

# **Answer to MTP\_Intermediate\_Syllabus 2008\_Jun2015\_Set 1**

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## **Paper-6: COMMERCIAL AND INDUSTRIAL LAWS 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)**  
**2X7=14**

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

**(b) White elephant of rare kind was entrusted by ABC Zoo to the Indian Railway for carriage to Kolkata from Assam. The cage broke by jolts received during the journey and the elephant escaped. The elephant mowed down a herd of sheep belonging to X before being crushed under the wheels of the engine. Discuss the liability of Railway administration to ABC Zoo and X.**

**(c) R sells the goodwill of his shop to S for ₹10,00,000 and promises not to carry on such business forever and anywhere in India. Examine the validity of the contract.**

**(d) Mr. A offered to purchase shares of Xee Ltd on 1st May 2013. The company made allotment of shares on 30th November 2013. Mr. A refused to accept the shares. Can he do so?**

**(e) What tests can be applied in determining whether a person is an agent of another?**

**(f) Mr. "E" joined as supervisor on monthly salary of ₹ 9,900 on 01.02.2013 and resigned from his job on 28.02.2013. The company declared a bonus of 20% to all eligible employees and paid to on time. Mr. "E" knowing the facts made a claim to HRD, which in turn rejected the claim. Examine the validity in the light of the provisions of the Payment of Bonus Act, 1965.**

**(g) Mr. Amit joining on 01/11/2013 as an accountant wanted to become member of PF from 01/11/2013 but personnel manager disagreed.**

##### **Answer:**

**(a)** According to Section 136 of the Indian Contract Act, 1872, where a contract to give time to the principal debtor is made by the creditor with a third person and not with the principal debtor, the surety is not discharged. In the given question the contract to give time to the principal debtor is made by the creditor with X who is a third person. X is not the principal debtor. Hence P is not discharged.

**(b)** The liability of Railway administration in India is that of an ordinary bailee . A bailee should take reasonable care of the goods as a man of ordinary prudence would take of his own goods under similar circumstances.[Sec 151 of the Indian Contract Act, 1872] If the cage is broken by jolts during journey, it is fault of ABC Zoo . The railway administration is therefore not liable to ABC Zoo. It is also not liable to X as there is no fault on its part.

**(c)** As per Section 27 of the Indian Contract Act, 1872, an agreement in restraint of trade is void. However, a buyer can put such a condition on the seller of good will, not to carry on same business. However, the conditions must be reasonable regarding the duration and the place of the business.

Here, agreement not to carry on similar business anywhere in India forever is unreasonable and

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hence void.

**(d)** According to Sec 6(2) of the Indian Contract Act, 1872 an offer is revoked by lapse of time prescribed in the proposal or by lapse of reasonable time without communication of acceptance. What is reasonable time is question of fact in each case. In the given case the offer lapsed as it was not accepted within reasonable time. [**Ramsgate Victoria Hotel Co. vs Montefiore.**]

**(e)** The test for determining whether a person is or is not an agent is whether that person has the capacity to bind the principal and make him answerable to a third person by bringing him (the principal) into legal relations with the third person and thus establish a privity of contract between the party and the principal. If yes, he is agent, otherwise not. This relationship of agency may be created either by express agreement or by implication.

**(f)** The claim of Mr. E is not valid:

- Since he has not worked for at least 30 working days in the Accounting Year 2012-13 (Sec. 8);
- Although he is covered in the definition of 'employee', i.e., he is employed on a salary or wage not exceeding ₹ 10,000 per month [Sec. 2(13)].

**(g)** As per P.F. Act an employee at the time of joining the employment and getting wages upto ₹ 6,500/- is eligible for membership of Provident fund.

Since inadequate of information in the question the answer can be as follows:

**(i)** In case Mr. Amit getting upto ₹ 6,500 per months, then he is eligible for membership under P.F Act from the first date of joining.

