of the concessions in respect of supplies of essential commodities at concession rates, where so authorised; or

- (iii) an all-inclusive rate allowing for the basic rate, the cost of living allowance and the cash value of the concessions, if any.
- (2) The cost of living allowance and the cash value of the concessions in respect of supplies of essential commodities at concession rate shall be computed by the competent authority at such intervals and in accordance with such directions as may be specified or given by the appropriate government.

Answer 10. (b)

As per the provision of Section 2(b) of E.P.F. and M.P. Act, 1952 'Basic Wages' means all emoluments which are earned by an employee while on duty or on leave or on holidays with wages in either case in accordance with the terms of the contract of employment and which are paid or payable in cash to him, but does not include-

- (i) The cash value of any food concession.
- (ii) Any dearness allowance, house rent allowance, overtime allowance, bonus commission or any other similar allowance payable to the employee in respect of his employment or of work done in such employment.
- (iii) Any presents made by the employer.

Q. 11. (a) Describe the procedure provided under the Payment of Bonus Act, 1965 for computing the number of days for determining the amount of minimum bonus payable to an employee. How is proportionate reduction in bonus made?

(b) When does an employee forfeit his right to gratuity under the Payment of Gratuity Act, 1972?

(c) Define a 'consumer' under the Consumer Protection Act, 1986.

Answer 11. (a)

Section 14 of the Payment of Bonus Act, 1965 provides how to compute the number of working days for purposes of Section 13. Section 13 in turn prescribes a scale whereby bonus can be proportionately reduced in certain cases. Under Section 14 following days shall be deemed to be the working days of an employee and shall be counted while calculating the total working days on which he has been on work for the purpose of bonus:

- (i) Day when he has been laid off under an agreement or by a standing order under the Industrial Employment (Standing Orders) Act, 1946 or Industrial Disputes Act, 1947 or any other law.
- (ii) He has been on leave with salary or wage.
- (iii) He has been absent due to temporary disablement caused by accident arising out of and in the course of his employment and
- (iv) The employee has been on maternity leave with salary or wages during the accounting year.

According to Section 13, where an employee has not worked for all the working days in an accounting year, the minimum bonus of Rs. 100 or, as the case may be of Rs. 60, if such bonus is higher than 8.33% of his salary or wage for the days he has worked in that accounting year, shall be proportionately reduced.

Answer 11. (b)

Sec. 4(6) of the Payment of Gratuity Act deals with cases in which gratuity payable to an employee may be forfeited, notwithstanding anything contained in Sec4(1). They are as follows :

- (A) The gratuity of an employee, whose services have been terminated for any act, willful omission or negligence causing any damage or loss to, or destruction of, property belonging to the employer, shall be forfeited to the extent of the damage or loss so caused.

- (B) The gratuity payable to an employee may be wholly or partially forfeited—
- (i) if the services of such employee have been terminated for his riotous or disorderly conduct or any other act of violence on his part, or
 - (ii) if the services of such employee have been terminated for any act which constitutes an offence involving moral turpitude, provided that such offence is committed by him in the course of his employment.

Answer 11. (c)

A 'Consumer' under this Act refers to any person who—

- (i) buys any goods for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any user of such goods other than the person who buys such goods for consideration paid or promised, or partly paid and partly promised, or under any system of deferred payment when such use is made with the approval of such person, whether such purchase of goods is for resale or for any commercial purpose or for personal use ;
- (ii) hires or avails of any services for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any beneficiary of such services other than the person who hires or avails of services for consideration paid or promised, or partly paid and partly promised , or under any system of deferred payment when such services are availed of with the approval of the first mentioned person, whether such hiring or availing of services of goods is for any commercial purpose or for personal use.

Therefore, to be a 'consumer' under the Act :

- (i) The goods or services must be purchased or hired or availed of for consideration which have to be paid in full or in part or under a system of deferred payment;
- (ii) Goods purchased or services availed should not be meant for resale or commercial purpose.

Q. 12. (a) Limited Liability Partnerships are body corporates. Do you agree? Justify.

(b) Under the Right to Information Act, 2005 competent authority means authority competent to seek information. Comment.

Answer 12. (a)

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

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

Answer 12. (b)

Under the Right to Information Act, 2005 competent authority means—

- (i) the Speaker in the case of the House of the People or the Legislative Assembly of a State or a Union territory having such Assembly and the Chairman in the case of the Council of States or Legislative Council of a State;

- (ii) the Chief Justice of India in the case of the Supreme Court;
- (iii) the Chief Justice of the High Court in the case of a High Court;
- (iv) the President or the Governor, as the case may be, in the case of other authorities established or constituted by or under the Constitution;
- (v) the administrator appointed under article 239 of the Constitution.

The competent authority may, by notification in the Official Gazette, make rules to carry out the provisions of this Act.

Q. 13. (a) An understanding has been reached among the manufacturers of cement to control the price of cement, but the understanding is not in writing and it is also not intended to be enforced by legal proceedings. Examine whether the above understanding can be considered as an 'Agreement' with the meaning of Section 2(b) of the Competition Act, 2002.

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

Answer 13. (a)

'Agreement' includes any arrangement or understanding or action in concert :

- (i) Whether or not, such arrangement, understanding or action is formal or in writing or
- (ii) Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings. [Section 2(b)].

In view of the above definition of 'agreement', an understanding reached by the cement manufacturers to control the price of cement will be an 'agreement' within the meaning of Section 2(b) of the Competition Act, 2002 even though the understanding is not in writing and it is not intended to be enforceable by legal proceedings.

