

Answer to PTP_Intermediate_Syllabus 2008_Jun2014_Set 2

Paper- 6: COMMERCIAL & INDUSTRIAL LAWS AND AUDITING

Time Allowed: 3 Hours

Full Marks: 100

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)

1. Comment on the following based on legal provisions (no mark for wrong reasons or justification) 2X7
- (a) An agreement was entered into on 11.10.2013 between the owner of building and Mr. Ramesh for exhibition cum sales centre. On 30.11.2013 owner expressed his intention to cancel the agreement as the building is unsafe as declared by Municipal Corporation on 29.11.2013.
 - (b) Every termination of employment is retirements.
 - (c) A maker of the bill of exchange can't be discharged until the payment against bill is made.
 - (d) Mr. Ramesh purchased 10 kgs. fish. On returning home, he found that fish was not fresh, Ramesh demand replacement or refund but the seller refused.
 - (e) Consumer under Consumer Protection Act, 1986 means persons who obtain goods for resale or for any commercial purpose.
 - (f) Public Information Officer shall as expeditiously as possible and in any case within 30 days of receipt of request provide the required information.
 - (g) Workmen working in a public utility services have right to go on strike even without giving notice.

Answer:

1. (a) When a contract becomes impossible to perform at a date subsequent to the date of agreement, it is called doctrine of supervening impossibility or Doctrine of frustration. If the Municipality's declaration is known to the owner after the date of execution of agreement, this agreement is discharged and Mr. Ramesh cannot force the owner.
- (b) Retrenchment is termination by the employer of the service of a workman for any reason whatsoever otherwise than as a Punishment inflicted by way of disciplinary action but does not include voluntary retirement, superannuation, termination by non-renewal of employment contract, termination for ill health.
- (c) False. The maker, acceptor or endorsee is discharged from liability by
- (i) by payment in due course,
 - (ii) by maker or acceptor becoming the holder,

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(iii) by express waiver,

(iv) by cancellation.

It may also discharged like a contract for the payment of money.

- (d)** Section 16 of the Indian Sale of Goods Act begins with the enunciation of the principle involved in the maxim caveat emptor. It states that subject to the provisions of the Act and any other law for the time being in force, there is no implied warranty or condition as to the quality of fitness for any particular purpose of the goods supplied under the contract of sale. The principle of Caveat Emptor (let the buyer beware) lays down that it is the duty of the buyer to satisfy himself before purchasing the article, that the article which he buys, is the one he wants.

Seller may refuse replacement and refund based on caveat emptor. If he makes a bad choice, he can't blame the seller.

- (e)** False. A consumer under the Consumer Protection Act, 1986 means any person who buys goods for consideration and includes any user of such goods. It does not include a person who obtains such goods / services for any commercial purpose. However commercial purpose does not include use by a consumer of goods bought and used by him and services availed by him exclusively for the purpose of earning livelihood by means of self employment.
- (f)** Public information officer shall as expeditiously as possible and in any case within 15 days of receipt of request provides the information requested on payment of prescribed fees or reject the request for any of the reasons specified in section 8 and 9. Where the information sought for concern of life and liberty the same shall be provided within 48 hrs. of receipt of such request.
- (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.

2. **(a) P, Q and R jointly borrowed ₹5,00,000 from W. The whole amount was repaid to W by Q. Decide in the light of the Indian Contract Act, 1872 whether:**
- (i) Q can recover the contribution from P and R,**
 - (ii) Legal representatives of P are liable in case of death of P,**
 - (iii) Q can recover the contribution from the assets, in case R becomes insolvent. [1+1+1]**
- (b) Explain the power of Central Government to appoint Inquiry Committee under Section 41-D of the Factories Act, 1948. [3]**
- (c) Explain the powers of Labour Courts, Industrial Tribunals and National Tribunals to give appropriate relief in case of discharge or dismissal of workmen under section 11 –A of the Industrial Dispute Act, 1947. [4]**
- (d) "Lock-out is employer's weapon"- Explain. [4]**
- (e) P appoints A as his agent to sell his estate. A, on looking over the estate before, selling it, finds the existence of a good quality Granite-Mine on the estate, which is unknown to P. A buys the estate himself after informing P that he (A) wishes to buy the estate for himself but conceals the existence of Granite-Mine. P allows A to buy the estate, in ignorance of the existence of Mine. State giving reasons in brief the rights of P, the principal, against A, the agent.**
- What would be your answer if A had informed P about the existence of Mine before he purchased the estate, but after two months, he sold the estate at a profit of ₹ 1 lac? [2]**

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- (f) E was an employee of Tea Estate Ltd. The whole of the undertaking of Tea Estate Ltd. was taken over by a new company – Asia Tea Estate Ltd. The services of E remained continuous in new company. After serving for one year E met with an accident and became permanently disabled. E applied to the new company for the payment of gratuity. The company refused to pay gratuity on the ground that E has served only for a year in the company.

