

**Paper-6: COMMERCIAL AND INDUSTRIAL LAWS AND AUDITING**

Full Marks: 100

Time Allowed: 3 Hours

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

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

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

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

**Question 1: Answer all questions**

**[2 X 7 = 14]**

Comment on the following:

(i) "Fragrance" Soap Co. advertised that it would give a reward of ₹ 1,000 who developed skin disease after using, "Fragrance" soap of the company for a certain period according to the printed directions. Miss Nisha purchased the advertised "Fragrance" soap and developed skin disease in spite of using this soap according to the printed instructions. She claimed reward of ₹ 1,000. The company refused the reward on the ground that offer was not made to her and that in any case she had not communicated her acceptance of the offer. Decide whether Miss Nisha can claim the reward or not. Refer the relevant case law, if any.

(ii) A draws a bill on B. B accepts the bill without any consideration. The bill is transferred to C without consideration. C transferred it to D for value. Decide -

- A. Whether b can sue the prior parties of the bill, and  
B. Whether the prior parties other than D have any right of action intense?

Give your answer with reference to the Provisions of Negotiable Instruments Act, 1881.

(iii) Mr. Wadhwa is working as an accountant in a company on salary basis. The following payments were made to him by the company during the previous financial year -

- (a) Overtime allowance,  
(b) Dearness allowance  
(c) Commission on sales  
(d) Employer's contribution towards pension fund  
(e) Value of free food.

Examine as to which of the above payments form part of 'salary' of Mr. Wadhwa under the provisions of the Payment of Bonus Act, 1965.

(iv) While an employee may increase his contribution to Provident Fund, is an employer also liable to proportionately increase his contribution to the above under the Employees Provident Funds and Miscellaneous Provisions Act, 1952? Comment.

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(v) National Steels Limited decided to forfeit the amount of gratuity of its employee Cezar on account of disorderly conduct and other acts which caused loss to the property belonging to the company. Cezar committed the following act. He, after superannuation, continued to occupy the quarter of the company for six months.

Against the decision of the company, Cezar applied to the court for relief. The Company contended that the right to gratuity is not a statutory right and the forfeited amount of gratuity was within the law.

Examine the contention of the company and the decision taken by the company to forfeit the amount of gratuity in the light of the Payment of Gratuity Act, 1972.

(vi) With a view to boost sales Harmeet Automobiles sells a motorcar to Ms. Nikki on trial basis for a period of three days with a condition that if Ms. Nikki is not satisfied with the performance of the car she can return it back. However the car was destroyed in a fire accident at the place of Ms. Nikki, before the expiry of three days. Would Ms. Nikki be liable for the loss suffered?

(vii) Winston parks his car at a parking lot, locks it, and keeps the keys with himself. Whether this constitutes a contract of 'Bailment' under the provisions of the Indian Contract Act, 1872?

### **Answer:**

(i) Miss Nisha can claim the reward, since there is a contract between Miss Nisha and Fragrance Soap Co.; and in case of a general offer, the acceptance of offer is not to be given by way of communication of acceptance, but is given by way of performance of the terms and conditions of offer.

(ii)

A. Rights of D - D can recover the amount of the bill from all the prior parties since D is a holder for value.

B. Rights of prior parties other than D- No party prior to D can recover the amount of the bill from any prior party since a negotiable instrument creates no obligation of payment between the parties if it was made, drawn, accepted, endorsed, or transferred without consideration.

(iii) Items to be included in 'salary or wage' are:

1. Dearness allowance
2. Value of free food (provided it is given in lieu of salary)

Items not to be included in 'salary or wage'

1. Overtime allowance
2. Commission on sales
3. Employer's contribution towards pension fund

(iv) Rate of contribution of PF is 10% of pay, which may be increased upto 12% of pay by the CG by issuing a Notification in the Official Gazette;

Increase in the rate of contribution - An employee may opt to contribute at a higher percentage than 10% / 12%, as the case may be. However, the employer shall not be bound to make such higher contribution.

(v) Forfeiture of gratuity of Mr. Cezar is not valid since the company is entitled to deduct from the gratuity payable the charges or rent due for six months; but occupying company's quarter does not entitle the company to forfeit the gratuity payable (Wazir Chand v Union of India).