Answer 13. (b)

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

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

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

Q. 14. (a) What is the extent of liability of a partner of a LLP constituted under the Limited Liability Partnership Act, 2008?

(b) What are the salient features of the RTI Act, 2005.

Answer 14. (a)

Extent of liability of partner is defined u/s 28 of the Limited Liability Partnership Act, 2008 .

- (1) A partner is not personally liable, directly or indirectly for an obligation referred to in sub-section (3) of section 27 solely by reason of being a partner of the limited liability partnership.

- (2) The provisions of sub-section (3) of section 27 and sub-section (1) of this section shall not affect the personal liability of a partner for his own wrongful act or omission, but a partner shall not be personally liable for the wrongful act or omission of any other partner of the limited liability partnership.

Answer 14. (b)

The Right to Information Act, 2005 provides an effective framework for effectuating the right to information recognised under Article 19 of the Constitution. The salient features of the act are as follows :

- (i) The RTI Act extends to whole of India except Jammu & Kashmir.
- (ii) It provides a very definite day for its commencement i.e 120 days from enactment.
- (iii) It shall apply to Public Authorities.
- (iv) All citizens shall have the right to information, subject to provisions of the Act.
- (v) The Public Information Officers/Assistant Public Information Officers will be responsible to deal with requests for information and to assist persons seeking information.
- (vi) Fee will be payable by the applicant depending on the nature of information sought.
- (vii) Certain categories of information have been exempted from disclosure under Section 8 and Section 9 of the Act.
- (viii) Intelligence and security agencies specified in Schedule II to the Act have been exempted from the ambit of the Act, subject to certain conditions.

Q. 15. (a) The Competition Commission of India has received a complaint that M/s. ABC company has been abusing its dominant position in the cosmetics industry. Explain briefly the factors that will be considered by the commission to ascertain whether M/s. ABC company enjoys a dominant position in the industry.

(b) Bill of Exchange dated 1st February, 2011 payable two months after date was presented to the maker for payment 10 days after maturity. What is the date of Maturity? Explain with reference to the relevant provisions of the 'Negotiable Instruments Act, 1881 whether the endorser and the maker will be discharged by reasons of such delay.

Answer 15. (a)

The Competition Commission while inquiring whether the enterprise ABC Company enjoys a dominant position or not under Section 4 of the Competition Act, 2002 will take the following factors into account:

- (i) market share of the enterprise
- (ii) size and resources of the enterprise
- (iii) size and importance of the competitors
- (iv) economic power of the enterprise including commercial advantages over competitors.
- (v) vertical integration of the enterprises or sale or service net work of such enterprises.
- (vi) dependence of consumers on the enterprise.
- (vii) monopoly or dominant position whether acquired as result of any statute or by virtue of being a Government company or a public sector undertaking or otherwise.
- (viii) entry barriers including barriers such as regulatory barriers, financial risk, high capital cost of entry, marketing entry barriers, technical entry barriers, economies of scale, high cost of substitutable goods or services for consumers.
- (ix) countervailing buying power.
- (x) market structure and size of market.

- (xi) social obligations and size of market.
- (xii) relative advantage, by way of contribution to the economic development, by the enterprise enjoying a dominant position having or likely to have an appreciable adverse effect on competition.
- (xiii) any other factor which the commission may consider relevant for the inquiry.

Answer 15. (b)

If a Bill is made payable a stated number of months after date, it becomes payable three days after the corresponding date of months after the stated number of months (Section 23 read with Section 22 Negotiable Instruments Act 1881). Therefore in this case the date of maturity of the bill is 4th April, 2011.

In this case the promissory note was presented for payment 10 days after maturity. According to Section 64 of Negotiable Instruments Act read with Section 66, a promissory note must be presented for payment at maturity by on behalf of the holder. In default of such presentment, the other parties the instrument (that is, parties other than the parties primarily liable) is not liable to such holder. The endorser is discharged by the delayed presentment for payment. But the maker being the primary party liable on the instrument continues to be liable.

SECTION - II (Auditing)

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

- (a) Propriety audit is applicable to all limited companies in all aspects.
- (b) Accounting Standard – I requires all significant accounting policies to be disclosed normally in one place and as a part of the financial statements.
- (c) While conducting audit of stocks, verification of stock records is of primary importance to operational auditor.
- (d) Companies, on the grounds of confidentiality, may decline to provide information required by the auditor.
- (e) Interest accrued and due on secured loans has been disclosed in the Balance Sheet under the head "Current Liabilities and Provisions" on the ground that such interest has to be paid within six months from the end of the financial year.
- (f) Audit Committee has a two-fold relationship and has therefore, to react only with management and Internal Auditor.
- (g) As per Indian GAAP, where the company has obtained credit limits from a bank but has not availed them, the details of unused credit lines need not be disclosed in the financial statements.
- (h) Where, at an AGM, no auditors are appointed or reappointed, the vacancy will be filled in the next Annual General Meeting.
- (i) Shareholders, by a majority vote, have authorized the Board of Directors to keep the books of accounts of the company in its Administrative Office, as against the earlier practice of keeping them in the Registered Office. The ROC was not informed about this change. Company intends that this practice is in order.
- (j) For an internal audit function to be effective, the same must be independent of the activities to be audited.
- (k) Assets given on lease should be disclosed as part of fixed assets in the financial statements of the lessor.
- (l) Auditor of a company has to approach his work with suspicion.
- (m) There is no need to design better internal controls in an EDP or computerized system.
- (n) Dividends can be declared out of balances in share premium account.
- (o) Capitalisation of Borrowing Costs would continue during extended periods in which active development is interrupted.