Examine the validity of the refusal of the directors in the light of the provisions of the Payment of Gratuity Act, 1972. [2]

Answer:

- (a) Section 42 of the Indian Contract Act, 1872 requires that when two or more persons have made a joint promise, then, unless a contrary intention appears by the contract, all such persons jointly must fulfill the promise. In the event of the death of any of them, his representative jointly with the survivors and in case of the death of all promisees, the representatives of all jointly must fulfill the promise. Section 43 allows the promisee to seek performance from any of the joint promisors. The liability of the joint promisors has thus been made not only joint but "joint and several". Section 43 provides that in the absence of express agreement to the contrary, the promisee may compel any one or more of the joint promisors to perform the whole of the promise. Section 43 deals with the contribution among joint promisors. The promisors, may compel every joint promisors to contribute equally to the performance of the promise (unless a contrary intention appears from the contracts). If any one of the joint promisors makes default in such contribution the remaining joint promisors must bear the loss arising from such default in equal shares. As per the provisions of above sections, (i) Q can recover the contribution from P and R because P,Q, R are joint promisors. (ii) Legal representative of P are liable to pay the contribution to Q. However, a legal representative is liable only to the extent of property of the deceased received by him. (iii) 'Q' also can recover the contribution from R's assets.

- (b) **Appointment of an Inquiry Committee in the event of occurrence of an extraordinary situation.** The Central Government may, in the event of the occurrence of an extraordinary situation involving a factory engaged in a hazardous process, appoint an Inquiry Committee to inquire into the standards of health and safety observed in the factory. The object of appointing the Committee is to find out the causes of any failure or neglect in the adoption of any measures or standards prescribed for the health and safety of the workers employed in the factory or the general public affected or likely to be affected due to such failure or neglect and for the prevention and recurrence of such extraordinary situation in future in such factory or elsewhere [Sec. 41-D (1)].

Membership of the Committee and its tenure of office. The Committee shall consist of a Chairman and 2 other members. The terms of reference of the Committee and the tenure of office of its members shall be such as may be determined by the Central Government according to the requirements of the situation [Sec. 41-D (2)].

Recommendations of the Committee advisory. The recommendations of the Committee shall be advisory in nature [Sec. 41-D (3)].

- (c) Where an industrial dispute relating to the discharge or dismissal of a workman has been referred to a Labour Court, Industrial Tribunal or National Tribunal for adjudication and, in

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the course of adjudication proceedings, the Labour Court, Industrial Tribunal or National Tribunal, as the case may be, is satisfied that the order of discharge or dismissal was not justified, it may, by its ward, set aside the order of discharge or dismissal. It may also direct reinstatement of the workman on such terms and conditions, if any, as it thinks fit, or give such other relief to the workman including the award of any lesser punishment in lieu of discharge or dismissal as the circumstances of the case may require (Sec. 11-A). The Labour Court or the Tribunal has to be satisfied that even though the misconduct is proved and a penalty has to be imposed, the extreme penalty of dismissal or discharge was not justified in the facts and circumstances of the case, meaning thereby that the punishment was either disproportionately heavy or excessive. In order to avoid the charge of vindictiveness, justice, equity and fair play demand that punishment must always be commensurate with the gravity of the offence charged [Rama Kant Mishra v. State of U.P., (1982) 3 S.C.C. 346].

(d) In *Kairbetta Estate v. Rajamanickam*, A.I.R. (1960) S.C 893, the Supreme Court observed: "Lock-out can be described as the antithesis of a strike. Just as a strike is a weapon available to the employees for enforcing their industrial demands, a lock-out is a weapon available to the employer to persuade by a coercive process the employees to see his point of view to accept his demands."