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**(vi)** The subject of the contract, i.e. Motor car was destroyed before the transfer of property from seller to the buyer. The risk passes only when the ownership is transferred to the buyer. So, Ms. Nikki is not liable for the loss suffered due to the fire accident over which Ms. Nikki has no control and Harmeet automobiles has to bear the loss arising due to the accident.

**(vii)** No. Mere custody of goods does not mean possession. For a bailment to exist the bailor must give possession of the bailed property and the bailee must accept it (Section 148, Indian Contract Act, 1872 is not applicable)

### **Question 2:**

**(i) Comment on the following:**

- A. 'Goods seized by Customs Authority are a case of bailment under Indian Contract Act', offer your views.**
- B. Mr. A, Mr. B & Mr. C are Sureties to Mr. D for the sum of ₹6000 lent to Mr. E failed to repay on due date. Mr. A. one of the sureties disagreed to pay. Advice whether 'A' is right.**
- C. A deceit which does not deceive is not a fraud.**

**(ii) Raman instructed Soman, a transporter, to send a consignment of apples to Mumbai. After covering half a distance, Soman found that the apples will perish before reaching Mumbai. Hence, he sold the same at a half the market price. Raman sued against Soman. Will he succeed?**

**(iii) Bill of Exchange dated 1st February, 2014 payable two months after date - was presented to the maker for payment 10 days after maturity. What is the date of maturity?**

**(iv) How the surety is discharged from liability?**

**[6+3+3+6 = 18]**

### **Answer:**

**(i)**

**A.** True. In the instant case, the possession of goods is transferred to the customs authority. Therefore, the provisions of section 148 of the Contract Act, 1872 as to bailment is applicable in this case.

**B.** The liability of the surety towards the creditor is co-extensive with that of the principal debtor, unless it is otherwise provided in the contract of guarantee. The Supreme Court, in the case of Industrial Investment Bank of India Ltd v Biswanth Jhunjunwala, has discussed the issue elaborately and reiterated that the liability of the guarantor/surety and principal debtor is co-extensive and not in the alternative.

Where two or more persons are co-sureties for same debt, either jointly or severally, and whether under the same or different contracts, and whether with or without the knowledge of each other, the co-sureties, in absence of any contract to the contrary, are liable as between themselves, to pay each an equal share of the whole debt or of that part of it which remains unpaid by the principal debtor. In the instant case, Mr. A, Mr. B & Mr. C are liable to as between themselves to pay ₹ 2000/- each. Mr. 'A' cannot escape.

**C.** The statement is correct. A mere attempt to deceive by one party is not fraud unless the other party is actually deceived. If the party has not been deceived at all, there is no point in establishing a case of fraud, and gives no ground of action.

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### **(ii) Agent's Authority in an emergency**

In the instant case, Soman had acted in an emergency situation and Raman will not succeed against him.

As per section 189 of the sale of Goods Act, 1930, an agent has the authority in an emergency to do all such acts as man of ordinary prudence would do for protecting his principal from losses which the principal would have done under similar circumstances. A typical case is where the agent handling perishable goods like 'apples' can decide the time, date and place of sale, not necessary as per instructions of the principal, with the intention of protecting the principal from losses. Here the agent acts in an emergency and act as a man of ordinary prudence.

**(iii)** If a bill is made payable a stated number of months after date, it becomes payable three days after corresponding date of months after the stated number of months (section 23 read with section 22 of NI Act, 1881).

Therefore in this case the date of maturity of the bill is 4th April 2014 provided it is not Sunday or Public Holidays (1st April + 3 days).

### **(iv)**

**(a)** Under any of the following circumstances a surety is discharged from liability.

1. By revocation of the contract of guarantee.
2. By notice of revocation by surety.
3. Due to death of surety.
4. By novation i.e., when a fresh contract entered into, the original contract of guarantee comes to an end and so the surety stands discharged with regard to the old contract.

**(b)** By conduct of the creditor

1. Due to variance in terms of a contract, between the principal debtor and creditor without the surety's consent.
2. Release or discharge of the principal debtor by the creditor - A surety is discharged if the creditor makes a contract with the principal debtor by which the principal debtor is released or by any act or omission of the creditor which results in the discharge of the principal debtor.
3. A contract between the creditor and the principal debtor by which the creditor makes a composition with or promises to give time to or not to sue the principal debtor discharges the surety.
4. By creditor's act or omission impairing surety's eventual remedy (Section 189).
5. Loss of surety - if the creditor parts with or loses any surety given to him at the time of guarantee without the consent of the surety, the surety is discharged to the extent of the value of surety.