Answers 16.

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

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

- (b) The statement is true. Different Accounting policies affect the financial performance and financial position of the enterprise. For proper understanding of the financial statements, AS-I requires the disclosure of the policies at one place and as a part of the financial statements.
- (c) The statement is true. Operational Audit focuses more on qualitative aspects of operations rather than regular financial aspects. Operational audit is a systematic evaluation of operational activities to ensure that they are in line with objectives of the organization. So while auditing stocks the operational auditor is more concerned with reorder policy, inventory management policy, obsolescence policy, adequacy of security and insurance on stocks than mere ticking of stock records.
- (d) The statement is false. To enable the statutory auditor to perform the duties without fear or favour, the Companies Act, 1956 gives him certain rights such as right of access to books and records, right to require information and explanations from officers, right to attend general meetings etc.
- Under section 227 of the Companies Act, duties are cast on him to make enquiries in certain matters and his report should state whether he has obtained all information and explanations which to the best of his knowledge and belief were necessary for the purpose of audit, and whether the financial statement are in agreement with books of account and records. Hence the company cannot refuse to divulge the information required by the auditor. In case of such refusal the auditor will have to give a negative report or a qualified report depending upon the materiality of the information called for by him but refused by the company.
- (e) The disclosure is not in accordance with Part I of Schedule VI of the Companies Act, which specifically requires the disclosure of such interest under the appropriate subheads under 'Secured Loans'. Interest accrued but not due is to be shown under "Current Liabilities and Provisions".
- (f) The statement is false. The audit committee has a fourfold responsibility and therefore has to interact with management, internal auditor, statutory auditor and the public.
- (g) The statement is true. Only the current portion of the debt or whatever is the amount which is outstanding on the date of the preparation of the financial statement, is to be disclosed. There is no requirement as to disclosure of unused limits.
- (h) The statement is false. When at an AGM, no auditors are appointed or reappointed, the Central Government may appoint a qualified person to fill the vacancy. It is the duty of the company to inform Central Government about its failure to appoint auditor within seven days. [Sec 224(3) of Companies Act, 1956].
- (i) The statement is false. As per Section 209 of the Companies Act, 1956, the books of accounts can be kept in a place other than its registered office also, but the Board of Directors should within seven days, file a written notice to the Registrar of Companies, the full address of the new place. Here the company has not complied with this mandatory requirement.
- (j) The statement is true. It is imperative that the control to be exercised by the organization on the internal audit department shall not include the functional area of auditing. If internal audit function is desired to serve as a real management tool it must be allowed to function independently to achieve better efficiency and productivity.
- (k) The statement is false. The lessor cannot account for assets given on financial lease as all risks and refunds incidental to the ownership of such assets stand transferred to the lessee. He has to treat the lease amount receivable from the lessee as 'Receivables' on the asset side of the Balance Sheet.
- (l) The statement is false. The auditor need not be suspicious. He is a 'watch dog' but not a 'blood hound'. However, he has to approach his work with care and caution. Once his suspicions are aroused, he must probe it to the bottom.

- (m) The statement is false. Computerisation, automatically implies a constant review of the system to increase the efficiency in producing reliable data. As a result, the internal controls are normally better designed under computerized systems. Automatic checks are instituted and the responsibilities of various people are clearly stated.
- (n) Dividends can be declared only out of revenue profits available for distribution. Section 78 of the Company's Act, 1956 prescribes the purposes for which share premium amounts can be utilized and declaration of dividend is not one of the purposes declared under Section 78.
- (o) The statement is partly true. Though capitalization of borrowing costs should be suspended during extended periods in which active development interrupted (AS-16, Para 17), it is not suspended during a period when substantial technical and administrative work is being carried out, capitalization of borrowing costs is also not suspended when there is temporary delay as a necessary part of getting an asset ready for its intended use or sale. E.g high water level delaying or stopping the construction of a bridge for temporary period.

Q. 17. (a) State the matters which the statutory Auditor should look into before framing opinion on accounts on finalisation of audit of accounts?

(b) Briefly explain the inherent limitations of audit.

Answer 17. (a)

The principal aspect to be covered in an audit to form an opinion, an auditor has to look into following matters :

- (i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.
- (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
- (iv) Verification of the authenticity and validity of trans-action entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
- (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
- (vii) Verification of the title, existence and value of the assets appearing in the balance sheet.
- (viii) Verification of the liabilities stated in the balance sheet.
- (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
- (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
- (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

It will thus be realised that the duties of auditor are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

Answer 17. (b)

The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise.

The process of auditing, however, is such that it suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of audit procedures.

Such limitations arise, first of all, on account of exercise of judgment in the auditor's work in deciding the extent of audit procedures and exercising judgement also in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements.

Secondly, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable.

There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.

Another reason which may contribute to inherent limitation is the fact that the entire audit process is generally dependent upon the existence of an effective system of internal control.

In such an event, it is clearly evident that there will always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations since any system of internal control is ineffective against fraud involving collusion among employees or fraud committed by management.

Certain levels of management may be in a position to override controls; for example, by directing subordinates to record transactions incorrectly or to conceal them, or by suppressing information relating to transactions.

Such inherent limitations of internal control system also contribute to inherent limitations of an audit. Therefore, it is quite apparent from above that an audit suffers from certain inherent limitations.