In a tussle between employees and an employer whereas 'strike' is the weapon of the employees, 'lock-out' is the corresponding weapon in the armoury of the employer. If the employer shuts down his place of business as a means of reprisal or as an instrument of coercion or as a mode of exerting pressure on the employees, or, generally speaking, when his act is what may be called an act of belligerency, there would be a lock-out [*Sri Ramachandran Spg. Mills v. State of Madras*, A.I.R. (1956) Mad. 241].

(e)

Non- disclosure of fact of existence of mine amounts to breach of duty by A	- since A, without disclosing all material facts and without obtaining the consent of P, dealt in the business of agency on his own account.
If A had informed P about the existence of mine	- then, A would not be liable, even though he makes a profit of ₹ 1 lakh, since in such a case, there is no breach of duty of disclosure and obtaining consent.

(f) The refusal of the directors is not valid

- since E is entitled to gratuity;
- since the condition of continuous service of five year is not applicable in case the employment of an employee is terminated due to death or disablement due to accident or disease.

3. (a) **X, Y and Z were joint owners of a bus and possession of the said bus was with Y. P purchased the bus from Y without knowing that X and Z were also owners of the bus. Decide in the light of provisions of the Sale of Goods Act, 1930, whether the sale between Y and P is valid or not?** [2]
- (b) **What are the remedies available to the buyer for breach of conditions?** [2]
- (c) **Point out the defenses' available to employers regarding personal injury caused to a workman by accident arising out of and in the course of employment.** [3]

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- (d) What are the distinction between void agreement and illegal agreement? [3]
(e) What are the liabilities of Buyer for rejecting, neglecting or refusing delivery of goods? [4]
(f) Write down the permissible limits of exposure of chemical and toxic substances under section 41-F of the Factories Act, 1948? [2]
(g) A worker whose monthly wage is ₹ 2,000 loses one hand as a result of injury caused to him on 14th September, 2013. On 1st August, 2013 he had completed 30 years of age. Calculate the amount of compensation payable to him. Relevant factor for age 30 is 207.98. [2]

Answer:

- (a) This problem is based on Section 28 of the Sale of Goods Act, 1930 which lays down an exception to the general rule that a person cannot transfer a better title than that he himself possesses. A person who is one of joint owners may transfer a better title than that he possesses. Section 28 provides that – if one of several joint owners of goods has the sole possession of them by permission of the other co-owners, the property in goods is transferred to any person who buys them from such joint owner in good faith and has not at the time of the contract of sale notice that the seller has no authority to sell.
- (b) Remedies available to the buyer for breach of conditions:**
- (i) Affected party may claim refund of price and reject the goods;
 - (ii) Elect to treat breach of condition as breach of warranty and claim damages or compensation;
 - (iii) When the affected party treat breach of condition as breach of warranty he can not repudiate the contract but claim damages only;
 - (iv) No remedy is available when the fulfillment of condition is excused by law by means of impossibility or otherwise (13(3)).
- (c) An employer is not liable to pay compensation for personal injury caused to a workman by accident arising out of and in the course of employment—**
- (a) if the injury does not result in the total or partial disablement of the workman for a period exceeding 3 days ;
 - (b) if the injury, not resulting in death, is caused by an accident which is directly attributable to—
 - (i) the workman having been at the time of the accident under the influence of drink or drugs ; or
 - (ii) the wilful disobedience of the workman to an order expressly given, or to a rule expressly framed, for the purpose of securing the safety of workmen ; or
 - (iii) the wilful removal or disregard by the workman of any safety guard or other device (which is an offence under the Factories Act, 1948) which he knew to have been provided for the purpose of securing the safety of the workmen [Proviso (a) to Sec. 3 (1)].

The exceptions, namely (i) intoxication by drink or drugs, (ii) wilful disobedience of certain rules and orders, (iii) wilful removal of safety devices, are not applicable in case of a fatal accident [Proviso (b) to Sec. 3 (1)]. The reason is that where a workman has died as a result of personal injury it is extremely difficult for the dependants to rebut evidence that the accident was caused by the deceased's misconduct.

(d) Distinction between void agreement and illegal agreement

Basis of distinction	Void agreement	Illegal agreement
1. Meaning	An agreement not enforceable by law is said to be a void agreement.	An agreement which is forbidden {i.e. prohibited} by any law for the time being in force, is an illegal agreement.
2. One in another	All void agreements are not illegal.	An illegal agreement is always void.
3. Reason	If an agreement does not satisfy one or more requirements of Sec. 10, 29 or 56, it is void.	An agreement becomes an illegal agreement only if it is made against the provisions of any law for the time being in force.
4. Punishment	The Parties are not liable to be punished.	In case of an illegal agreement, the parties are criminally liable.
5. Void-ab-initio	A valid contract may subsequently become void.	An illegal agreement is void from the very beginning.
6. Effect on collateral transactions	A transaction which is collateral to a void agreement, is not void.	A transaction which is collateral to an illegal agreement, is also illegal.

