

Paper-6: COMMERCIAL AND INDUSTRIAL LAWS AND AUDITING

Full Marks: 100

Time Allowed: 3 Hours

The figures in the margin on the right side indicate full marks.

- Please: (i) Answer all bits of a question at one place
(ii) Open a new page for answer to a new question
(iii) Attempt the required number of question only.

Answer Question No. 1 and Question No. 5 which are compulsory and attempt any two from the rest in Section-I and any two from the rest in Section-II.

**Section-I
(50 Marks)
(Commercial and Industrial Laws)**

Question 1: Answer all questions

[2 X 7 = 14]

- (i) A is sixteen years of age. He lends ₹1 lac to B on the strength of a mortgage executed in his favour. Is the borrower liable to repay the money? Give reasons.
- (ii) Can a minor appoint an agent?
- (iii) Does the endorsement of a Railway Receipt amount to Transfer of Ownership?
- (iv) What is 'Caveat Emptor'?
- (v) Gratuity can be attached by an order of the court.
- (vi) Eligibility to Bonus depends on the period of actual service.
- (vii) As per Industrial Disputes Act, 1947, the Charitable Institutions are not industry

Answer:

(i) Yes, A can recover the money from B. Though a contract with a minor is void ab initio, he is allowed to be a beneficiary in a transaction and enforce his claim. The basic logic is that a contract with a minor has been kept void only to protect his interest and not to prejudice his interest.

(ii) Section 183 of the Indian Contract Act permits only persons of the age of majority to employ an agent. Thus, a minor cannot appoint an agent.

(iii) The question was raised in a Bombay case of Shamji v. N . W. Rly.. The High Court, in the case, ruled that endorsing a railway receipt in favour of another does not by itself, pass property in the goods to the endorsee. It merely constitutes the endorsee the agent of the consignor, to receive the goods. Such an endorsement by itself does not constitute the endorsee either a bona fide pledge or transferee for value of the goods represented by the railway receipt.

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(iv) Caveat Emptor is the fundamental principle of the law of sale of goods. It means 'buyers beware' or 'caution buyer' (i.e. let the buyer beware). In the other words, it is no part of the seller's duty to point out defects of his own goods. The buyer must inspect the goods to find out if they will suit his purpose. He must buy goods after satisfying himself about quality, suitability etc. If he makes a bad choice, he cannot blame the seller.

(v) No gratuity payable under the Act and no gratuity payable to an employee in any establishment, factory, mine, oilfield, plantation, port, railway company or shop exempted under Section 5 shall be liable to attachment in execution of any decree or order of any Civil, Revenue or Criminal Court.

(vi) Eligibility to Bonus amount depends on the actual period of service of an employee provided he has worked for a minimum number of 30 days in a year. Sanctioned leave is treated as actual service.

(vii) As per Industrial Disputes Act institutions owned or managed by organisations wholly or substantially engaged in any charitable, social or philanthropic service are not covered in the definitions of "Industry".

Question 2:

(i) 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 ₹ 50,000. One month later X revokes the guarantee, when Z had lent to Y ₹ 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. ₹ 5,000?

(ii) What do you understand by "Agency by Ratification"? What is the effect of ratification?

(iii) P rents out his house situated at Kolkata to Q for a rent of ₹ 5000/- per month. A sum of ₹ 2 lac, the house tax payable in arrears, his house is advertised for sale by the Municipal Corporation. Q pays the Corporation, the sum due from P to avoid legal consequences. Referring to the provisions of Indian Contract Act, 1872, decide Q is entitled to get reimbursement of the said amount from P.

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

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

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

[4+4+2+2+2+4 = 18]

Answer:

(i) 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:

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By Notice:

A continuing guarantee may at any time be revoked by the surety as to future transactions, by notice to the creditor.

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 ₹ 5,000 on default of Y since the loan was taken before the notice of revocation was given to Z.

(ii) A person may act on behalf of 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 if the former had latter'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.

(iii) As per provisions of Section 69 of the Indian Contract Act, 1872, Q is entitled to recover from P the amount paid to Municipal Corporation because of the following reasons :

- There is a contract between P and Q, viz. quasi contracts.
- P is bound to make payment of house tax to Municipal Corporation.
- Q is interested in such payment
- Q himself is not liable for such payment.

(iv) As per Section 15 of Indian Contract Act, committing or threatening to commit any act forbidden by Indian Penal Code is coercion. As such 'threat to commit suicide' amounts to coercion as it is forbidden by the Code.

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

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the buyer. Applying the provision of Section 16(2), Mr. X would succeed in claim for damages from the owner of the shop.

(vi) The exceptions to the rule are given vide Sections 27 to 30 of Sale of Goods Act, 1930. These are as follows:

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

Question 3:

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

(ii) Write a note on Constructive delivery.

(iii) Safety officers in any factory are optional and not mandatory.

