

Paper-6: COMMERCIAL & INDUSTRIAL LAW AND AUDITING

SECTION - A

Answer Q No. 1 (Compulsory) and any 2 from the rest of Section A

Question 1:

Comment on the following based on legal provisions (no mark for wrong reasons or justification)
[2 X 7 = 14]

- (a) S induced R to buy his motorcycle saying that it was in a very good condition. After taking the motorcycle, R complained that there were many defects in the motorcycle. S proposed to get it repaired and promised to pay 40% cost of repairs. After a few days, the motorcycle did not work at all. Now R wants to rescind the contract.
- (b) P contracts with Q for a fixed price to construct a house for Q within a stipulated time. Q would supply the necessary material to be used in the construction. R guarantees P's performance of the contract. Q does not supply the timber as per the agreement. Is R discharged from his liability?
- (c) Bonus is payable only if there is profit. Comment.
- (d) Walter 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
- (e) Gratuity can be attached by an order of the court.
- (f) Anand drew cheques in favour of Bikash. Anand's clerk forged Bikash's endorsement and negotiated the cheques to Chetan who took them in good faith and for value. Chetan received payment of the cheques. Anand claims to recover the amount from Chetan. will he succeed?
- (g) Workmen working in a public utility services have right to go on strike even without giving notice.

Answer:

- (a) The aggrieved party, in case of misrepresentation by the other party, can avoid or rescind the contract [Section 19, Indian Contract Act, 1872]. The aggrieved party loses the right to rescind the contract if he, after becoming aware of the misrepresentation, takes a benefit under the contract or in some way affirms it. Accordingly in the given case R could not rescind the contract, as his acceptance to the offer of S to bear 40% of the cost of repairs impliedly amount to final acceptance of the sale [Long v. Lloyd, (1958)].
- (b) According to Section 134 of the Indian Contract Act, 1872, the surety is discharged by any contract between the creditor and the principal debtor, by which the principal debtor is released or by any act or omission for the creditor, the legal consequence of which is the discharge of the principal debtor. In the given case the Q omits to supply the timber. Hence R is discharged from his liability.
- (c) Subject to the other provisions of the Payment of Bonus Act, every employer shall be bound

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to pay to every employee in respect of the accounting year commencing on any day in 1979 and in respect of any subsequent accounting year, a minimum bonus which shall be 8.33% of the salary or wage earned by the employee during the accounting year or ₹ 100 (₹ 60 in case of employees below 15 years of age), whichever is higher. The minimum bonus is payable whether or not the employer has any allocable surplus in the accounting year.

- (d) 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)
- (e) 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.
- (f) In his claim to recover the amount from Chetan, Anand will succeed if the cheque was an order cheque, but fail if the cheque was payable to bearer.
- (g) No person employed in a public utility service can go on strike without giving "Notice of Strike" to the Employer.
- (i) Within 6 weeks before strike
 - (ii) Within 14 days of giving such notice
 - (iii) Before the expiry of the date of strike specified in the notice.
 - (iv) During the pendency of any conciliation proceedings before a conciliation officer and 7 days after the conclusion of such proceedings.

Question 2:

- (a) **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.**
- (b) **Safety officers in any factory are optional and not mandatory.**
- (c) **Farhan failed to give details of travelling expenses on account of tour inspite of several reminders. His company deducted the amount of tour advance from Farhan's salary after expiry of 3 months. Is the company justified under the Payment of Wages Act, 1936?**
- (d) **Y, on retirement withdrew the entire amount of his accumulation in the provident fund. Later on, he was re-appointed for a fixed tenure. The PF Inspector claimed contribution in respect of salary paid to Y. Is the demand made by PF Inspector tenable in law under The Employees 'Provident' Funds and Miscellaneous Provisions Act, 1952?**
- (e) **What do you understand by the terms 'premises' and 'precincts' under the Factories Act, 1948?**
- (f) **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?**

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- (g) A agrees to sell to B a horse for ₹20,000 if it wins a race and for ₹500 if it does not. The horse wins the race. Advise the parties if —
- i) B refuses to pay ₹ 20,000 and buy the horse
 - ii) A refuses to sell the horse to B
 - iii) B agrees to buy the horse for ₹ 10,000
- (h) At an auction sale, A makes the highest bid for a flower vase. Purporting to accept the bid, the auctioneer strikes the vase and breaks it. Who is to bear the loss? Would your decision differ if the auctioneer had struck the table on which the vase was kept with the hammer and the vase fell down and broke to pieces?
- (i) A seller agrees to supply to the buyer timber of 1/2" thickness for being made into cement barrels. The timber actually supplied varies in thickness from 1/2" to 5/8". The timber is merchantable and commercially fit for the purpose for which it was ordered. The buyer rejects the timber. Is his action justified?