Q. 18. How will you vouch and/or verify the following?

- (a) Goods sent on consignment
- (b) Provision for Income Tax
- (c) Goodwill
- (d) Machinery acquired under Hire-purchase system
- (e) Work-in-progress

Answer 18. (a)**Goods Sent on Consignment :**

- (i) Verify the accounts sales submitted by the consignee showing goods sold and stock of goods in hand.
- (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the proforma invoices and accounts sales received during the year. If any consignment stock was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- (iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
- (iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs dues, etc., unless the value is lower. In case net realisable value is lower, the stock in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
- (v) See that goods in hand with the consignee have been shown distinctly under stocks.

Answer 18. (b)**Provision for Income Tax :**

- (i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc

Answer 18. (c)**Goodwill :**

- (i) Ensure that as required by AS 10 on "Accounting for Fixed Assets", goodwill has been recorded in the books only when some consideration in money or money's worth has been paid for. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.
- (ii) Check the vendor's agreement on the basis of which assets of the running business have been acquired by the company at a price existing in the book value of the assets or where a specific sum has been paid for the goodwill.
- (iii) See that only the amount paid to the vendors not represented by tangible assets has been debited to the goodwill account. Therefore, it is not prudent that goodwill should be shown in the company's accounts by way of writing up the value of its assets on revaluation or writing back the amount of goodwill earlier written off by the company.
- (iv) See whether goodwill has been written off as a matter of financial prudence.

Answer 18. (d)**Machinery acquired under Hire-purchase system :**

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

Answer 18. (e)**Work-in-progress :**

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

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

Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.

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

- (a) Travelling expenses of Rs. 3.35 lacs shown in Profit and Loss Account of W Ltd., including a sum of Rs. 1.65 lacs spent by a Director on his foreign travel for company's business accompanied by his father for his medical treatment.
- (b) GR Ltd. is engaged in manufacturing and supply of gear boxes to AI Ltd. As per terms of supply, full price of the goods are not released by AI but 10% thereof is retained and paid after one year, if there is satisfactory performance of the parts supplied. GR Ltd. accounts for only 90% of the invoice value as sale at the time of supply and balance 10% is accounted as sale in the year of receipt of payment.

Answer 19. (a)

As per the provisions of Section 227(1A) of the Companies Act, 1956, the auditor shall enquire whether personal expenses have been charged to revenue account and make a report to the members in case he is not satisfied with the answer.

In this case, the auditor should examine documentary evidence in support of the travelling expenses of Rs.1.65 lacs incurred by the director and ascertain the personal component thereof. Then he should enquire as to whether such personal expenses incurred by the company are covered by contractual obligations or by any accepted business practices. In case, the answer is negative, the auditor should make a report thereon and qualify his audit report.

Answer 19. (b)

According to AS 9 on Revenue recognition, revenue from sale of goods should be recognised when the seller has transferred to the buyer, the property in the goods for a price or when the seller has transferred all significant risk and rewards and the seller retains no effective control over goods and no significant uncertainty exists regarding the amount of consideration and its collectability.

In the given case the goods as well as the risk and ownership has been transferred by GR Ltd., to AI Ltd., on the basis of invoice and delivery of material.

In the instant case, therefore, GR Ltd., should recognise sale at full 100% of the invoice value in spite of the fact that 10% payment will be released after one year. However, depending upon the past experience regarding collectability of 10% amount, they can make a provision for the amount that is not likely to be realised.

Hence, the treatment given by the company is not correct and if they do not correct it, the auditor should qualify his report.

Q. 20. Comment on the following statements :

- (a) 'In vouching payments, the duty of the auditor does not end by merely checking the proof that money has been paid away.'
- (a) It is not essential to verify the sale proceeds of scrap which did not have a significant value if the company had a good accounting and costing systems.

Answer 20. (a)

Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching the payments of a business is not merely to ascertain that money has been paid away; but the auditor aims to obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account that –

- (i) a transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period;
- (ii) a transaction pertains to entity and took place during the relevant period;
- (iii) all transactions which have actually occurred have been recorded;
- (iv) all transactions were properly authorised; and
- (v) transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transaction in the context of the client's business, nature of the organisation and organisational rules.

Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy but also to see its substantial accuracy and then to make a report thereon.

This substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records.

Answer 20. (b)

An auditor is required to review the production and cost records for the determination of the extent of scrap materials that may arise in a given period. Normally speaking, in the ordinary course of his duties the auditor would expect that scrap generated in the company, if any, are properly accounted for. The existence of an accounting and costing system would provide evidence about the adequacy and reliability of accounting records. The records should adequately show the details of sale of scrap. Besides the rates at which the scrap have been sold, correct billing of the same and their identification that good quality material has not been mixed up, are the other aspects to be examined by the auditor. As per MAOCARO, 1988, the auditor was required to report whether the company is maintaining reasonable records for the sale and disposal of scrap.

Therefore, just because the sale proceeds are not significant and the company has a good accounting and costing system, the auditor cannot overlook other aspects.

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

- (a) Repayment of amount of foreign loan for purchase of an asset.
- (b) Stock lying with subcontractor for fabrication.
- (c) Purchase of quoted investment.
- (d) Amount due to subsidiary companies.