**(c)** By invalidation of contract - A contract of guarantee may be avoided if it becomes void or voidable at the option of the surety. A surety in this respect may be discharged from liability in the following cases.

1. When guarantee obtained by misrepresentation.
2. When guarantee obtained by concealment of some material fact relating to contract.
3. Due to failure of co-surety to join a surety. When contract of guarantee provides that creditor shall not act on it until another person joined in it as a co-surety. The guarantee is not valid if that other person does not join.

### **Question 3:**

**Comment on the following:**

**(i) In case of personal injury, the employer is liable to pay compensation within 3 months from**

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the date when it falls due. State legal provisions

(ii) Personal Manager told to Director that at least one canteen shall be provided in every factory. Do you agree?

(iii) Calculate the amount of gratuity of Mr. X who joined the company on 1.5.83 and retired on 30.11.2013 when his salary was ₹ 26,000 per month. During November, 2013 he received overtime and incentive ₹5,000.

(iv) When and under what circumstances a person can receive pension under Employees Provident Fund Scheme?

(v) Dr. B has been dismissed by the Manager of an Industrial Establishment. Workmen demanded his reinstatement. Comment legal position.

(vi) 'A' saved life of 'B' who was drowning, Latter A' demanded remuneration from 'B' for saving of life was valid consideration, A' would succeed.

(vii) There are in total two parties to a Promissory Note.

(viii) What are the circumstances in which limited liability partnership may be would up by Tribunal?

[(7 × 2) + 4 = 18]

### Answer:

(i) In case of personal injury to a workman by accident arising out of and in the course of his employment, compensation in accordance with the provision of the workmen's Compensation Act, shall be paid within 30 days from the date when it falls due otherwise the Employer is to pay interest and penalty too.

(ii) False: In any specified factory wherein more than 250 workers are ordinarily employed, a canteen shall be provided for the workers. Hence it is not mandatory for every factory to provide Canteen.

(iii) Mr. X worked from 1.5.83 to 30.11.13 i.e. 30 years 6 months 29 days.  
For the purpose of gratuity calculation, service period is taken for 31 years.  
Hence  $31 \times 26000 / 26 \times 15 = 4,65,000$  or ₹ 10,00,000  
Whichever is lower. Hence he will be entitled to ₹ 4,65,000. Overtime or incentives are excluded.

(iv) Under following circumstances pension can be allowed:

- A. On superannuation on reaching 58 years of age or more and at least 10 years of service.
- B. Before superannuation but on reaching 5 years of age or more up to 58 years with at least 10 years of service but the members may not be in service.
- C. On death of the member while in service or not in service.
- D. Permanent disability totally unfit for the employment which the member was doing at the time of such disablement.

(v) As per Industrial Disputes Act a workman includes any person including an apprentice employed in an industry to do manual, unskilled, skilled, technical, operational, clerical or supervisory work. However it excludes those employed in Managerial or Administrative capacity.

- A. The workmen can demand reinstatement of Dr. B treating Dr. B as workman.

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- B. However Dr. B may not be termed as workman as he was employed in Administrative or managerial capacity
- C. Hence there may be industrial disputes.

**(vi)** Consideration should be at the desire of promisor 'A' cannot demand payment for his service to save B's life because (i) it was voluntary gratuitous act and not at the desire of 'B'. Where, however, a 'Person' lawfully does anything for "another person" not intending to do so gratuitously and such other persons enjoys the benefit thereof the "another person" bound to make compensation to the "person" in respect of the thing so done.

**(vii)** A 'promissory note' is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument. There are only two parties, the maker (debtor) and the payee (creditor). A note contains an unconditional promise by the maker to pay the payee. No prior acceptance is needed. The liability of the maker on drawer is primary and absolute. No notice of dishonour need be given. The maker of the note stands in relation with the payee

**(viii)** The circumstances in which a limited liability of partnership may be dissolved by Tribunal are provided in section 64 of the Limited Liability Partnership Act, 2008 A limited liability partnership may be wound up by the Tribunal in following ways-

1. The limited liability partnership decides that limited liability partnership be wound up by the Tribunal;
2. If, for a period of more than six month, the number of partners of the limited liability partnership is reduced below two;
3. If the limited liability partnership has acted against the interests of the sovereignty and integrity of India, the security of the state or public order;
4. If the limited liability partnership has made a default in filing with the Registrar the statement of account and solvency or annual return for any five consecutive financial year; or
5. If the Tribunal is of the opinion that it is just and equitable that the limited liability partnership be wound up.
6. If the limited liability partnership is unable to pay its debts.