**(ii)** In case Mr. Amit getting more than ₹ 6,500 per month, then he is not eligible for membership under P. F. Act.

### **Question: 2**

**(a) An employee agrees not to institute any legal proceedings against his employer. Can the agreement be enforced by the employer?**

**(b) "A mere mental acceptance not evidenced by words or conduct is, in the eyes of the law, no acceptance." Comment.**

**(c) Write a note on 'Counter Offer'.**

**(d) Distinguish between an 'agent' and a 'servant'.**

**(e) Write a note about Bailee's lien.**

**(f) Mr. A found some lost goods. Is he eligible to retain or sell those goods?**

**[6 × 3 = 18]**

### **Answer:**

**(a)** No, such an agreement is void ab initio since it constitutes restraint of legal proceedings. Section 28 of the Indian Contract Act, in this regard, provides that every agreement by which any party thereto is restricted absolutely from enforcing his rights under or in respect of any contract, by the usual legal proceedings in the ordinary tribunals or which limits the time within which he may thus enforce his rights, is void to that extent.

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Thus, the agreement is question shall be void as per Section 28 and hence the employer will not be in a position to enforce the agreement.

**(b)** One of the rules of valid acceptance is that it must be communicated to the offeror. The communication may, however, be express or implied. A mere, mental acceptance is no acceptance.

A mere mental acceptance means that the offeree is assenting to an offer in his mind only and has not communicated it to the offeror. Since communication is not made, acceptance is not complete.

**(c)** Where the offeree, instead of unconditionally assenting to the terms of the offer, accepts subject to certain conditions, he is said to have made a counteroffer.

Thus, where A offers his car to B for ₹1,00,000 and B accepts to buy A's car for ₹80,000, B has made a counter offer. A counter offer has the effect of terminating the original offer. If in the aforesaid illustration, B later accepts to pay ₹1,00,000 for the car, it shall amount to a fresh offer by B which A may or may not accept. Similarly, where an offeree agreed to accept half the quantity of goods offered by the offeror on the same terms and conditions as would have applied to the full contract, it was held that there was no contract as there was a counter offer to the original offer.

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

**(e)** Bailee's right of lien is particular in certain cases whereas general in other cases. Particular Lien is conferred upon a bailee by virtue of the provision of Section 170. It reads: 'Where the bailee has, in accordance with the purpose of the bailment, rendered any service involving the exercise of labour or skill in respect of the goods bailed, he has, in the absence of a contract to the contrary, a right to retain such goods until he receives due remuneration for the service he has rendered in respect of them.'

General Lien: The provisions of Section 171 empower certain categories of bailees to exercise a general lien. These include: bankers, factors, wharfingers, attorneys of High Court and policy brokers. These bailees can retain all goods of the bailer so long as anything is due to them, unless there is a contract to the contrary.

**(f)** Finding is not keeping. A finder of lost goods is treated as the bailee of the goods found and is, therefore, charged with the responsibilities of a bailee, besides the responsibility of exercising reasonable efforts in finding the real owner. However, he enjoys certain rights also. His rights may be summed up hereunder:

Right to retain the goods (Section 168): A finder of lost goods may retain the goods until he receives the compensation for money spent in preserving the goods and/or amount spent in finding the true owner. A finder, however, cannot sue for such compensation. But, where a specific reward has been offered by the owner for the return of lost goods, the finder may sue for such reward, and may retain the goods until he receives it.

Right to sell (Section 169): When a thing which is commonly the subject of sale is lost, if the owner cannot, with reasonable diligence, be found or if he refuses, upon demand, to pay the lawful charges of the finder, the finder may sell it:

- i. When the thing is in danger of perishing or of losing the greater part of the value; and

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- ii. When the lawful charges of the finder in respect of the thing found, amount to 2/3 of its value.

### **Question: 3**

**(a) A bill of exchange is payable to Shyam on order. At maturity another person of the same name wrongfully gets possession of the bill and presents it to the acceptor for payment. After being satisfied that the person presenting is Shyam, the acceptor makes payment on it in due course. Is the acceptor discharged?**

**(b) Define the followings as per The Competition Act, 2002**

- i. Dominant Position
- ii. Predatory Price.