[9 × 2 = 18]

Answer:

- (a) 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.
- (b) As per Sec 40-B of The Factories Act, 1948 in every factory (i) wherein 1000 or more workers are ordinarily employed, or (ii) wherein, in opinion of the State Government, any manufacturing process or operation is carried on, which involves any risk or bodily injury, poisoning or any other hazard to health, to persons employed in factory, the occupier shall if so required by State Government by notification in Official Gazette, employ such number of safety officers as specified in the notification [Sec 40B(1)]. The duties, qualifications and conditions of service of Safety Officers are to be prescribed by State Government.[Sec.40 B(2)].
- (c) 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.
- (d) An employee who has been member of PF, withdrew the full amount of his accumulations is an 'excluded employee.' However , once he is reappointed in connection with work of the company, he attracts definition of 'employee' and the Act becomes applicable to him afresh. In *Harrison Malayalam Ltd. and Ors vs. RPFC & Ors.* (CAL H.C) 2001 I LLJ 1160, the company was held liable to cover an employee who took VRS and later appointed for a lump sum basis. Thus the demand made by authorities is tenable.
- (e) Premises means the building or shed where the factory machineries are set up and manufacturing process are carried on. Precincts means the surrounding areas like open space inside the factory boundary, roads, gardens, open godowns etc where the workers move inside the factory boundary.

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- (f) This is based on Section 16(2) of the Sale of Goods Act, 1930, which states that where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be of merchantable quality. Though the term 'merchantable quality' is not defined in the Act, it means that in the present case, the bottle must be properly sealed. In other words, if the goods are purchased for self-use, they should be reasonably fit for the purpose for which it is being used. In the instant case, on an examination of the bottle of cold drink, it exploded and injured the buyer. Applying the provision of Section 16(2), Mr. X would succeed in claim for damages from the owner of the shop.
- (g) A wager is an agreement between two parties by which one promises to pay money or money's worth on the happening of some uncertain event in consideration of the other party's promise to pay if the event does not happen. As per Section 30 no suit can be brought for recovering anything alleged to be won or any wager, or entrusted to any person to abide by the result of any game or other uncertain event on which any wager is made. In the given case, as the agreement is a wager, the effect will be as follows:
- i. A cannot compel B to buy the horse and pay ₹20,000
 - ii. B cannot compel A to sell the horse
 - iii. A is not bound to sell the horse
- (h) As per Section 64 of The Sale of Goods Act where goods are destroyed or damaged before the completion of sale, the loss will fall on the seller. The sale is complete when the auctioneer announces its completion by the fall of the hammer or in some other customary manner. Until such announcement any bidder may retract (withdraw, revoke) his bid. In the given case, as the auctioneer did not announce the completion of sale by the fall of the hammer or any other customary manner, the sale is not complete. So in both the cases the loss is to be borne by the owner of the vase.
- (i) Where there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description. The rule of law contained in Section 15 of the Sale of Goods Act summarized in the following maxim: "If you contract to sell peas, you cannot oblige a party to take beans. If the description of the article tendered is different in any respect, it is not the article bargained for and the other party is not bound to take it". In the given case the buyer can reject the timber even if the timber is merchantable and commercially fit for the purpose for which it was ordered.

Question 3:

- (a) **A is the owner of a concern manufacturing cigars. 20 persons are employed in the concern. Of these 20 employees, one is a graduate for supervising the work and another apprentice learning work. The remaining 18 are employed not on the time wage system, but on the piece work system. Is the concern a factory within the meaning of the term under the Factories Act, 1948?**
- (b) **When an unpaid seller's lien is lost.**
- (c) **What are the exceptions to the doctrine of Caveat Emptor?**

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- (d) A sold some land to B. At the time of sale both parties believed in good faith that the area of the land sold was 10 hectares. It, however, turned out that the area was 7 hectares only. How is the contract of sale affected? Given reasons
- (e) H who was badly in need of money offered to sell his piano worth ₹5,000 to C for ₹4,000. C refused to buy. H gradually lowered his price until ₹1,000 was reached, which C accepted. Before the piano was delivered, H received an offer of a larger sum from T, and he refused to carry out the contract with C, claiming that the consideration was inadequate. Is H liable to pay damages to C for failure to carry out his part of the contract?
- (f) Explain the concept of 'misrepresentation' in matters of contract.