(e)

- (i) Buyer not bound to return rejected goods (Sec 43). As per section 43 unless otherwise agreed, if the goods are delivered to the buyer and he refuses to accept them, he is not bound to return them to the seller. But at the same time he is to intimate the seller that he refuses to accept them. Quite possible the seller may also refuse to take back the delivery. In such cases the buyer becomes bailee and his position is that of a bailee for which he can charge reasonable amount for keeping the goods.
- (ii) As per section 44 failure of the buyer to take delivery of goods within a reasonable time of seller's request, the buyer becomes liable to the seller for any loss occasioned by his neglect or refusal to take delivery and also for a reasonable charge for the care and custody of the goods. This does not affect the rights of the seller where the neglect or refusal of the buyer to take delivery amounts to a repudiation of the contract.

- (f)** The maximum permissible threshold limits of exposure of chemicals and toxic substances in manufacturing processes (whether hazardous or otherwise) in any factory shall be of value indicated in the Second Schedule [Sec. 41-F (1)]. The Second Schedule, added by the Amendment Act of 1987, lays down permissible levels of certain chemical substances in work environment.

The Central Government may at any time for the purpose of giving effect to any scientific proof obtained from specialised institutions or experts in the field, by notification in the Official Gazette, make suitable changes in the said Schedule [Sec. 41-F (2)].

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(g) As per Schedule I, the injury results in 60 per cent loss of earning capacity. The amount of compensation, therefore, will be 60 per cent of the compensation payable in case of permanent total disablement. It shall be calculated as follows:

$$60\% \text{ of } \frac{60 \times 2000 \times 207.98}{60} = 60\% \text{ of } ₹ 2,49,576 = ₹ 1,49,746.$$

4. (a) Answer any Four:

[4 × 4]

- i. Effects of 'coercion' on a contract.
- ii. Powers of Inspector (Minimum Wages Act)
- iii. Recovery of Gratuity
- iv. Seller's lien
- v. Rights of the unpaid seller.

(b) Partnership by holding out is also a partner with full rights. Comment.

[2]

Answer: (a)

(i) Effect of Coercion.

Following are the effect of coercion on a contract:

- Contract induced by coercion is voidable to at the option of aggrieved party whose consent was obtained by coercion – sec 19.
- If the aggrieved party decided to rescind the contract, it will have to restore benefit to party from whom it was received as per sec. 64.
- The aggrieved party can insist that contract be performed.
- If a party rightfully rescinds a contract, it can claim compensation for any damage/loss/suffer through non-fulfillment of contract as provided in section 75.

(ii) Powers of Inspector (Minimum Wage Act):

- The inspector may enter at all reasonable hours any premises for the purpose of examining any register, record of wages or notices and require the production of such documents for inspection.
- Examine any person whom he finds in any such premise or place and who he has reasonable cause to believe is an employee employed therein or an employee to whom work is given out therein.
- Require any person giving out work and outworkers to give any information.
- Seize or take copies of such register, record of wages or notice, or portion thereof as he may consider relevant in respect of an offence under the minimum wages Act 1948, which he has reasons to believe has been committed by an employer and exercise such other powers as may be prescribed.

(iii) Recovery of Gratuity:

If the amount of Gratuity payable under the act is not paid within the prescribed time i.e., 30 days to the employee entitled thereto, the said employee may apply to the Controlling Authority for direction to pay the gratuity.

Controlling Authority gives a reasonable opportunity of showing cause.

After hearing both the parties, the Controlling Authority, issues orders for payment of gratuity with interest specifying the last date for such payment.

If the employer fails to pay the gratuity within the prescribed time against the order of the controlling Authority, then the Controlling Authority issues certificates for that amount to the collector who shall recover the same with compound interest at such rate as the central Government may specify from the date of expiry of prescribed time as arrears of land revenue and pay the same to the employee entitled thereto.

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(iv) Sellers lien:

The unpaid seller of goods who is in possession of goods is entitled to retain possession of such goods until payment are tendered of the price in the following cases viz.

