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GROUP I

PAPER - 6 : COMMERCIAL & INDUSTRIAL LAW AND AUDITING

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INTERMEDIATE EXAMINATION

(REVISED SYLLABUS - 2008)

GROUP - I

Paper-6 : COMMERCIAL AND INDUSTRIAL LAW AND AUDITING

SECTION - I

(Commercial and Industrial Law)

Q. 1. Comment on the following based on legal provisions :

(i) 'A' rides an autorickshaw for going to his destination and takes a seat. The fare chart is displayed boldly in the auto stand. Whether A is bound to pay the fare displayed in the chart?

(ii) D appoints his brother C who is 16 years 7months as his agent.

(iii) C delivered furniture items to AB Transport Co. for transporting the goods from Asansol to Kolkata. On the way the truck carrying the items met with an accident due to rash driving on part of the driver and the goods got damaged . C sued the owner of the Co. for the loss.

(iv) Minor under Contract Act is always beneficiary.

(v) F advances money to E. E uses the money to smuggle pirated CDs and DVDs. F unaware of the purpose, sues E to recover the amount.

(vi) Risks follows ownership.

(vii) X obtains possession of a motorcycle under hire-purchase agreement. He then sells the same to Y who purchased the same in good faith and for value. Meanwhile X defaults in paying the hire charges and the owner wants his motorcycle back. Y pleads ignorance of the defective title.

(viii) A places an order with D for supply of tomato sauce of a particular brand. D supplies tomato sauce of a different brand. A rejects the lot. D redelivers the ordered lot with correct specifications. But A refuses to accept the same and cancels the order.

(ix) 'A stipulation may be a condition though called warranty in a contract.'

(x) Factories employing women workers should maintain crèches.

(xi) 'A' joined FL Engineering Works (P) Ltd. on 5.3.2009. On 8th December, 2009 he was laid off as the management wanted to slow down due to shortage of power. 'A' was not allowed lay-off compensation on the ground that his period of service was less than one year.

(xii) X met with an accident while returning from work. He was travelling by bus provided by his employer. He filed a civil suit against the employer for claim of compensation.

(xiii) XYZ (P) Ltd. imposed a fine on D, one of its employees for regularly reporting late for work. The fine was imposed on 4th April, 2008. The management wanted to recover the amount in September, 2008 during half yearly increment.

(xiv) Minimum wage rate may vary.

(xv) 'B' joined ADC (P) Ltd. on 6.3.2009. The employer said that he will have to wait for one year to be a member of EPF till he becomes permanent.

(xvi) When is a person allowed Gratuity even before completing 5 years of employment?

(xvii) K earns a salary Rs. 9000/- per month. Bonus declared by the establishment is 12% of salary . Bonus received by K is Rs. 5040.

(xviii) W has balance of Rs. 4000/- in XY Bank. He draws a cheque of Rs. 14,000/- in favour of C knowing fully that he has no O/D facility. The cheque is dishonoured. Is notice of dishonour to W necessary?

(xix) Limited Liability Partnership is distinct from limited partnership.

(xx) "Predatory price" is sale of goods or provision of services at cost plus nominal profit for purposes of Section 4 of Competition Act ,2002.

(xxi) Applicability of RTI Act, 2004.

Answers 1.

(i) As per law, acceptance can be both express and implied. From the circumstances, one can infer that there is an implied acceptance on part of 'A' to pay the fare on reaching his destination.

(ii) As per Law of Contract, as an agent doesnot make contract on his own, he need not have contractual capacity. So a minor may be appointed as an agent. However a minor cannot be held responsible to his principal. So, nothing in law prohibits C from becoming an agent of 'D'. But he will not be responsible to 'D'.

(iii) The position of owner of the transport company is that of a bailee. He is responsible to take reasonable care of the goods.The goods got damaged due to negligence of his employed driver. So he is liable to pay C for the loss.

(iv) As per Indian Contract Act, 1872 an agreement with a minor is void abinitio. However there is nothing that debars him from becoming a beneficiary i.e. payee, endorsee or promisee in a contract. The law does not regard him incapable of accepting a benefit. It should be however remembered that his property is liable for meeting the liability arising out contracts to supply him his necessaries.

(v) The agreement is void as the purpose is illegal. However, as F was not aware of the purpose, F can recover his money.

(vi) As per Sec. 26 of Sale of Goods Act the goods are at buyer's risk when the property in the goods passes to the buyer whether delivery has been made or not. So risk follows ownership unless otherwise agreed.

(vii) As X possesses a defective or no title to the motorcycle, he cannot give a better title as sale involves transfer of ownership. So Y cannot claim a good title to the motorcycle and the owner has right to get it back.

(viii) As per Sale of Goods Act, the right reject goods is not equivalent to right to reject the contract. So A is bound to accept the lot sent with correct specifications.

(ix) How a contract is constructed decides whether a stipulation is a condition or warranty in a contract. For example, when a person buys a particular Pressure Cooker which is warranted to cook rice in just 5 minutes. In case it doesn't the only remedy to the buyer is to claim damages. But if the buyer insists on buying a Pressure Cooker that cooks rice in just 5minutes, the stipulation is a Condition and the buyer may reject the offer.

(x) As per Sec. 48(1) of Factories Act, 1948 , every factory employing more than 30 women workers should maintain crèches for children under the age of six. Such crèches should have adequate lighting and ventilation facility and under charge of women trained in child care.

(xi) Under Sec. 25-B of Industrial Disputes Act, 1947, a workman shall deemed to be in continuous service of one year if has worked for at least 240 days during the period of 12 months preceding the reference date of calculation. 'A' has worked for 273 days before he was laid off. So he is entitled to lay-off compensation and can claim the same.