Answer 21. (a)**Repayment of amount of foreign loan for purchase of an asset :**

- (i) Check the loan agreement, rate of interest, terms of security.
- (ii) Check the remittances made during the year towards installments of repayments made.
- (iii) Check the receipted voucher/account confirmation for the balance of outstanding.
- (iv) The year end liability of foreign loan should be translated to the rate of exchange prevalent as on the closing date.
- (v) The gain or loss arising on exchange conversion is to be credited or debited to Profit and Loss account in accordance with the Accounting Standard 11.
- (vi) Check banker exchange rate chart for correctness of the conversion.
- (vii) Check RBI or other agencies' permission for remittances outside India.

Answer 21. (b)**Stock lying with sub-contractors for fabrication :**

- (i) The stock lying with the sub contractor for processing should be confirmed by the confirmation letter obtained from the sub contractors.
- (ii) The necessity of holding stock by them should be vouched. If the stock is lying with them for long, the reason for the same should be ascertained. The condition of the stock should be confirmed by the management.

- (iii) The stock should be valued at cost or net realizable value whichever is less. The processing charges incurred should be added to the cost. The provision for the liability towards unpaid processing charges should be created.
- (iv) The stock should be disclosed under the head current assets under the sub head inventory.
- (v) Adjustment in accounts should be made for any discrepancies between stock confirmed and stock sent out as per memorandum records.

Answer 21. (c)**Purchase of Quoted Investment :**

- (i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., cum-dividend/interest/right/bonus.
- (ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.
- (iii) Verify the amount paid towards purchase of investments.
- (iv) Trace the amount in the cheque book counterfoils and bank statements.
- (v) Obtain a schedule of investment from Management for physical verification at the year end.
- (vi) Verify the investment certificate to confirm title.
- (vii) Confirm compliance with statutory provisions such as 227(1A) and CARO, 2003 under section 227(4A) of the Companies Act, 1956.
- (viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

Answer 21. (d)**Amounts due to Subsidiary Companies :**

- (i) Examine whether the subsidiary company is authorized by its Memorandum of Association to advance the loan to the holding company.
- (ii) Verify the interest rate at which the loan has been obtained and particulars of the security that has been furnished for confirming the amount of interest and disclosure of the charge in the Balance Sheet.
- (iii) Inspect the documents executed by the holding company which constitute the basis of the loan and the provision in the Memorandum under which the loan has been raised.

Q. 22. Comment on the following :

- (a) In case the existing auditor(s) appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy.
- (b) The auditor of TJK Ltd. did not report on the matters specified in sub-section (1A) of Section 227 of the Companies Act, 1956, as he was satisfied that no comment is required.
- (c) The auditor of a limited company has given a clean report on the financial statement on the basis of Xerox copies of the books of accounts, Vouchers and other records which were taken away by the Income-tax Department in search under section 132 of the I.T. Act, 1961.
- (d) The Auditor of ABC Ltd. refused to deliver the Books of account of the company, which were given to them for the purpose of audit, as the audit fees is not paid to them in full.

Answer 22. (a)

The appointment of an auditor is complete only on the acceptance of the offer by the auditor. The non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one, the matter would not make any difference since the appointment has to be made

at each AGM and the auditor must accept the same. The casual vacancy is said to arise only in case of death, resignation, etc. Therefore, the Board is empowered to fill such a vacancy. Section 224(3) of the Companies Act, 1956, empowers the Central Government to fill up a vacancy in case no auditors are appointed or re-appointed at an annual general meeting (AGM). (It is also opined that the appointment of an auditor having been made by shareholders, sub-section (3) cannot be invoked. Thus the auditor could only be appointed by shareholders at general meeting). Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditor(s) appointed at the Annual General Meeting refuse to accept the appointment.

Answer 22. (b)

Section 227(1A) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, personal expenses, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1A) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of TJK Ltd. is correct in non-reporting on the matters specified in Section 227(1A).

Answer 22. (c)

The degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be considerably increased if the xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly.

Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

Answer 22. (d)

As per general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. Thus, an auditor also can exercise such lien on books and documents placed at his possession by the client for non payment of his fees for work done on the books and documents. In this regard it is necessary that —

- (i) Documents retained must belong to the client who owes the money.
- (ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
- (iii) The auditor can retain the documents only if he has done work on the documents assigned to him.
- (iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

As per the provisions of law, the auditor can retain books of accounts & documents connected with the work on which fees have not been paid.

Under Section 209 of the Companies Act, 1956 books of account of a company must be kept at the registered office of the company and if removed from the registered office, a resolution to this effect must be passed in BOD's meeting, and should have informed this removal to the Registrar of Companies. If this is done then only the auditor can have lawful possession.

In all other cases, it will be considered as unlawful possession of the books and in such circumstances, he can not exercise such lien.

In the given case, the auditor retains the books of accounts of ABC Ltd., as they have not received their audit fees. He can do so subject to the above provisions of company Law.

Q. 23. As a Company Auditor how would you react to the following situations?

- (a) Insurance claim of Rs. 5 lacs received stands included under Miscellaneous Income.
- (b) Rs. 7.50 lacs paid by a cosmetics company to the legal advisor defending the patent of a product treated as Capital Expenditure.
- (c) ABC Ltd. has not deposited provident fund contributions of Rs.50 lacs to the authorities, but accounted in the books.
- (d) Directors of SPW Ltd. declared a final dividend of 30% for 2010-11 in their meeting held on 11-8-2011.

Answer 23. (a)

The principle laid down in AS 5 that even those items of income and expense which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance may be disclosed separately.

However, money received from the insurance company is against a specific loss. It has to be adjusted against the loss. The auditor should check the adjustment of the amount received in short of the value of actual loss as per the insurance policy.