- (a) Whether the goods have been sold without any stipulation as to credit.
- (b) Whether the goods have been sold on credit but the term of credit has expired.
- (c) Whether the buyer becomes involvement.

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

(v) Rights of the unpaid seller.

An unpaid seller has the following rights by implication of law. (Sale of Goods Act).

- (a) Right of lien on the goods for the period while he is in possession of goods.
- (b) Right of stoppage in transit, In case of insolvency of the buyer, a right of stopping the goods in transit after he has dispatched. Seller may retain this goods till the payment is received.
- (c) Right of Resale.

- (b)** If a person who is not a partner, but by his words or by his conduct represents himself as a partner of a firm, he is liable as a partner to anyone who has on the faith of such representation given credit to the firm. But since he is not partner he has no right and he acquires no claim upon the firm also.

Section -II (50 Marks) (Auditing)

5. **Comment on the following statements based on legal provisions: (No mark for wrong reasons or justification) [2X7]**

- (a) Internal Auditor has a big role to play in preventing fraud.**
- (b) ABC Ltd. has made provision for payment of dividend out of Capital Redemption Reserve fund.**
- (c) It is mandatory to provide cash flow statement with annual accounts of all companies. Do you agree?**
- (d) Interest on loan for purchase of raw materials is included in the cost of production.**
- (e) While auditing in computer information system, auditor should make assessment of inherent risk.**
- (f) ABC Ltd. is not listed on any stock-exchange. Hence provision relating to Audit Committee is not applicable.**
- (g) M/s. S. S. & Associates. Chartered Accountants who were appointed as Auditor by the members in A.G.M. refuses to accept the appointment. In such cases Central Govt. only appoint another Auditor.**

Answer:

- 5 **(a)** True, Internal Audit Dept. has a big role to play in preventing fraud as a part of protective function. Big organizations have an internal Audit manual which outlines the functions in details, vulnerable areas, where loss through fraudulent means may arise frequently e.g.

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stores, cash, civil maintenance jobs, process loss etc. Internal Audit shall guard both visible and invisible fraud. Frequent checking and wide coverage specially in respect of vulnerable items is essential.

In discharging his functions in sensible areas, the Auditor has to be extra intelligent & imaginative to enable him to think ahead of many others.

Fraud may be categories viz.

1. Defalcation, involving either misappropriation of money or goods.

2. The fraudulent manipulation of accounts not involving defalcation.

Falsification of accounts without corresponding defalcations is naturally considerably less frequent than the class of fraud & misappropriation. Auditor shall guard accordingly.

- (b) When preference shares are redeemed out of undistributed profit, the nominal value of shares so redeemed should be transferred to Capital Redemption Reserve account which is not freely available for distribution of dividend. However it can be utilized by issuing fully paid up bonus shares.
- (c) False. Attachment of cash flow statement with annual account is mandatory in case of commercial enterprise having turnover for the accounting period exceeding ₹ 50 Crores or enterprises whose equity or debt securities are listed on a recognized stock exchange and the enterprise which is in the process of issuing equity or debt securities that will be listed on a recognized stock exchange as evidenced by Board of Directors.
- (d) While calculating the cost of production, CAS-4 shall be considered. As per CAS-4, interest being a financing charge shall not be considered to be part of cost of production.
- (e) It is true: the inherent risk may have pervasive effect and an account specific effect on the likelihood of material misstatement.
- (f) False. Although ABC Ltd. is not listed on any stock exchange but provisions relating to Audit Committee will apply when paid up capital is ₹ 5 Crore and above.
- (g) False. Another Auditor shall be appointed by the members in General Meeting only i.e. in this case by holding EGM (Sec 224 (6)), as Board of Directors has no power to appoint auditor in place of auditor resigned.

6. (a) What are the main sources of GAAP in India? [2]
(b) How will you verify Development of Property? [3]
(c) Distinguish between – Negative Opinion and Disclaimer of Opinion. [3]
(d) Subsequent to the issue of audit opinion, the auditor of a company came to know about an important matter about the company. Had he known about this earlier, he would have given a different opinion. How you will as an auditor deal under this situation? [3]
(e) What are the advantages of Working Papers? [3]
(f) Financial audit suffers from a number of limitations. Discuss. [4]

Answer:

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

- (i) Accounting Standards and Statements issued by the Institute of Chartered Accountants of India.
(ii) 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.)