(iv) 'X' joined BE Engineering Works (P) Ltd. on 25.3.2014. On 8.12.2014 he was laid off as the management wanted to slow down due to shortage of power. 'X' was not allowed lay-off compensation on the ground that his period of service was less than one year.

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

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

- Piece rate wages
- Productivity bonus
- Additional dearness allowance
- Value of Puja gift.

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

[4+2+3+2+3+4 =18]

Answer:

(i)

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

(ii) Constructive delivery:

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

1. When buyer holding the goods, as bailor holds them as his own.
2. When seller holding the goods, holds them as bailee of the buyer.
3. When third person holding the goods on behalf seller, now agrees to hold them on behalf of buyer

(iii) As per Sec 40-B of The Factories Act, 1948 in every factory:

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

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

'A' has worked for 253 days before he was laid off. So he is entitled to lay-off compensation and can claim the same.

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

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

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

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

Question 4:

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

(ii) Discuss 'Hazardous process' under the Factories Act, 1948.

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

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

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

(vi) Comment on the following statement with reference to the provisions Negotiable Instruments Act, 1881: “Once a bearer instrument always a bearer instrument.”

[4+3+2+3+2+4 = 18]

Answer:

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

1. 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.
2. The gratuity payable to an employee may be wholly or partially forfeited—
 - 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
 - if the services of such employee have been terminated for any act which constitutes an offence involving moral turpitude, provided that such offence is committed by him in the course of his employment.

In the present case the employee has attained the age of superannuation and has retired. His misappropriation was noticed after his retirement. The employer wants to deduct

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misappropriated amount after his retirement. The decision of the employer is not tenable as H's services have not been terminated.

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

1. cause material impairment to the health of the persons engaged in or connected therewith, or
2. result in the pollution of general environment.

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

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

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

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

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

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

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

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

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

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

Section-II (50 Marks) (Auditing)

Question 5: Answer all questions

[2 X 7 = 14]

- (i) Audit is concerned with ethics of business.**
- (ii) In auditing, the concept of materiality can be judged only in relative context.**
- (iii) Contingent Liabilities do not form part of Balance Sheet, hence need not be verified.**
- (iv) Auditing in depth means checking all the transactions in minute details.**
- (v) All expenses /losses incurred during construction period should be capitalized including abnormal losses.**
- (vi) Test check approach and random sampling approach are same.**
- (vii) Auditor should qualify audit report if any Secret Reserve is created.**

Answer:

- (i)** The statement is false. Audit is not concerned with ethics of business unless the business itself is illegal or unlawful.
- (ii)** The statement is true. Materiality can be judged only in relative context. In a small business, ₹5000/- may be a material amount, whereas in a giant undertaking, ₹50,000 may not be so material as to merit a separate disclosure.
- (iii)** The auditor should verify that a proper disclosure about contingent liabilities is made in the financial statements as a footnote to the Balance Sheet as contingent liabilities may become actual liabilities on happening or not happening of certain events. As per para 68 of AS-29 an organisation should disclose for each class of contingent liabilities separately on Balance Sheet date. So the above statement is false.
- (iv)** The statement is false. Auditing in depth means the tracing of a transaction through its various stages from origin to conclusion, examining the supporting records at each stage and ascertaining whether all the requirements laid down in the system of internal check have been complied with.

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(v) The statement is false. Abnormal losses during construction period should not be capitalized but should be written off over a period of 3-5 years after commencement of production.

(vi) The statement is false. Test check approach is different from random sampling approach. Test check is based on intuition while random sampling approach is scientific verification on selective basis. In case of test check samples drawn may be biased but in statistical random sampling, samples are based on random number tables, so there will be no element of bias.

(vii) Auditor should carefully examine the necessity of creating Secret Reserve and need not qualify the audit report if it is found that intention of the company is honest and the amount is reasonable.

Question 6:

(i) **Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.**

(ii) **In the course of audit of a trade, you noticed that although there is no change in either selling or purchase price of the goods, there is considerable increase in Gross Profit Ratio in comparison to previous year. What matters would you examine to assess the reason for such increase? Comment, as an auditor.**

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

(iv) **Audit in EDP environment is easier as the Trial Balance always tallies.**

[5+6+4+3 = 18]

Answer:

(i) In planning and performing his examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are:

1. Weaknesses in the design of internal control system and non-compliance with the laid down control procedures, e.g., a single person is responsible for the receipt of all letters and marking it to the relevant sections or two persons are responsible for receipt of letters but the same is not followed in actual practice, etc.

2. Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees, and frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc.

3. Unusual pressures within the entity, for example, industry is doing well but the company is not performing all right, heavy dependence on a single line of product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc.

4. Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.

5. Problems in obtaining sufficient and appropriate audit evidence, e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc.