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

Answer:

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

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

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

- (b) An unpaid seller loses his lien in the following cases :
- i. when the seller delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer, without reserving a right of disposal of the goods to himself; e.g., takes R/R or Transport Receipt in the name of buyer or his agent;
 - ii. where the buyer or his agent lawfully obtains possession of the goods;
 - iii. by waiving the right of lien;
 - iv. where he assents to a sub-sale by the buyer;
 - v. where he takes a security from the buyer for the payment of the price, in place of his lien.

It should, however, be noted that an unpaid seller does not lose his lien by reason only that he has obtained a decree for the price of the goods.

- (c) The doctrine of "Caveat Emptor" is subject to the following exceptions :
- i. Where the seller makes a false representation and buyer relies on that representation. The rule of "Caveat Emptor" will not apply and the buyer will be entitled to the goods according to that representation.
 - ii. Where the seller actively conceals a defect in the goods, so that on a reasonable examination the same could not be discovered.
 - iii. Where the buyer makes known to the seller the purpose for which he is buying the goods, and the seller happens to be a person whose business is to sell goods of that description, then there is an implied condition that the goods shall be reasonably fit for such purpose. The rule Caveat Emptor will not apply.
 - iv. In case of sale by description, there is implied condition as to their being of merchantable quality. However, if the buyer has examined the goods, this condition of

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“merchantability” extends only to hidden or latent defects. The defects which examination ought to have revealed are not covered, i.e., the rule of Caveat Emptor will be applicable.

(d) Where both the parties to an agreement are under a mistake as to a matter of fact essential to the agreement, there is a bilateral mistake. In such a case, the agreement is void (Sec. 20). The following two conditions have to be fulfilled for the application of Sec 20.

- i. The mistake must be mutual
- ii. The mistake must relate to a matter of fact essential to the agreement.

As Sec 20 is applicable on the given case, the agreement is void.

(e) Consideration means “something in return”. This something in return need not necessarily be equal in value to “something given”. So long as consideration exists, the Courts are not concerned as to its adequacy, provided it is of some value. The adequacy of the consideration is for the parties to consider at the time of making the agreement, not for the Court when it is sought to be enforced. Consideration must; however be something to which the law attaches value though it need not be equal in value to the promise made.

In the given case, H is liable to pay damages to C for failure to carry out his part of the contract though the consideration is inadequate.

(f) 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

Question 4:

(a) Bill of Exchange dated 1st February, 2013 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.

(b) 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.

(c) 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.

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

(e) Define a ‘consumer’ under the Consumer Protection Act, 1986.

(f) What do you understand by “Agency by Ratification”? What is the effect of ratification?

Answer:

(a) 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, 2013.

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.

(b) '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.

(c) 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.

(d) 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.

(e) 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

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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

- (f)** 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 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.

SECTION - B

Answer Qs No. 5 (Compulsory) and any 2 from the rest of Section B

Question 5:

Comment on the following based on legal provisions (no mark for wrong reasons or justification)
[2 × 7 = 14]

- (a) Inventory turnover ratio is calculated by the auditor to obtain evidence concerning management's assertion about valuation of inventory.**
- (b) Working Papers of the auditor are to be returned to his client after audit since these are the property of the client.**
- (c) Non-adjusting events of a material nature need not be adjusted in accounts and can be disclosed by way of explanatory notes to the accounts.**
- (d) Efficiency audit examines whether the transactions have been done in conformity with established rules, principles and some established standards.**
- (e) Propriety audit is applicable to all limited companies in all aspects.**

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- (f) For an internal audit function to be effective, the same must be independent of the activities to be audited.
- (g) S Ltd. is the subsidiary of H Ltd. Ram owes S Ltd. ₹10,000, Laxman has given guarantee for the same. Can Laxman be appointed as statutory auditor of H Ltd.?