- (b) 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 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.

- (c) When the auditor does not have sufficient information (for example, where books of accounts are with the tax authorities) to serve as the basis of his opinion, he may disclaim an opinion on the accounts and balance sheet and profit and loss account. Accordingly, the auditor may state that he is unable to form an opinion on the financial statements. An example of the disclaimer of the opinion can be statement by the auditor that "we have been unable to state whether the Balance Sheet shows a 'true and fair' view....." In certain circumstances, the auditor may not get access to all the books of account for certain reasons. There may also exist very material items, the value of which may be totally uncertain. In many cases certain material information or explanations may not be forthcoming. Whenever an auditor disclaims an opinion he should give reasons for the same.

An adverse or negative opinion will be given when there is a sufficient basis for the auditor to form an opinion that the accounts and financial statements, taken as a whole, do not present a true and fair view of the financial statements and the operating results of the enterprise. Thus, the rule is that where the reservations are so material that rendering a qualified opinion would not serve the purpose, the alternative is to make an adverse report.

- (d) Section 231 of the Companies Act, 1956 empower the auditors of a company to attend any general meeting of the company, to receive all the notices and other communications relating to the general meeting of the company, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Where the auditor has reason to believe that the directors concealed deliberately a serious fact from the shareholders which came to his notice after issuance of the audit report, he should exercise this right. Normally speaking, an auditor considers subsequent events only upto the date of issuance of the audit report.

The discovery of a fact after the issuance of the financial statements that existed at the date of the audit report which would have caused the revision of the audit report requires that the auditor may bring this to the notice of shareholders.

Likewise, it may be advisable for the auditor to attend the meeting with a view to bringing to the notice of the shareholders, any matter which came to his knowledge subsequent to his signing the report and if it had been known to him at the time of writing his audit report, he would have drawn up the report differently, or where the accounts

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have been altered after the report was attached to the accounts.

(e) Working Papers are necessary to -

- (i) Aid in planning and performance of the audit,
- (ii) Aid in the supervision and review of the audit work,
- (iii) Provide evidence of the audit work performed to support the Auditor's opinion,
- (iv) Record and demonstrate the audit work from one year to another,
- (v) Plan the timing and extent of audit procedures to be performed,
- (vi) Draw conclusions from the evidence obtained,
- (vii) Standardise the Working Papers and audit procedures to improve the efficiency of the audit,
- (viii) Facilitate the delegation of work as a means to control quality of work performed,
- (ix) Provide guidance to the audit staff with regard to the manner of checking the schedules,
- (x) Fix responsibility on the staff member who signs each schedule checked by him, and
- (xi) Act as evidence in a Court of law when a charge of negligence is brought against the Auditor.

(f) Financial audit is primarily concerned with verification of accounting data for determining the reliability and accuracy of accounting statements and report upon whether the financial statements reveal the 'true and fair' view of the working results and state of affairs of the enterprise. With this end in view, the financial auditor limits his work to vouching of transactions, reviewing internal controls, assessing the effectiveness of internal audit to the extent he can plan the audit or simplify audit procedures and verifies the assets and liabilities in order to express his opinion on the financial statements.

In view of time constraints, financial auditor performs only Test Checks depending upon his judgement of the controls present in the organization. He relies mostly on vouchers, minutes of the Board Meeting and correspondence with customers/ suppliers and that too on test basis and is not concerned about the quality of transactions.

Since his attention is preoccupied with books of accounts and records, financial audit does not cover qualitative aspects of business or human resources/factors in the organization.

Financial auditor does not get time enough to examine supervisory efficiency, propriety of managerial decisions, and contributions of the enterprise to environment and society at large. The scope of Financial audit does not cover audit efficiency, economy, effectiveness and last but not least, the need for incurring expenses-propriety aspects.

The financial auditor largely relies on Books of Accounts; and the controls functioning in the entity and expresses his opinion on the financial statements in respect of the working results and state of affairs as they are, not as they ought to be. Thus the scope of financial audit is very limited.