(ii) In assessing the reason for considerable increase in Gross Profit Ratio, the auditor should examine the followings:

1. Under valuation of opening stock due to non-inclusion of certain items or applying lower rate to one or more items of stock.
2. Over valuation of closing stock either by the inclusion of fictitious items or over valuing some of the items of Stock.
3. Change in the method of valuation of opening and closing stock. For example, opening stock was valued at lower of cost and market value, whereas closing stock has been valued at market price which is higher than cost.
4. Goods sold but not delivered are included in stock.
5. Goods delivered last year but sales invoice raised in current year.
6. Recording of fictitious sales to boost up profits.
7. Goods returned to supplier awarding dispatch and included in closing stock.
8. Goods returned by customers but not debited to sales return and included in closing stock.
9. Inclusion in the closing stock of goods received for sale on approval or consignment basis.
10. Treatment of goods sent on consignment basis as regular sales.
11. Non-provision of outstanding expenses like wages, carriage inward etc.
12. Wrong allocation of expenses in Trading and Profit & Loss Account.

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

(iv) In today's complex business environment, the importance of trial balance in an audit has to be gauged not from the view point of arithmetical accuracy but the nature of transaction to be recorded which in fact have become very complex. The emergence of new forms of financial instruments like option and futures, derivatives, off-balance sheet financing, etc. have given rise to further complexities in recording and disclosure of transactions. A tallied Trial Balance may still

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contain errors of omissions like omission of certain entries, compensating errors, duplication of entries, etc. In an audit besides the tallying of a trial balance, there are also other issues like estimation of depreciation, valuation of inventories, etc. which still require judgment to be exercised by the auditor. So responsibility of auditor will still remain even in an EDP environment.

Question 7:

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

- 1. Receipt of capital subsidy**
- 2. Provision for income tax**

(ii) Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses.

(iii) A sum of ₹10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing ₹12,00,000. The amount is credited to the Purchases Account.

(iv) What are the review areas of an IS Auditor?

[(4+4)+3+3+4 = 18]

Answer:

(i)

1. Receipt of Capital Subsidy :

(a) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(b) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(c) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(d) Check relevant entries for receipt of subsidy.

(e) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements

2. Provision for Income Tax :

(a) 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.

(b) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.

(c) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.

(d) Compute tax payable as per the latest applicable rates in the Finance Act.

(e) 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.

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

(iii) AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period. The claim for loss of goods in transit is arising out of ordinary activities of the enterprise as a part of its normal course of business. However, the cost of goods lost in transit is only ₹10,00,000 while the insurance money received is ₹12,00,000. Purchases Account need not be credited since it would distort the purchases done during the year and as also the gross profit. Therefore, entire amount of ₹12 lacs needs to be taken to profit and loss account under an appropriate head. This is an income arising from ordinary activities of the enterprise but having regard to amount involved and exceptional nature, a separate disclosure be made in the profit and loss account. Such disclosure would enable the users to understand the performance of an enterprise for the period.

(iv) The IS auditors may focus on following review areas:

1. 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.

2. Information Processing Facilities:

This facility must be controlled to ensure timely, accurate and efficient processing of applications under normal and potentially disruptive conditions.

3. 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.

4. 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.

5. 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

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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.

Question 8:

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

- 1. Audit against Rules and Orders**
- 2. Audit of Sanctions**
- 3. Audit against Provision of Funds**

(ii) Mention the special points in the case of an audit of the organisation from Incomplete Records.

(iii) Draft an audit programme to audit the receipts of an amusement park owned by a partnership firm.

[6+6+6 = 18]

Answer:

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

1. Audit against Rules & Orders:

The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority. It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of auditor is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

- (a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;
- (b) they are consistent with the essential requirements of audit and accounts as determined by the C & AG;
- (c) they do not come in conflict with the orders of, or rules made by, any higher authority; and
- (d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

2. Audit of Sanctions:

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

3. Audit against Provision of Funds:

It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriation made.

(ii) 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:

1. Where records are kept on single entry basis; or
2. 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:

1. 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.
2. Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.
3. Check that all entries on the payment side of cash book are posted in the ledger.
4. Confirming that all entries appearing in bank account are posted in the ledger.
5. 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.

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(iii) Audit programme for checking the receipts of an amusement park of a partnership firm.

1. The partnership deed should be first scrutinized.
2. The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.
3. The internal control for collections from sale of tickets should be checked.
4. See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.
5. Check the rough cash book and reconcile from the stock of ticket books issued, the cash to be collected each day.
6. Check that the cash balance and ticket sales from stock is daily checked by the manager.
7. Check that the collections are banked daily, the very next day.
8. See rates for each class and the ticket rates are as per current prices.
9. The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.
10. Check the relation between the amounts of tax collected and sales.
11. The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.
12. Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.
13. The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.
14. Do surprise checking of cash balances.
15. See that cash collections are insured and the policy is in force.
16. Compute analytical ratios in respect of the receipts pattern i.e. on weekends, holidays, etc. and make comparisons to draw conclusions.