**(c) What are the documents required for a limited liability partnership to be incorporated?**

**(d) A draws for his own accommodation a bill for ₹1,000 on B, and after acceptance by B, endorses it to C as security for ₹500. B is adjudged insolvent. Discuss the rights of C.**

**(e) Describe the events when gratuity becomes payable?**

**(f) Write short notes on – Rights of a consumer under the Consumer Protection Act, 1986?**

**[6 × 3 =18]**

### **Answer:**

**(a)** "Payment in due course" means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof the payment to the person in possession of the instrument must be under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount mentioned in the instrument. If, under suspicious circumstances, the person making the payment does not make the necessary inquiry, the payment is not a payment in due course. In the given case, if the acceptor does not make the necessary inquiry before making the payment, it is not a payment in due course. So, he is not discharged.

**(b) Dominant Position :**

It means a position of strength, enjoyed by an enterprise, in the relevant market, whether in India or outside India, which enables it to—

- i. operate independently of competitive forces prevailing in the relevant market; or
- ii. affect its competitors or consumers or the relevant market in its favour.

**Predatory price:**

It means the sale of goods or provision of service, at a price which is below the cost, as may be determined by regulations, of production of the goods or provision of services, with a view to reduce competition or eliminate the competitors [Sec. 4(2)].

**(c) For a limited liability partnership to be incorporated —**

- i. two or more persons associated for carrying on a lawful business with a view to profit must have subscribed their names to an incorporation document,
- ii. there must have been delivered to the registrar either the incorporation document or a copy authenticated in a manner approved by him, and
- iii. there must have been so delivered a statement in a form approved by the registrar, made by either a solicitor or CS, CA or Cost Accountant engaged in the formation of the

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limited liability partnership or anyone who subscribed his name to the incorporation document, that the requirement under the act and rules made there under have been complied with.

(d) When there is a partial absence or failure or money-consideration for which a person signed a promissory note, bill of exchange or cheque, the same rules as apply to total absence or failure of consideration will apply. Thus the parties standing in immediate relation to each other cannot recover more than actual consideration, but this rule does not apply to a holder in due course. So, C can recover ₹500 from A.

(e) According to Section 4(1) gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than 5 years—

- i. on his superannuation, or
- ii. on his retirement or resignation, or
- iii. on his death or disablement due to accident or disease.

Gratuity cannot be claimed by a workman who has not put in service for the specified minimum period of five years. Where a workman is discharged before he has put in service for the minimum period, no liability attaches to the employer [May & Baker(India) Ltd. v. Their Workmen].

However, completion of continuous service of 5 years shall not be necessary where the termination of the employment of any employee is due to death or disablement. In case of his death, gratuity is payable to his nominee, or, if no nomination has been made, to his heirs. Where such nominee or heir is a minor, the share of such minor shall be deposited with the Controlling Authority who shall invest the same for the benefit of such minor in such bank or other financial institution, as may be prescribed, until such minor attains majority.

(f) Section 6 of the Act recognises the following six rights of consumers :

- i. Right to safety, i.e., the right to be protected against the marketing of goods and services which are hazardous to life and property.
- ii. Right to be informed, i.e., the right to be informed about the quality, quantity, potency, purity, standard and price of goods or services, as the case may be, so as to protect the consumer against unfair trade practices.
- iii. Right to choose- It means right to be assured, wherever possible, access to a variety of goods and services at competitive prices. In case of monopolies, say, railways, telephones, etc., it means right to be assured of satisfactory quality and service at a fair price.
- iv. Right to be heard, i.e., the consumers' interests will receive due consideration at appropriate forums. It also includes right to be represented in various forums formed to consider the consumers' welfare.
- v. Right to seek redressal- It means the right to seek redressal against unfair practices or restrictive trade practices or unscrupulous exploitation of consumers. It also includes right to fair settlement of the genuine grievances of the consumers.
- vi. Right to consumer education. It means the right to acquire the knowledge and skill to be an informed consumer.