In respect of claim against an asset, the profit and loss account should be debited with the shortfall of the claim against the book value. If the claim was lodged in the previous year but no entries were passed, entries in the profit and loss account should be appropriately described.

Answer 23. (b)

Legal expenses of Rs. 7.50 lacs incurred to defend the patent of a product of the cosmetics company is revenue expenditure pertaining to the asset since by this expenditure neither any enduring benefit can be obtained in future in addition to what is presently available nor the capacity of the asset would be increased.

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

Answer 23. (c)

The auditor's report under CARO, 2003 has to specifically state whether the company is regular in depositing provident fund dues with the appropriate authority and, if not, the extent of arrears of provident fund shall be indicated by the auditor. The auditor may also ascertain the period since which dues have not been paid. In this case, the failure of ABC Ltd. to deposit provident fund of Rs. 50 lacs will be reported by the auditor in CARO, 2003 issued u/s 227(4A) of the Companies Act, 1956. In indicating the arrears, the period to which the arrears relate should preferably be also given.

Answer 23. (d)

As per provisions of the law, the final dividend of a company shall be declared only by the shareholders based on the recommendation of Board of Directors. The Board can only propose the dividend which shall become final only after approval by shareholders at the AGM.

The Board is empowered to declare the interim dividend only. Hence in the given case, the action of SPW Ltd.'s directors is not in accordance with the law and the auditor should have qualified his report to this effect. The auditor would also have to confirm whether the provision for the same has been made in Part II of Schedule VI to the Companies Act, 1956.

Q. 24. (a) Draft a audit programme for audit of Income and Expenditure of a Charitable institution running a hospital.**(b) Draft a audit programme stating the important items to be examined by the auditor in the receipt of Income of Non-Governmental Organisations' (NGOs').****Answer 24. (a)**

While auditing the Income and Expenditure Account of a charitable institution running a hospital, following points may be examined:

- (i) Verify the register of patients with duplicate copy of bills and patients admission record to see that bills have been properly and correctly prepared for all the services, tests and treatments.
- (ii) Check cash collections from patients by tracing the receipt issued into cash book.
- (iii) Check receipt of interest, rent, dividend etc., with receipt counterfoil into cash book and bank book and ensure that all such income has been duly accounted for.
- (iv) Check collection of subscription, donations from the receipt issued, correspondence etc., into cash book.
- (v) Verify that all grants from government and other bodies have been duly accounted for and have been applied in the manner as specified.
- (vi) Verify all recurring nature of revenue expenditure, with necessary evidence like bill, authority, period etc.
- (vii) Examine the internal check as regards the receipt and issue of stores, medicines, linen etc., to ensure that these have been properly recorded and issued/consumed only on proper authorisation.
- (viii) See that depreciation has been written off in respect of all the assets at appropriate rate and method as in the earlier year.
- (ix) Verify the receipts from supply of food and canteen receipts and compare the same with previous year as regards number of patients.
- (x) Ensure that all outstanding liabilities have been adequately provided for and similarly all accrued incomes and receipts have been duly accounted for.
- (xi) Obtain inventory of stock and stores as at the end of the year and physically check a percentage of items.

Answer 24. (b)

Non-Governmental organisations are non-profit making organisations which raise funds from members, donors or contributors for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, etc. The receipt of income of NGOs requiring examination by the auditor are as under :

- (i) *Contribution and Grants for Projects & Programmes* : Check agreement with donors and grants' letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

- (ii) *Receipts from Fund raising programmes* : Verify in detail the internal control system. Ensure that collections are counted and deposited in the bank daily.
- (iii) *Membership Fees* : Check fees received with membership register. Ensure proper classification is made between entrance fees, annual and life membership fees. Reconcile fees received with fees to be received during the year.
- (iv) *Subscriptions* : Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine/circulars/periodicals. Check the receipts with subscription rate schedule.
- (v) *Interest & Dividends* : Check the interest and dividends received and receivable with investment held during the year.

**Q. 25. (a) What are the main points involved in 'Performance Audit' under Government Accounting system?
(b) In carrying out audit of Government expenditure, what are the basic standards that you will examine and consider?**

Answer 25. (a)

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

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

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

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

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

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

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

Answer 25. (b)

Audit of government expenditure is a major segment of government audit. The basic standards set for audit of expenditure are :

- (i) That the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with financial rules and regulations. This is called Audit against rules and orders.
- (ii) That there is proper sanction, either specific or general accorded by the competent authority. This is called as Audit of sanction.
- (iii) That there is provision of funds out of which expenditure can be met with the authorisation of the competent authority. Such an audit is called Audit against provision of fund.
- (iv) That the expenditure is incurred with due regard to broad and general principles of financial propriety. This is called as propriety audit.
- (v) That the various programmes, schemes and projects where large financial expenditure has been incurred is being run economically and are yielding results expected of them.

Q. 26. (a) As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery and whether any of these items have become obsolescent and not in use. What points you would consider while conducting the internal audit?