Answer:

- (a) The statement is true. Calculation of inventory turnover ratio and its comparison with those of previous year's ratio will provide evidence on correct valuation of slow-moving, defective and obsolete items included in inventories.
- (b) The statement is false. Working Papers are the property of the Auditor. He may, at his discretion, take portions or extracts from his working papers and make available to his client. However, the auditor should take reasonable care for custody and keep confidentiality of his working papers and retain for a necessary period of time to meet future needs, if any.
- (c) The statement is true. Non-adjusting events are those which do not provide any additional evidence with regard to the conditions existing on the Balance Sheet date and hence do not merit any financial adjustment. However, such events may be dealt with the Directors in their report under Section 217, or by way of explanatory notes to the accounts, if material.
- (d) The statement is false. Efficiency audit involves review of adequacy of the effectiveness of working personnel to attain business objective as also of the tools and techniques adopted. Propriety audit examines whether the transactions have been done in conformity with established rules, principles and some established standards.
- (e) 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.
- (f) 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.
- (g) Section 226 of the Companies Act, 1956 speaks of the qualifications and disqualifications of auditors.
As per Section 226(3), a person who has given any guarantee in connection with the indebtedness of any third person to the company for an amount exceeding ₹1,000 shall not be qualified to be appointed as auditor of the company. Hence Laxman cannot be appointed as auditor of S Ltd.

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Sub-section (4) of section 226 states that where a person is not qualified to be appointed as auditor of a company, the disqualification shall extend to the holding company of the said company also.

Hence Laxman cannot be appointed as statutory auditor of H Ltd. also.

Question 6:

(a) How will you verify Development of Property?

(b) What are the main sources of GAAP in India?

(c) Proposed dividend is not adjusted in the financial statements. Decide

(d) A company running a Departmental Store and having total turnover of ₹150 Cr. during the financial year, need not get its branch audited whose turnover is ₹ 2.85 cr. during the same year. Decide.

(e) The cost auditor of a company can be its internal auditor, and is to be appointed by the shareholders of the company. Comment on the validity.

(f) Briefly state the basis and types of liability of auditor.

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

Answer:

(a) When expense incurred for the development of any property, they cannot be conveniently added to the value of such property. Such expenses should be capitalized under the head "Development of Property" e.g. expenses incurred in grading and preparing the soil for plantations.

Such amount shall be written off over the period during which the benefit from such development will accrue to the business. To verify this, the auditor should:

- i. Verify the amount of budget allocation for such expenditure and note the sanction of the appropriate authority.
- ii. Examine whether the amount of expenditure is reasonable based on Technical Reports, if applicable.
- iii. Vouch the payment made and expenditure incurred on the basis of bills enclosed and payments made through the cash/bank book.
- iv. Verify whether an appropriate amount has been written off, keeping in view the period of benefit or the exploitation, as the case may be.

(b) The main sources of GAAP in India are :

- i. Accounting Standards and Statements issued by the Institute of Chartered Accountants of India.
- ii. Derived from the Companies Act, 1956.
- iii. Standards issued under Income Tax Act, 1961.
- iv. Statement and Regulations issued under SEBI Act and Guidelines issued by SEBI.
- v. Industry specific Legislations (Insurance, Banking, Financial Institutions, etc.)

(c) Proposed dividend should be disclosed in the financial statements as per the requirements of schedule VI to Companies Act, 1956, though the dividend proposal is subject to the approval of the General Body in the Annual General Meeting. Dividend proposal is one of

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the appropriations of the profits of the company and as such it should be taken in the preparation of the financial statement as per schedule VI of Companies Act, 1956.

- (d)** A branch office of a company shall be exempted from audit, if the company carrying on any manufacturing, processing or trading activity and the average quantum of activity of the branch does not exceed –

- i. ₹2 lakhs or
- ii. 2% of the average of the Total Turnover of the Company, whichever is higher.

In the given case, the turnover of the Branch Office of the Trading Company (Departmental Store) is 1.90%, i.e. less than 2% of the average of the total turnover of the company. Hence, the branch office is exempted from audit.

Even if exemption is available, it is necessary that the fact must be mentioned in the Audit Report. The Company Auditor should expressly state in his Audit Report that the Branch Office is exempt from audit, by virtue of quantum of activity.

- (e)** The cost auditor of a company cannot be its internal auditor or vice versa.

The disqualifications attracting the (financial) auditor of a company are equally applicable to cost auditor of a company also. [Section 226(3) of the Companies Act, 1956].

Section 226 is made applicable to appointment of cost auditor under section 224 (1B) of Companies Act. Therefore, a qualified person can be appointed as cost auditor of a company but he cannot be at the same time be its internal auditor or financial auditor.

Even a qualified cost accountant who is acting as an internal auditor cannot be appointed as cost auditor of that company in view of the provisions of section 226(3) read with clause (ie) of that section.

The Cost Auditor having the requisite qualification will be appointed by the Board of Directors of the company with the previous approval of the Central Government and submit his report to the Central Government within the time prescribed by it.

The ceiling on the number of audits is also applicable to persons or firms appointed as Cost Auditors.