### **Question: 4**

**(a) Perfect Ltd. is a navratna undertaking having its factories throughout India. The company has an impeccable record of best welfare measures and working conditions. Does the company require appointing welfare officers?**

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**(b) PQR Ltd. orders ex parte dismissal of A, an employee for unauthorized absence without leave for more than 10 days. Examine the validity of the order under the Industrial Dispute Act, 1947.**

**(c) X was engaged as a car driver by Y, Manager of India Bank who received an allowance in this regard. Examine whether X can be held as an employee of the Bank under the Industrial Dispute Act, 1947, if the car is maintained at the Bank's expenses.**

**(d) X, an employee of Fortune Industries Ltd. lost mental balance in an accident while reporting to work early and committed suicide. Is the employer liable to pay compensation under the Employees' Compensation Act, 1923?**

**(e) ABC(P) Ltd. imposed a fine on Q, one of its employees for irregular attendance. No prior notice specifying this particular act in respect of which could be imposed was exhibited. ABC (P) Ltd deducted the fine in four installments from salary of Q. Is the employer justified?**

**(f) R was occupying service quarters of ABC Ltd at the time of retirement. He did not vacate the quarter's in spite of reminders. In retaliation, the company withheld the gratuity payable to him. Is action of the company justified?**

**[6 × 3 = 18]**

**Answer:**

**(a)** According to Section 49(1) of The Factories Act, 1948, in every factory wherein five hundred or more workers are ordinarily employed the occupier shall employ in the factory such number of Welfare officers as may be prescribed. The State Government may prescribe the duties, qualifications and Conditions of service of officers employed under sub-section (1). [Sec 49(2)]. In the given question Perfect Ltd. is a navratna undertaking having its factories throughout India. If the company has five hundred or more workers it is required to appoint welfare officers.

**(b)** Before taking any action against any employee, proper opportunity needs to be given to him. As per law, proper reconciliation proceeding be started. Holding of formal inquiry is necessary before dismissing an employee on the ground of misconduct. The employee should be given an opportunity of being heard.

In the given case, the order is valid if proper inquiry has been made before dismissal even if the dismissal order is ex parte.

**(c)** According to section 2 of the Industrial Disputes Act, 1947, "workman" means any person (including an apprentice) employed in any industry to do any manual, unskilled, skilled, technical, operational, clerical or supervisory work for hire or reward, whether the terms of employment be express or implied.

X cannot be regarded as workman or an employee under the said act as the control of him was not with bank, as held in case of PNB v Ghulam Dastagir, (1978) 2 SCC 358.

**(d)** According to Section 3(1) of the Employees' Compensation Act, 1923, if personal injury is caused to an employee by accident arising out of and in the course of his employment, his employer shall be liable to pay compensation in accordance with the provisions of this act.

The theory of notional extension of the term employment was laid down by Supreme Court in Saurashtra Salt Mfg. Co. v Bai Valu Rajr, A.I.R.(1958) S.C. 881. According to this theory in certain circumstances, an employer is liable to pay compensation even when employee is not at premises at the time of accident.

In the present case the employee lost his mental balance while coming to work early and committed suicide. Suicide is effect of injury sustained by him while trying to report early (on management's instruction as may be implied from the circumstances) for work. To succeed in claim it must be proved that the accident arose out of and in the course of his employment as

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compensation is given only for those injuries which occur in accident out of and in the course of his employment

**(e)** According to Section 8 of the Payment of Wages Act, 1936:

- i. A notice specifying such acts and omissions shall be exhibited in the prescribed manner on the premises in which the employment carried on or in the case of persons employed upon a railway (otherwise than in a factory) at the prescribed place or places.[Sec 8(2)]
- ii. No fine imposed on any employed person shall be recovered from him by installments or after the expiry of sixty days from the day on which it was imposed.[Sec 8(6)]

Thus ABC(P) Ltd violates the provisions of Secs. 8(2) and 8(6) of the Payment of Wages Act, 1936.