### **Question 4:**

**(i) Mr. Arun was an employee of High Developers Limited. He retired from the company after 30 years of continuous service. He applied to the company for payment of gratuity within the prescribed time. The company refused to pay the gratuity and contended that due to stringent financial conditions the company is unable to pay the gratuity. Mr. Arun applied to the appropriate authority for recovery of the amount of the gratuity. Examine the validity with reference to Payment of Gratuity Act, 1972**

**(ii) Kumari is an employee of Rahul software limited, which works 5 days a week. Kumari was not in continuous service during the financial year 2013-14. However, she worked only for 150 days because she was on maternity leave with full pay for 50 days. Referring to the provisions of Payment of Gratuity Act, 1972 decide whether kumari is entitled to gratuity payable under this Act. Would your answer be different had Rahul Software worked for 6 days a week.**

**(iii) X, a temporary employee drawing a salary of ₹3000 per month, in an establishment to which the Payment of Bonus Act, 1965 applies was prevented by the employers from working in the establishment for two months, during the financial year 2013-14, pending certain injury. Since there were no adverse findings X was re-instated in service. Later when the bonus was to be paid**

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to the other employees, the employers refused to pay bonus to X, even though he had worked for the remaining ten months in the year. Referring to the provisions of Payment of Bonus Act, 1965 examine the validity of employers refusal to pay bonus.

(iv) Mr. Paul sold to Mr. Ray certain quantity of foreign refined palm oil warranted equal to sample. The samples consisted of palm oil mixed with vegetable oil. The oil tendered corresponds with the sample but it was not such as is known in market as foreign refined palm oil. Mr. Ray wants to reject the oil on the ground that the oil supplied was not in accordance with the foreign refined palm oil. Advise Mr. Ray.

(v) During 2001-2002, the employees were 50 and subsequently reduced to 10 during 2013-2014, Employer discontinued deduction as EPF not applicable due to reduction of Employees. Comment.

(vi) Manager of the factory fixed the working hours of women from 6:00 P.M. to 1:00 A.M. during the period from Monday to Friday of first week of May 2014. Whether it is permissible, cite with Rule position.

[2+5+5+2+2+2 = 18]

### Answer:

(i) The refusal of the company to pay gratuity is not valid, since it is a statutory obligation of the employer to pay gratuity to Mr. Arun and no such ground is provided under the Act for non-payment of gratuity.

Hence Mr. Arun is entitled to recover the gratuity with the provisions of Sec 8.

(ii) Number of working days for Kumari as per Sec 2A would be:

= Days actually worked + Days on which a female employee was on maternity leave provided that the period of maternity leave does not exceed 12 weeks  
= 150 + 50 = 200 days

Kumari shall be deemed to be in continuous service since she has worked for not less than 190 days in the establishment which works for less than 6 days in a week. Therefore, Kumari shall be entitled to Gratuity, since she was in continuous service, as per Sec 2A

Kumari would not have been entitled for gratuity if Rahul Software Ltd. worked for 6 days a week since, in such a case the legal requirement for being in continuous service is that the employee should have worked for 240 days, whereas Kumari has worked only for 200 days.

(iii) X is an employee since his salary is not more than ₹10,000. It is immaterial that he is a temporary employee. Sec 2(13).

X would be eligible to receive bonus since he has worked for 10 months i.e. 30 days or more during the AY (sec 8) and since it is immaterial that the employment of X was of temporary nature or permanent nature. X is not disqualified u/s 9 since he has not been dismissed from service.

Therefore we may conclude, employer's refusal to pay bonus to X is not valid. X would be entitled to bonus for the entire period of 12 months since absence for the period of 2 months due to suspension was not due to the fault of X. [Project Manager, Ahmedabad Projects, ONGC Vs Shyam Kumar Sahegal]

(iv) Mr. Ray can reject the goods. In case of sale by sample as well as by description, goods

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must not only correspond to sample but also to description i.e. foreign refined palm oil.  
(Section 15 of the Sale of Goods Act, 1930)

No amount of exemption clauses can compel a person to buy a thing different from contracted to buy.