- (f)** The liability of professional negligence may arise under the statute or agreement with the client. The liability may be civil or criminal liability; further, the auditor may expose himself to disciplinary action by ICAI under the Chartered Accountants Act, 1949 for professional negligence and for failure to conduct the audit with reasonable care and caution required of him, under the facts and circumstances of the case.

The liability of an auditor may also arise under misfeasance provisions of the Companies Act, for failure to report properly and adequately the mis-statements in the financial statements, in order to hide more than they reveal.

The auditor will also be held criminally liable for negligent performance of his task and for collusion with the company management in the commission of frauds etc.

Question 7:

- (a) State with reasons whether you, as an auditor, would approve the payment of dividend out of capital?**

- (b) Discuss the rights and powers of statutory auditor of a public limited company.**

- (c) A company has purchased Plant and Machinery from a foreign supplier on installment payment basis. The liability has been classified as "Secured Loan" by the Company. Give your opinion on the above.**

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(d) Before accepting your appointment as auditor of a limited company, what steps will you take to ensure that your appointment is valid?

[5+6+3+4 = 18]

Answer:

(a) According to the Companies Act, no dividend can be paid out of capital as it expressly provides in Section 205 that the dividend is payable only out of current profit or past undistributed profits, arrived at after providing for depreciation. Therefore, if the memorandum or the articles of association even empower the company to declare dividend out of capital, such power becomes automatically invalid. [Verner vs General and Commercial Investment Trust Ltd. (1894)]

In the following circumstances, payment of dividend may amount to payment of dividend out of capital:

- i. If dividend is paid out of the sale proceeds of fixed assets
- ii. If profits are inflated by the following :
 - a. Charging revenue expenditure to capital
 - b. Making lower provisions for depreciation or liabilities
 - c. Overvaluing closing stock or investments
 - d. Excluding revenue expenditure from accounts
 - e. Increasing profit by any other way
- iii. If a deficiency of capital exists and dividend is paid without making good such deficiency

(b) Rights and Power of Auditor:

- i. As per section 227(1) of the companies act 1956, every auditor shall have a right of access to the books, accounts and voucher of the company at all time.
- ii. The auditor is entitled to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as Auditor. He may also obtain information under section 221 from the officers as he may deem fit.
- iii. The auditor is required to make a report to the members of the company on the financial statement and relevant annexures which are laid before the shareholders in general meeting.
- iv. Section 231 of the Companies Act provides that all notices and other communications relating to any general meeting of a company which any member is entitled to have sent to him shall also be forwarded to the auditor of the company.
- v. The auditor shall be entitled to attend any general meeting and make any statement/explanation with regard to the accounts audited by him.
- vi. Under Section 228, Power of the auditor wherein accounts of branch are audited by another auditor has been dealt with.

(c)

- i. General Principles: There are no specific disclosure requirements for Deferred Payment Liabilities under Schedule VI. The same should be disclosed on the basis of sound accounting principles and practices prevailing in the country, considering the general requirements of Sec. 211.
- ii. Nature: Deferred Payment Liability should be disclosed keeping in view the nature of the liability. It is not in the nature of Loan as per common commercial parlance.

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- iii. Disclosure: The instalments of Deferred Payment Liabilities payable within 12 months of the Balance Sheet date must be disclosed as "Current Liabilities" while the other instalments i.e. long-term liabilities may be disclosed under "Provisions" in the Balance Sheet.

(d) The Incoming Auditor should take the following steps before accepting his appointment:

- i. Ceiling Limit: Ensure that a certificate has been issued u/s 224 so that total number of Company Audits held by him (including the new appointment) will not exceed the specified number.
- ii. Resolution at AGM: Inspect General Meeting Minutes Book to see that the appointment is duly recorded.
- iii. Compliance with law: Satisfy that the legal procedure contemplated in Sec. 224 and 225 of the Act dealing with removal of existing Auditor, if required, has been followed. Also see whether Sec. 224A (special resolution) and Sec. 619B (C & AG Appointment) are attracted and complied with, if required.
- iv. Code of Conduct: Communicate with the previous Auditor, if any, to ascertain if there are any professional reasons for not accepting the appointment.

Question 8:

(a) What are the types of internal controls likely to be found in a computer based system.

(b) Write short note on – Types of CAATs.

(c) How will the auditor overcome loss of or changes in audit trail in an EDP environment?

(d) Write short note on – Qualities of Management Auditor.

(e) Briefly list out the points of distinction between the Companies Auditor's Report Order (2003) (CARO) and section 227 of the Companies Act.