**(f)** Gratuity cannot be withheld for non-vacation of service quarters by retiring employees. Gratuity can only be forfeited to the extent of damage or loss where services have been terminated for any act of willful omission or negligence causing damage /loss/destruction of employer's property and not for non-vacation of service quarters.

Gratuity is exempted from attachment in execution of any decree or order in any Civil, Revenue or Criminal Court.

So action of ABC Ltd is not justified.[Travancore Plywood Ltd. v Regional Joint Labour Commissioner, Kerala(1996) LLJ 14]

### **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)**

**2X7=14**

- (a) Procedural error arises as a result of transactions having been recorded in a fundamentally incorrect manner.**
- (b) An auditor requires more reliable evidence to reach the conclusion regarding materiality.**
- (c) The auditor examines debit notes to vouch sales return.**
- (d) Inventory turnover ratio is calculated by the auditor to obtain evidence concerning management's ascertain about valuation of inventory?**
- (e) 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. No Government authority has been informed about this. Company contends that this practice is in order.**
- (f) What do you understand by Computer Information System (CIS) environment?**
- (g) An adverse report is one where an auditor gives an opinion subject to certain reservation.**

##### **Answer:**

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**(a)** Errors of omission and errors of commission constitute Procedural Errors. If transaction is basically recorded in the books in an incorrect manner, it is an error of principle. These errors do not affect the Trial Balance. Hence, the given statement is incorrect.

**(b)** The concept of materiality is fundamental to the process of aggregation, classification and presentation of accounting information. It is an important and relevant consideration for an auditor who has to constantly judge whether a particular item of transaction is material or not. Obviously, an auditor requires more reliable evidence in support of material items.

**(c)** The statement is false. The auditor examines purchase return transaction with reference to copies of debit notes issued to suppliers and outward return notes to vouch purchase return.

**(d)** The statement is true. Calculation of inventory turnover ratio and its comparison with those of previous year's ratio will provide evidences on correct valuation of slow-moving, defective and obsolete items included in inventories.

**(e)** The statement is false, as per section 128 of the Companies Act, 2013, the books of accounts can be kept in a place other than its registered office also, but the board of Directors should, within 7 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.

**(f)** A CIS environment exists when one or more computers of any type or size is involved in the processing of financial information, including quantitative data. Those computers may be operated by the entity or by a third party.

**(g)** The statement is false. A qualified report is one where an auditor gives an opinion to certain reservation. An adverse report is given when the auditor concludes that based on his examination, he does not agree with the affirmation made in the financial statements/ financial report.

### **Question: 6**

**(a) 'Doing an audit is full of risk'. Narrate the factors which cause the risk.**

**(b) As an auditor, how will you vouch and /or verify Borrowing from Banks.**

**(c) One of the debtors of Ayush Ltd. from whom ₹60 lacs is recoverable for credit sales gives a motor car in full settlement of dues. The directors estimate that the market value of the car transferred is ₹60.50 lacs. As on date of Balance Sheet, the car has not been registered in the name of Ayush Ltd. Comment**

**(d) M/s Delphi Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2013-14 it received a communication from an Insurance Company informing that premium amount for the accounting year 2012-13 was less charged by ₹95 lacs on account of arithmetical error on the part of Insurance Company. M/s Delphi Ltd. paid the said sum of ₹95**



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lacs during the accounting year 2013-14 by debiting the same to Prior period expenses. Justify

**(e) Write a note on "Computer Auditing"**

**[5+4+3+3+3 = 18]**

**Answer:**

**(a)** An independent audit whether performed in terms of relevant statutory legislation or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgments made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks. Factors which cause such risk in conducting an audit are discussed below:

- i. Exercising judgment on the part of the auditor: The auditor's work involves exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements
- ii. Nature of audit evidence: The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such evidence may far exceed the benefits.
- iii. Inherent limitations of internal control: Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite natural that an audit suffers from control risk on account of inherent limitations of internal control risk and detection risk on account of test nature of audit and judgment and estimates involved in formulating accounting policies

**(b)** Borrowing from banks may be either in the form of overdraft limits or term loans.

In each case, the borrowings should be verified as follows:

- i. Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- ii. Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of Charges.