**(iii)** Employees' Provident Fund & Misc. Provisions Act, 1952 provides that once the Act, applies to any establishment it shall continue to be governed by the Act irrespective of the fact that the number of employees working there in have subsequently fallen below 20.

Hence in this case EPF scheme shall continue.

**(iv)** As per provisions of Factories Act no women shall be allowed to work from 7:00 P.M. to 6:00 A.M.

However the State Government may in respect of any factory or group or class or description of factories vary the above limits. No such variation shall authorize the employment of any women between, the hours of 10:00 P.M. and 6:00 A.M.

Hence factory manager violated the rules.

### **Section-II (50 Marks) (Auditing)**

#### **Question 5: Answer all questions**

**[2 X 7 = 14]**

**(i) Propriety audit is applicable to all limited companies in all aspects.**

**(ii) Accounting Standard – I requires all significant accounting policies to be disclosed normally in one place and as a part of the financial statements.**

**(iii) While conducting audit of stocks, verification of stock records is of primary importance to operational auditor.**

**(iv) Companies, on the grounds of confidentiality, may decline to provide information required by the auditor.**

**(v) Interest accrued and due on secured loans has been disclosed in the Balance Sheet under the head " Current Liabilities and Provisions" on the ground that such interest has to be paid within six months from the end of the financial year.**

**(vi) As per Indian GAAP, where the company has obtained credit limits from a bank but has not availed them, the details of unused credit lines need not be disclosed in the financial statements.**

**(vii) Shareholders, by a majority vote, have authorized the Board of Directors to keep the books of accounts of the company in its Administrative Office, as against the earlier practice of keeping them in the Registered Office. The ROC was not informed about this change. Company intends that this practice is in order**

**Answer:**



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

In case of non-government companies, the auditor has to comment upon some of the propriety aspects in the transactions of the companies, for example under CARO 2003 pursuant to section 227 of Companies Act, 1956. Otherwise, nongovernment company auditors do not conduct propriety audit unlike in case of Government Companies.

**(ii)** The statement is true. Different Accounting policies affect the financial performance and financial position of the enterprise. For proper understanding of the financial statements, AS-1 requires the disclosure of the policies at one place and as a part of the financial statements.

**(iii)** The statement is true. Operational Audit focuses more on qualitative aspects of operations rather than regular financial aspects. Operational audit is a systematic evaluation of operational activities to ensure that they are in line with objectives of the organization. So while auditing stocks the operational auditor is more concerned with reorder policy, inventory management policy, obsolescence policy, adequacy of security and insurance on stocks than mere ticking of stock records.

**(iv)** The statement is false. To enable the statutory auditor to perform the duties without fear or favour, The Companies Act, 1956 gives him certain rights such as right of access to books and records, right to require information and explanations from officers, right to attend general meetings etc.

Under section 227 of the Companies Act, 1956 duties are cast on him to make enquiries in certain matters and his report should state whether he has obtained all information and explanations which to the best of his knowledge and belief were necessary for the purpose of audit, and whether the financial statement are in agreement with books of account and records. Hence the company cannot refuse to divulge the information required by the auditor. In case of such refusal the auditor will have to give a negative report or a qualified report depending upon the materiality of the information called for by him but refused by the company.

**(v)** The disclosure is not in accordance with Part I of Schedule VI of the Companies Act, 1956 which specifically requires the disclosure of such interest under the appropriate subheads under 'Secured Loans'. Interest accrued but not due is to be shown under "Current Liabilities and Provisions"

**(vi)** The statement is true. Only the current portion of the debt or whatever is the amount which is outstanding on the date of the preparation of the financial statement is to be disclosed. There is no requirement as to disclosure of unused limits.

**(vii)** The statement is false. As per Section 209 of the Companies Act, 1956, the books of accounts can be kept in a place other than its registered office also, but the Board of Directors should within seven days, file a written notice to the Registrar of Companies, the full address of the new place. Here the company has not complied with this mandatory requirement.