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

Answer 26. (a)

The points to be considered while conducting internal audit in connection with Plant and Machinery may be as follows :

- (i) *Internal Control Aspects* : The following may be incorporated in the audit programme to check the internal control aspects :
- (A) Maintaining separate register for hired assets, leased asset and jointly owned assets.
 - (B) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.
 - (C) All movements of assets are accurately recorded.
 - (D) Authorisation be obtained for –
 - a declaring a fixed asset scrapped.
 - selling a fixed asset.
 - (E) Check whether additions to fixed asset register are verified and checked by authorised person.
 - (F) Proper recording of all additions and disposal.
 - (G) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.
 - (H) Regular review of adequate security arrangements.
 - (I) Periodic inspection of assets is done or not.
 - (J) Regular review of insurance cover requirements over fixed assets.
- (ii) *Assets Register* : To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.
- (iii) *Cost Report and Journal Register* : To review the cost relating to each plant and machinery and to verify items which have been capitalised.
- (iv) *Code Register* : To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.
- (v) *Physical Verification* : To see physical verification has been conducted at frequent intervals.
- (vi) *Movement Register* : To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.
- (vii) *Assets Disposal Register* : To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorisation, sales memos or other appropriate documents.
- (viii) *Spare Parts Register* : To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.
- (ix) *Review of Maintenance* : To scrutinise the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilisation of maintenance department services.

- (x) *Review of Obsolescence* : To scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.
- (xi) *Review of R&D* : To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

Answer 26. (b)

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

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

Q. 27. (a) Write short note on Cut-off arrangement.**(b) Mention the special points in the case of an audit of the entity from Incomplete Records.****Answer 27. (a)**

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

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

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

Answer 27. (b)

The examination of records and documents is one of the most important techniques through which an auditor collects evidence. Therefore, in case the records and documents maintained by an enterprise are incomplete, it would prove to be a great handicap to the auditor.

An auditor may face the situation of incomplete records under the following circumstances :

- (i) Where records are kept on single entry basis; or

- (ii) Where records are kept on double entry basis, but some of the records are destroyed accidentally, or are seized by authorities, or are otherwise not available for the auditors examination due to similar reasons.

Under the second circumstance, an ideal approach for carrying out audit would be that the auditor may direct the management of the enterprise to complete or reconstruct the accounting records, e.g., if vouchers are available but the cash book, journal and the ledger are not maintained, then the cash book, journal and ledger should be written up. However, if vouchers are also not available, then cash book/journal/ledger will have to be prepared by correlating the evidence available, e.g., memoranda records, bank statements, statements from outside parties, etc. Even though such books which are prepared may not be complete, but may still contain useful information for the auditor.

On the other hand, when books are maintained on single entry basis, then the management of the enterprise would be asked to write up the books, to the extent possible, as they would have been written up under double entry system.

In any case, the following steps would be required to conduct an audit :

- (i) Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single entry system, cash, bank, and personal accounts are maintained.
- (ii) Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.
- (iii) Check that all entries on the payment side of cash book are posted in the ledger.
- (iv) Confirming that all entries appearing in bank account are posted in the ledger.
- (v) Analyse personal accounts of debtors. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills dishonoured, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtors accounts.

Similarly, it would be necessary to analyse the creditors' accounts and post entries relating to credit purchase made, discounts earned, purchases returns, bills payable issued to suppliers, bills payable dishonoured, etc., to relevant accounts.

From an auditor's view point, the supervisory controls exercised by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination/ observation, management representation and perform analytical procedures.

**Q. 28. (a) Why are Computer Aided Audit Techniques (CAAT) required in EDP audit?
(b) What are review areas of an IS Auditor?**

Answer 28. (a)

The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. CAATs are such techniques applied through the computer which are used in the verifying the data being processed by it. System characteristics resulting from the nature of EDP processing that demand the use of Computer Aided Audit Techniques (CAAT) are :

- (i) *Absence of input documents* : Data may be entered directly into the computer systems without supporting documents. In on-line transaction systems, written evidence of individual data entry authorization, e.g., credit limit approval may not be available.
- (ii) *Lack of visible transaction trail* : Certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In an EDP environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.

- (iii) *Lack of visible output* : In a manual system, it is normally possible to examine visually the results of processing. In EDP systems, the results of processing may not be printed or only a summary data may be printed. Thus, the lack of visible output may result in the need to access data retained on machine readable files.
- (iv) *Ease of Access to data and computer programmes* : Data and computer programmes may be altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and allocation of, data and programmes by persons inside or outside the entity.

Answer 28. (b)

The IS auditors may focus on following review areas :

- (i) *Computerised systems and applications* : The auditor should verify that systems and applications are appropriate to the users' needs, efficient and adequately controlled to ensure valid, reliable, timely and secure input, processing and output at current and projected levels of system activity.
- (ii) *Information Processing Facilities* : This facility must be controlled to ensure timely, accurate and efficient processing of applications under normal and potentially disruptive conditions.
- (iii) *Systems Development* : An IS auditor should ensure that systems under development meet the objectives of the organization, satisfy user requirements and provide efficient, accurate and cost effective systems and applications. The auditor should also ensure that these systems are written, tested and installed in accordance with generally accepted standards for systems development.
- (iv) *Management of Information Systems* : MIS must develop an organizational structure and procedures to ensure a controlled and efficient environment for information processing. This plan should also specify the computers and peripheral equipments required to support all functions in an economic and timely manner.
- (v) *Client/Server, Telecommunications and Intranets* : In a client/server environment, all applications that can be dedicated to a user are put on the client. All resources that need to be shared are put on the server. Auditors must ensure that controls are in place on the client as well as on the server and on the network. Auditors must provide the same level of control assurance in an Internet/Intranet environment as in a client/server environment, with special emphasis on TCP/IP and HTTP.

Q. 29. (a) State the specific problems, which may arise in the implementation of internal control in an EDP system.

(b) Write short note on Sampling Risks.