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- iii. Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- iv. Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

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

**(c)** The motor car has been acquired in exchange for another asset i.e. receivables. The fair value of motor car is ₹ 60.5 lacs and that of receivables is ₹ 60 lakhs. As per AS- 10 the asset acquired in an exchange of assets should be valued at the fair market value of assets acquired in an exchange or the asset given up, whichever is more clearly evident. Here fair market value of asset given up obviously is more clearly evident. Hence the motor car should be valued at ₹ 60 lakhs. Also the motor car should be recognized as an asset.

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

In the given case –

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

**(e)** In information processed on computers the one way of auditing is to get the printouts of all records, accounts and information and then check it as usual, but this is very time consuming and cannot evaluate the system of internal controls and certain errors found etc, remains undetected. The other more acceptable way is to evaluate the controls in the computer information system and then decide the nature of timing and extent of the substantive procedure to be followed and make use of computer in conducting compliance tests as well as substantive test, but and the auditor must have sufficient knowledge of computer system even in certain of cases specialised skills in operations of computer system.

### **Question: 7**

**(a) The auditor of a company wanted to see the minute's book of Directors meetings. The Chairman of the company refused for the same on the ground that matters of confidential nature**

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were contained therein. Comment

(b) What are the essential features of good audit working papers.

(c) Management audit is advantageous. Comment

(d) Write a note on "Audit in case of environment of personal computer"

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

**[3+4+4+4+3 = 18]**

**Answer:**

(a) Under Section 143 of the Companies Act, 2013, the auditor of a company has the right of access at all times to books and accounts and vouchers of the company whether kept at the head office of the company or elsewhere.

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

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

(b) The essential features of good audit working paper are:

- i. Completeness i.e. they should contain all the essential information so that they may be of maximum utility. Facts which are not important should be omitted.
- ii. Organisation and Agreements. The working paper should be so arranged that one may not find any difficulty in locating a particular matter. If they are not properly arranged it will entail loss of time in finding a particular fact while preparing the Report.
- iii. Clearness. The facts in the working papers should be set out clearly.
- iv. The facts stated should be readily apparent to the reader later on, e.g. schedules, where necessary, should be fully explanatory so that it will not be necessary to puzzle over the various sections.
- v. Papers should be clearly fastened together, arranged in a logical order, properly and adequately referenced and the subject matter clearly marked on the top.
- vi. Sufficient space should be left after each note so that any decision taken by the auditor may be taken down in that space.

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- vii. It is therefore felt that if audit working papers are handed over to the clients, an auditor may not be able to defend himself, if any dispute arises in future.

**(c)** Management audit is advantageous for the following reasons:

- i. The company's personnel know the organizational policies, plans, personnel operations, personalities and working relationships, the political climate, the functional importance, and some of the problems themselves.
- ii. The audit team need not spend an unduly long time for familiarizing themselves with the background information for study.
- iii. It may be easier to get the support of the higher management, because such audit in the form of self appraisal apparently involves no extra cost.
- iv. The acceptance of the findings may be comparatively easier because the concerned personnel may readily accept the recommendations from the internal management audit team (consisting of co-workers) than from the external management auditors (or consultants).
- v. The implementation of the new method of operation or organizational arrangement may be easier because the personnel who designed and advised it are on the premises. The constant co-operation necessary in the implementation phase are greatly facilitated.
- vi. The experience and expertise gained by the company personnel in the conduct of management by self appraisal could be gainfully utilized for subsequent audits.