### **Question 6:**

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**(i) State the matters which the statutory Auditor should look into before framing opinion on accounts on finalisation of audit of accounts?**

**(ii) How will you vouch and/or verify the following?**

- 1. Goods sent on consignment**
- 2. Provision for Income Tax**
- 3. Goodwill**

**[6+(3 × 4) = 18]**

**Answer:**

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

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

**(ii)**

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### **1. Goods Sent on Consignment :**

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

### **2. Provision for Income Tax :**

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

### **3. Goodwill :**

- A. Ensure that as required by AS 10 on "Accounting for Fixed Assets", goodwill has been recorded in the books only when some consideration in money or money's worth has been paid for. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.
- B. Check the vendor's agreement on the basis of which assets of the running business have been acquired by the company at a price existing in the book value of the assets or where a specific sum has been paid for the goodwill.
- C. See that only the amount paid to the vendors not represented by tangible assets has been debited to the goodwill account. Therefore, it is not prudent that goodwill should be shown in

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the company's accounts by way of writing up the value of its assets on revaluation or writing back the amount of goodwill earlier written off by the company.

D. See whether goodwill has been written off as a matter of financial prudence.

### **Question 7:**

**(i) Capitalisation of Borrowing Costs would continue during extended periods in which active development is interrupted. Comment**

**(ii) Global Ltd. is engaged in manufacturing and supply of gear boxes to International Ltd. As per terms of supply, full price of the goods are not released by International but 10% thereof is retained and paid after one year, if there is satisfactory performance of the parts supplied. Global Ltd. accounts for only 90% of the invoice value as sale at the time of supply and balance 10% is accounted as sale in the year of receipt of payment.**

**(iii) What are the main points involved in 'Performance Audit' under Government Accounting system?**

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

**(v) Dividends can be declared out of balances in share premium account. Comment**

**[3+4+5+4+2 = 18]**

### **Answer:**

**(i)** The statement is partly true. Though capitalization of borrowing costs should be suspended during extended periods in which active development interrupted (AS-16, Para 17), it is not suspended during a period when substantial technical and administrative work is being carried out, capitalization of borrowing costs is also not suspended when there is temporary delay as a necessary part of getting an asset ready for its intended use or sale. E.g high water level delaying or stopping the construction of a bridge for temporary period.

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

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

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

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

**(iii)** Performance audit refers to an examination of a program, function, operation or the management systems and procedures of a governmental or non-profit entity to assess whether the entity is achieving economy, efficiency and effectiveness in the employment of available

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resources. The examination is objective and systematic, generally using structured and professionally adopted methodologies.

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

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

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

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

Efficiency cum performance audit is examination of Financial & operational aspect of performance. The performance audit involves preliminary study, planning & execution of audit & reporting.

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

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

**(v)** Dividends can be declared only out of revenue profits available for distribution. Section 78 of the Company's Act, 1956 prescribes the purposes for which share premium amounts can be utilized and declaration of dividend is not one of the purposes declared under Section 78.

### **Question 8:**

**(i) As a Company Auditor how would you react to the following situations?**

- 1. Insurance claim of ₹ 5 lacs received stands included under Miscellaneous Income.**
- 2. ₹ 7.50 lacs paid by a cosmetics company to the legal advisor defending the patent of a product treated as Capital Expenditure.**
- 3. ABC Ltd. has not deposited provident fund contributions of ₹ 50 lacs to the authorities, but accounted in the books.**
- 4. Directors of Sweet Ltd. declared a final dividend of 30% for 2013-14 in their meeting held on 11-8-2014.**

**(ii) In carrying out audit of Government expenditure, what are the basic standards that you will examine and consider?**

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**(iii) Auditor of a company has to approach his work with suspicion. Comment**

**[(4 × 3)+4+2 = 18]**

**Answer:**

**(i)**

1. The principle laid down in AS 5 that even those items of income and expense which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance may be disclosed separately. However, money received from the insurance company is against a specific loss. It has to be adjusted against the loss. The auditor should check the adjustment of the amount received in short of the value of actual loss as per the insurance policy.

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

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

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

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

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

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

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

1. That the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with financial rules and regulations. This is called Audit against rules and orders.

2. That there is proper sanction, either specific or general accorded by the competent authority. This is called as Audit of sanction.

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3. That there is provision of funds out of which expenditure can be met with the authorisation of the competent authority. Such an audit is called Audit against provision of fund.
  4. That the expenditure is incurred with due regard to broad and general principles of financial propriety. This is called as propriety audit.
  5. That the various programmes, schemes and projects where large financial expenditure has been incurred is being run economically and are yielding results expected of them.
- (iii)** The statement is false. The auditor need not be suspicious. He is a 'watch dog' but not a 'blood hound'. However, he has to approach his work with care and caution. Once his suspicions are aroused, he must probe it to the bottom.