7. (a) How will you vouch / verify stock lying with job-worker? [3]
(b) What are the rights of the Branch Auditor and the Company Auditor, with regard to audit of Branches? [3]
(c) What are the responsibilities of joint auditor? [2]
(d) Write short note on – Qualities of Management Auditor. [3]

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- (e) The overall objective and scope of audit does not change in computerized environment – Explain. [4]
- (f) Write short note on – Types of CAATs. [3]

Answer:

- (a) Semi-Finished Goods may be lying with the third parties for further processing. The Auditor's responsibility in relation to such goods can be summarized as under-

Aspect	Matters to be verified /Auditors' Duties
Delivery Challan and Excise Records	Verify the quantity of the goods despatched to the third party to know the value of the goods sent at the time of despatch.
GRN of Contractor	Confirm whether the goods despatched to third parties have been actually received by them, by examining GRN issued by them.
Confirmation from processor	<ul style="list-style-type: none">• Verify the quantity lying with the processor at the year-end, by obtaining a confirmation showing quantity of materials and date of receipt.• Confirm whether goods sent have been received back within reasonable time and are in accordance with the agreed specifications.
Valuation and Disclosure	<ul style="list-style-type: none">• Ensure that the goods are valued properly at each stage of completion in respect of WIP, inclusive of expenses incurred in sending the goods for processing.• Where the amount is material, disclose the same separately as "Stock in hands of Processors or Contractors".

- (b) Rights of Branch Auditor [Sec.228 (3)]:

- (a) Audit Powers: To exercise the same powers and duties in respect of Branch Office Audit as enjoyed by the Company's Statutory Auditor in respect of the Company's Audit.
- (b) Reporting: To prepare a Report on the accounts of the Branch Office examined by him and to forward it to the Company's Auditor who shall deal with it in the manner required to prepare / finalise his Report.
- (c) Remuneration: To receive such remuneration as the Company in General Meeting or the Board may fix.

Rights of Company Auditor [Sec.228 (2)]: The Company Auditor shall have the following rights when the Branch Accounts are audited by another person -

- (a) To visit Branch Office, if deemed necessary for the performance of his duties, and
- (b) To have access at all times to the books, accounts and vouchers maintained at the Branch Office.

In case of Foreign Branches of Banking Companies, the Company Auditor is allowed access to such copies of and extracts from the books and accounts of the Branch, as have been transmitted to the Head Office in India.

- (c) **Responsibilities of joint auditor**

In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him.

Each auditor should bring to the attention of the other joint auditors matters requiring discussion, disclosure or application of judgment, by submitting a report or a note prior to the finalisation of audit. If any such matter were brought to the attention of the other joint

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auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible in respect of those matters.

It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him.

(d) Whoever maybe 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 most important objective of an audit of financial statements, prepared in accordance with recognized accounting policies and practices and within the framework of relevant statutory requirements, if any, is to ensure that the financial statements reflect a true and fair view of the state of affairs of the auditee. The scope of an audit of financial statements is determined by the auditor taking due note of the terms of the audit reference, the requirements of relevant legislation and the pronouncements of the Institute made from time to time. This would involve assessment or reliability and sufficiency of the information contained in the accounting records and other source data; this in turn involves systematic study and evaluation of accounting system and internal controls in place. The overall objective and scope of an audit does not change in an EDP environment; it remains the same. It is the use of the computer which modifies the processing and storage of financial information. This may affect the methods and procedures employed by the entity to endure presence of adequate internal control system. As a logical consequence, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls as well as the nature, timing and extent of his other audit procedures may be significantly influenced by an EDP environment. The computerization of accounts would also have an impact on the increase in fraud and errors. In an EDP environment, empirical studies have revealed that a huge quantum of loss arises on account of errors and omissions and that the greatest threat to the organization comes from its employees. The auditor should bear these aspects in mind while auditing the computerized system. Further, when auditing in an EDP environment, the auditor should have sufficient understanding of computer hardware, working idea of the software and processing systems to plan the engagement and to understand how EDP affects the study and evaluation of internal control and application of auditing procedures. These would be required to plan usage of generalized audit software and computer-assisted audit techniques. Thus, it is clear from the above that overall objective and scope of audit does not change irrespective of fact that whether the accounting is generated manually or through EDP.

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(f) 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.