(f) Mother Ltd. had its Registered Office at Madras. During the current accounting year, it has shifted its Corporate Head Office to Kolkata though it has retained the Registered Office at Madras. The Managing Director of the Company wants to shift its books of account to Kolkata from Madras, as he feels that there is no legal bar in doing so. Comment

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

Answer:

(a) In a computer based system, internal control can be classified as :

- i. Procedural Controls
- ii. Systems Development Controls
- iii. Administrative Controls.

Procedural Controls are exercised over separate computer application, different techniques will be appropriate for different application.

Procedural Controls are those which are designed to ensure a satisfactory standard of designing and testing of systems and programmes and of implementing and documenting them,

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wheareas Administrative Controls are those which ensure a standard of discipline and efficiency for running of Computer Department

(b) CAATs can be broadly categorised into the following three types :

- i. Generalised audit software (GAS): These are also referred as Package Programmes. GAS refers to generalised computer programmes designed to perform data processing functions such as reading data, selecting and analysing information, performing calculations, creating data files and reporting in a format specified by the auditor. GAS is standard off-the-shelf audit software, which can be used across enterprises and platforms.
- ii. Specialised audit software (SAS): These are also referred to as Purpose-Written Programmes. They perform audit tasks in specific circumstances. These are specifically written for performing audit tests for specific type of applications. These programmes may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity's existing programmes in their original or modified state because it may be more efficient than developing independent programmes.
- iii. Utility software: These are used by an entity to perform common data processing functions, such as sorting, creating and printing files. Utility software also includes utility programmes available in system programmes for performing debugging or analysis of various aspects of usage/access. These programmes are generally not designed for audit purposes but can be used for performing specific tests

(c) The Auditor may use special techniques to overcome the loss or changes in audit trail. Some measures to overcome the loss of audit trail include —

- i. Arranging for special printouts containing additional information,
- ii. Programmed interrogation facilities, e.g. records on magnetic or card files may be printed on a selective basis,
- iii. Clerical re-creation like re-verification of computer generated totals with manually prepared vouchers,
- iv. Testing on a total basis and ignoring individual items,
- v. Reliance on alternative tests, and
- vi. Use of Special Audit Techniques, either manual or computer aided.

(d) Whoever may be appointed as management auditor, should possess the following qualities—

- i. Ability to understand the problems of the business.
- ii. General understanding as to nature and objects of the organization.
- iii. Expert knowledge of the principles of delegation of authority, management by objectives, management by exception, management control, budgetary control, internal control, flow charts, use of computers etc.
- iv. Sufficient knowledge and experience in preparing different reports for presentation to the different levels of management including top management.
- v. Background of engineering, costing, statistics, management accounting, financial accounting, industrial psychology, managerial economics etc.
- vi. General understanding of different laws and regulations like company laws, tax laws, etc.
- vii. Tactfulness, perseverance, pleasing & dynamic personality.

(e) The requirements laid down by the CARO, 2003 are in addition to those laid down in the existing provision of section 227 of the Companies Act regarding the auditor's report.

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Nevertheless, there are certain points of difference between the Order and the requirements of section 227, which are as under :

- i. While CARO exempts certain classes of companies from its application, the provisions of sub-sections (1A), (2), (3) and (4) of section 227 are applicable to all companies; and
 - ii. The provisions of sub-section (1A) cast an obligation on the auditor to make certain specific enquiries during the course of his audit. There is no requirement to report on any of the matters specified in the sub-section unless he has any special comments to offer in respect of the said matters. If he is content as a result of the enquiries conducted, there is no further obligation to report that he is so satisfied, CARO, 2003, on the other hand, casts an obligation to voice the opinion in respect of each of the matters specified therein even if he has no comments to make on any of the matter(s) contained in Order. In this regard, the provisions of CARO are similar to the provisions of sub-sections (2), (3) and (4) of section 227.
- (f) Sec. 209 Requirements :** Sec. 209 provides as under —
- i. The books of account shall be kept at the Registered Office of the Company.
 - ii. All or any of the books of account may be kept at such other place in India as the Board of Directors may decide. The Company shall within 7 days of the decision of the Board, file with the ROC, a notice in writing giving the full address of that other place. The Notice to ROC shall be given in Form 23AA and shall specify the names of the books of account to be kept at other place.

Conclusion: From the above, it is clear that the Board of Directors of the Company may decide to keep the books of accounts of the Company in any other place other than the Registered Office of the Company by fulfilling the requirements specified in the above paragraph.