Answer 29. (a)

In an EDP system, the following specific problems arise in the implementation of internal control :

- (i) *Separation of duties* : In a manual system, separate individuals are responsible for initiating transactions, recording transactions, and custody of assets. As a basic control, separation of duties prevents or detects errors and irregularities. In a computer system, however, the traditional notion of separation of duties does not always apply. For example, a program may reconcile a vendor invoice against a receiving document and print a cheque for the amount owed to a creditor. Thus, the program is performing functions that in a manual systems would be considered incompatible. In minicomputer and PC environments, separation of incompatible functions may be even more difficult to achieve. Some minicomputers and PCs allow users to change programs and data easily; furthermore, they provide no record of these changes. If the minicomputer or PC does not have an inbuilt capability to provide a secure record of changes, it may be difficult to determine whether incompatible functions have been performed by systems users.

- (ii) *Delegation of authority and responsibility* : A clear line of authority and responsibility is an essential control in both manual and computer systems. In a computer system, however, delegating authority and responsibility in an unambiguous way may be difficult because some resources are shared among multiple users. For example, one of the objectives of using a database management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data. When multiple users have access to the same data and integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organizations have attempted to overcome these problems by designating a single user as the owner of data. This user assumes ultimate responsibility for the integrity of the data.
- (iii) *Competent and trustworthy personnel* : The technology of data processing is now exceedingly complex-much more complex than in the days of manual systems. Highly skilled personnel are needed to develop, modify, maintain, and operate today's computer systems. Thus, the existence of competent and trustworthy personnel becomes even more important when computer systems are used to process an organization's data, since a relatively small number of individuals assume major responsibility for the integrity of the data.
- (iv) *System of authorizations* : Management issues two types of authorizations to execute transactions. General authorizations establish policies for the organization to follow: for example, a fixed price list is issued for personnel to use when products are sold. Specific authorisations apply to individual transactions: for example, acquisitions of major capital assets may have to be approved by the board of directors. In a manual system, auditors evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system authorisation procedures often are embedded within a computer program. For example, the order entry module in a sales system may determine the price to be charged to a customer. Thus, when evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of program processing.
- (v) *Adequate documents and records* : In a manual system, adequate documents and records are necessary to provide an audit trail of activities within the system. In computer systems, documents may not be used to support the initiation, execution and recording of some transactions. For example, in an on line order entry system customers orders received by telephone may be entered directly into the system. Similarly, some transactions may be activated automatically by a computer system: For example, an inventory replenishment program may initiate purchase orders when stock levels fall below a set amount. Thus, no visible audit or management trail may be available to trace the transaction. The absence of a visible audit trail is not a problem for the auditor provided that systems have been designed to maintain a record of all events and there is a means of accessing these records. In well-designed computer systems, audit trails are often more extensive than those maintained in manual systems.
- (vi) *Physical control over assets and records* : Physical control over access to assets and records is critical in both manual systems and computer systems. Computer systems differ from manual systems, however, in the way they concentrate the data processing assets and records of an organization. For example, in a manual system, a person wishing to perpetrate a fraud may be maintained at a single site-the data processing installation. Thus, the perpetrator does not have to go to physically distance locations to execute the fraud.
- (vii) *Adequate management supervision* : In a manual system management supervision of employee activities is relatively straight forward because managers and employees are often at the same physical location. In computer systems, however, data communications may be used to enable employees to be closer to the customers they service. Thus, supervision of employees may have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and inquiry.

- (viii) *Comparing recorded accountability with assets* : Periodically, data and the assets that the data purports to represent should be compared to determine whether incompleteness or inaccuracies in the data exist or shortages in the assets have occurred. In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system, however, programs are used to prepare this data. For example, programs may sort an inventory file by warehouse location and prepare counts by inventory item at different warehouses. If unauthorized modifications occur to the programs or data files that the programs use, an irregularity may not be discovered.

Answer 29. (b)

Sampling Risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows :

(A) Tests of Control :

- (i) *Risk of Under Reliance* : The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.
- (ii) *Risk of Over Reliance* : The risk that, although the sample result supports the auditor's assessment to control risk, the actual compliance rate would not support such an assessment.

(B) Substantive Procedures :

- (i) *Risk of Incorrect Rejection* : The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is materially mis-stated, in fact it is not materially mis-stated.
- (ii) *Risk of Incorrect Acceptance* : The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is no materially mis-stated, in fact it is materially mis-stated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Q. 30. (a) Mention briefly the behavioural problems involved in conducting Management Audit. How would you as an internal auditor solve them?

(b) Write short note on broad objectives of operational audit.

Answer 30. (a)

Management auditor is viewed as a fault finder or critic and this creates heart burns among the auditees. Management auditors being staff experts came in conflict with line managers. While proposing recommendations, the view points of line manager involving their practical difficulties may be ignored by management auditors resulting in stiffness and conflicts. The management auditor is expected to evaluate the effectiveness of control systems . Consequently the report may have adverse effect on auditees, leading to hostile relationship on account of :

- (i) Fear of criticisms stemming from adverse audit findings.

- (ii) Action by superiors on basis of reported defects and deficiencies in audit practices namely:
 - (A) In sensitive and highly critical reports.
 - (B) Reports that focus only on deficiencies.
 - (C) Hostile audit style such as when the management auditor is cold in his approach, lack of understanding of the practical problems of auditees and excessive concentration on insignificant errors.

The following steps may be taken to overcome the aforesaid problems :

- (i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.
- (ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.
- (iii) To demonstrate the review will be with minimum interference with regular operation.
- (iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

Answer 30. (b)

Broad objectives of operational audit :

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