**(d)** The environment where in personal computers are used is different from the environment where in large computers are in use and that is why auditor has to adopt different approach to audit in such environment. According to the guideline issued by International Federation of Accountants, the auditor has to consider following points while conducting audit in such environment of personal computers :

- i. He should understand that P.C.s generally does not have controls as many as those in large computers, the program and data can be saved on portable media like C.D.s and also on hard disk. The storage media is prone to accident. Portable storage media are also subject to damage or theft or misplacement.
- ii. He should know that inadequate control measures can create serious problems like theft or alteration of data due to unauthorized use of P.C.
- iii. He should see whether proper controls are introduced to avoid unauthorized use of P.C.s, downloading data, improper documentation, improper use of storage capacity etc.

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- iv. He should ensure that software are not subject to manipulation.
- v. He should examine the control procedure like cross checking the results, testing of application programs, documentation of processed data, and range test of data to strengthen the software and data integrity.
- vi. He should verify whether proper arrangement is made for back up copies of all data and important programs.
- vii. He should concentrate on substantive tests and not waste his time in detailed examining of the computer information system's controls effectiveness.
- viii. He should use computer assisted audit techniques.
- ix. He should examine larger samples of transactions.
- x. He should verify the effectiveness of different control measures utilized and report about that.

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

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

### **Question: 8**

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

**(b) 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. Comment**

**(c) At an Annual General Meeting, Mr. B a retiring auditor claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. A, could not be proceeded with, due to Mr. A's death. Comment**

**(d) Explain the importance of improving auditor-auditee relationship.**

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**(e) At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Can the powers of the Statutory Auditors can be restricted?**

**(f) The auditor of High Ltd. did not report on the matters specified in sub-section (1) of Section 143 of the Companies Act, 2013, as he was satisfied that no comment is required. Justify**

**[6 × 3 =18]**

**Answer:**

**(a)** 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.

**(b)** 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 ₹12,00,000 while the insurance money received is ₹10,00,000. 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 ₹10 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.

**(c)** Section 139 of the Companies Act, 2013 dealing with reappointment of auditors specifies that a retiring auditor may be re-appointed at an AGM, if –

- i. He is not dis-qualified for re-appointment
- ii. he has not given to the company a notice in writing of his unwillingness to be re-appointed; and
- iii. a special resolution has not been passed at the AGM appointing some other auditor or providing expressly that he shall not be re-appointed.

Where in an AGM, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

Thus, Mr. B may be re-appointed, since the special resolution has not been passed at the AGM appointing some other auditor or providing expressly that he shall not be re-appointed

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**(d)** It may be appreciated that for carrying out internal audit functions properly and efficiently, there should be a cordial relationship between the Auditor and the Auditee. The maintenance of good relations between the two would, however, be like a two way traffic. The auditor must keep in mind that he is to sell a product viz the audit service and the customer i.e. the management must be ready to accept the product if it is of standard quality. If the management is really interested in improving the efficiency of the business operation by utilizing this important management tool "(Internal Audit)", it must appreciate and take action on the Internal Audit Report and findings; if however, the products of audit are useful.

The Internal Auditor's campaign must be aggressive and dynamic. Each audit performed in traditional financial area must be thorough and sound. Each audit report should show the imprint of professional quality both in terms of form and substance. Such audit report would be more useful to the management if the audit is carried out keeping in view the management's view point. It may, therefore, be said that even in the traditional, financial accounting area there is scope for improvement of the audit products.

If the Internal Audit Department can continue its effort in making the audit report more attractive, by carrying out audit keeping in view the management's requirements, the cordial relationship between the two, that has once grown would continue providing newer scope to the Internal Audit Department for offering better service to the management.

**(e)** Section 143 of the Companies Act, 2013 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit. These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence' any such resolution even if passed by entire body of shareholders is ultra vires and therefore void. In the case of *Newton vs. Birmingham Small Arms Co.*, it was held that any regulations which preclude the auditors from availing themselves of all the information to which they are entitled under the Companies Act, are inconsistent with the Act

**(f)** Section 143 of the Companies Act, 2013 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 auditor is not required to report on the matters specified in sub-section (1) 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 High Ltd. is correct in non-reporting on the matters specified in Section 143.