8. (a) State the basis and types of liability of auditors. [2]
- (b) Z Ltd. wanted to treat the heavy advertisement expenditure incurred by them to launch a new product as Revenue Expenditure. The product did not pick up and the sales were negligible. It is anticipated that no material benefit would accrue in future from such heavy advertisement expenditure. Comment. [3]
- (c) List the areas in which internal audit operate. [2]
- (d) List the factors to be considered for preparing an Audit Programme? [2]
- (e) Mention any four items that are not suitable for test checking. [3]
- (f) List the situations where statistical sampling methods may not be appropriate. [3]
- (g) "Doing an audit in an EDP environment is simpler since the Trial Balance always tallies." Analyse critically. [3]

Answer:

(a) Liabilities of Auditor

Auditor's liability is most dynamic & always changing from time to time. In past auditors were held liable to their principals only but now a days they are liable to third parties too. Auditors liabilities can be classified as under.

- Liabilities for Negligence
- Liabilities under the Companies Act 1956
- Liabilities for misfeasance
- Liabilities under Penal Code
- Liabilities under Chartered Accountants Act, 1949 and under Cost & Works Accountants Act 1959. (under specific reference)
- Liabilities under the Income Tax Act 1961.
- Liabilities to the third parties.

(b) Deferred Revenue: When "heavy" advertisement expenditure is incurred for a "new" product, the inherent presumption is that the benefits will be received over a longer

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period. Hence, such expenditure are treated as Deferred Revenue Expenditure and written off to the P&L Account over a future period, say 4 or 5 years.

Analysis: Deferral of expenditure is done only with the anticipation that benefit is likely to accrue in future accounting periods. However, if it is almost established that the advertising effort is not going to succeed i.e. no benefit is likely to flow in future, there is no purpose in deferring the same.

Conclusion: If product is unsuccessful, the expenses incurred should be written off to the P & L A/c. Hence, the writing off of the entire expenditure to revenue is appropriate and correct.

(c) Internal Audit covers the following areas:

- (i) Review of accounting system and related internal controls.
- (ii) Examination of financial and operating information, on behalf of management.
- (iii) Examination of economy, efficiency and effectiveness of operations, including non-financial controls of the organization.
- (iv) Physical examination and verification of Tangible Assets.

(d) While constructing an Audit Programme, the Auditor should keep the following points in his mind -

- (i) To operate within the scope and limitation of the assignment.
- (ii) To determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- (iii) To apply only those steps and procedures, which are useful in accomplishing the verification purpose in the specific situation.
- (iv) To consider all possibilities of error.
- (v) To co-ordinate the procedures to be applied to related items.

(e) The following items are not suitable for test-checking:

- Opening and Closing Entries.
- Bank Reconciliation Statement.
- Balance Sheet Items - Loans, Advances, Other Assets and Liabilities.
- Matters involving estimation as well as computation, e.g. Depreciation, Royalty, etc.
- Transaction that may be small in number but important and material.
- Transactions, which are recognised by law to be looked into by the Auditor carefully, e.g., Managerial Remuneration, Dividends, Shares issued for Cash Consideration, etc.
- Seasonal industry, where test checking is carried out on annual basis.
- Transactions of non-recurring nature or exceptional transactions.
- Transactions involving statutory payments / dues, e.g. ESI, EPF, Tax Deduction at Source, etc.

(f) The Auditor should not adopt statistical sampling, in the following circumstances:

- When the population is too small (i.e. all items can be checked in such case),
- When the population is very diverse and cannot be identified into strata or clusters,
- When the internal control system is weak and unreliable,
- When another audit approach is necessary to obtain sufficient evidence,
- When another audit approach will provide satisfactory information in less time or less effort,
- Where the statistical sampling methods are not likely to satisfy the level of assurance

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- required,
- When exact accuracy is required, and
- Where legal requirements are involved

(g) In an EDP environment, the Trial Balance may always tally, but it does not necessarily mean that the job of an auditor becomes simpler.

There is a possibility of -

- (i) Errors of complete omission
- (ii) Compensating errors
- (iii) Duplication of entries
- (iv) Errors of principles, and
- (v) Deliberately concealed frauds even when the Trial Balance tallies.

Tallying of Trial Balance may mean arithmetical accuracy in most cases. But the audit objective is expression of opinion on the true and fair view of the Financial Statements, not just ensuring arithmetical accuracy.

Accounting aspects have become multi-faceted due to emergence of concepts like lease finance, options and futures, derivatives, off-balance sheet financing, packaged lending, book building etc.

Besides tallying a Trial Balance, there are other audit issues like estimation of depreciation, valuation of inventories, etc. where the auditor is required to exercise his skill and judgement.

In view of the above, it may be concluded that a tallied Trial Balance in an EDP environment need not necessarily simplify the audit function.