(xii) X is not entitled to compensation under Workmen's Compensation Act , 1923 as he has filed a civil suit against the employer.

(xiii) As per Sec. 8(7) of The Payment of Wages Act, 1936 no fines can be recovered after expiry of 90 days from the date on which it is imposed. So XYZ(P) Ltd. will not be able to recover the fine in September, 2008 as the gap exceeded 90 days.

(xiv) As per Sec.3(3)(a) of Minimum Wages Act, 1948 minimum wage rate may vary depending on different :

(a) scheduled employment

(b) classes of work in same scheduled employment

(c) locality.

(xv) As per EPF and Miscellaneous Provisions Act, an employee can become a member of EPF scheme from the very first day of joining a covered establishment. So B has a right to join the scheme from 6.3.2009 itself.

(xvi) In case of death of an employee, he is entitled to Gratuity even before completing 5 years of service.

(xvii) As per Sec. 12 of The Payment of Bonus Act, where the salary /wage of an employee is more than Rs. 3500/- per month, for the purpose of calculation of bonus salary should be taken as Rs. 3500/-.

(xviii) Notice of dishonour is not necessary when the party charged could not suffer damage for want of notice. As such notice of dishonour to W is not necessary.

(xix) Limited Liability Partnership is distinct from limited partnership in the following ways :

Limited liability partnership is granted to all partners.	Limited partnership is granted to a set of non managing partners only.
The law relating to partnership is not applicable.	The law relating to partnership is very much applicable.

(xx) For the purposes of the above mentioned section of the said Act, "predatory price" is sale of goods or provision of services at a price below cost, as may be determined by regulations, of production of goods or provision of services, with a view to reduce competition or eliminate the competitors.

(xxi) The Act extends to whole of India except the State of Jammu and Kashmir.

Q. 2. Write explanatory notes on the following :

Law of Contract :

(i) Consensus ad idem

(ii) Sometimes a contract without consideration is valid.

(iii) Agency by estoppel.

(iv) Obligations of a finder of lost goods.

(v) Some contracts need not be performed.

Sale of Goods Act :

(vi) The term 'property' in Sale of Goods Act denotes both possession and ownership.

(vii) Delivery of goods may be actual or constructive.

(viii) Unpaid seller's 'Right of lien'.

Industrial Laws :

(ix) 'Standard family ' under Sec. 59 of Factories Act, 1948.

(x) Settling an EPF A/c.

(xi) Lay off and retrenchment have same legal implication under Industrial Dispute Act.

(xii) How do you define 'disablement' under the Workmen's Compensation act?

(xiii) Permissible limit on deductions from wages under Payment of Wages Act.

(xiv) Define an "Establishment in public sector". What are the circumstances when the Payment of Bonus Act, 1965 becomes applicable to such an establishment?

(xv) Normal wages of B along with his colleagues were reduced by his employer for a particular day in a month. The reason provided by management was that as they had worked for less than normal working hours on account of power failure, their wages have been proportionately reduced . Whether the employer is right or wrong?

(xvi) Maximum amount of gratuity under Payment of Gratuity (Amendment) Act, 1998 has been fixed at Rs. 350000. This ceiling cannot be exceeded.

Others Laws :

(xvii) Define the term 'complainant' under the Consumer Protection Act. 1986.

(xviii) B fraudulently induces C and obtains a B/E from C in his own favour. Later, he endorses the same to A under a commercial deal as a consideration. A gets the bill as holder in due course. A subsequently endorses it back to B for some other deal and for value. On maturity C refuses to pay up and B sues him for recovery of money. With reference to the provisions of the Negotiable Instruments Act, should B succeed in the case?

(xix) ABC Ltd filed a complaint with Competition Commission Of India that XYZ is misusing its dominant position. State the factors that the Commission should consider while deciding the validity of ABC LTD.'s complaint.

(xx) When is a LLP not bound by act of its members?

(xxi) What is 'information' under RTI Act?

Answer 2. Law of Contract :

(i) The above mentioned phrase means that the parties to an agreement must have agreed about the subject matter of agreement in the same sense and at the same time. Unless there is *Consensus ad idem*, there can be no contract.

(ii) A contract without consideration is valid under following circumstances :

(a) Love and affection [sec. 25(1)] A written and registered agreement based on natural love and affection between near relatives is enforceable even if there is no consideration.

(b) Compensation for voluntary services [Sec. 25(2)] A promise to pay for past voluntary service is binding on the promissor.

(c) A promise to pay a time barred debt is binding provided it is in writing and signed by debtor or his authorized agent. [Sec. 25(3)]

(d) A completed gift between donor and donee [Exp. 1 to Sec 25]

(e) Contract to create an agency [Sec. 185]

(f) Charitable subscription where the promisee has made commitments on the strength of the promise.

(iii) The doctrine of estoppel states when a person by his words, spoken or written or by his conduct willfully leads another person to believe about certain state of affairs, and induces the person to act in a particular manner, he is estopped from denying that state of affairs subsequently. Sec.237

deals with agency by estoppel. According to it, if a person by his conduct leads another to believe that certain person is his agent or his agent is authorized to incur the particular obligation, the principal is bound by acts of the person posing as his agent or where the agent has exceeded his authority.

For e.g. A terminates the services of B, his agent but forgets to give notice of the same. C contracts with B . A is bound by the contract.

(iv) The obligations of finder of lost goods are as follows:

(a) He must take reasonable care of the goods . However, if goods are destroyed inspite of that, he is not responsible for loss.

(b) He must not mix the goods with his own goods.

(c) He must not use the goods for his own purpose.

(d) He must try his best to find the owner of goods.

(v) A contract need not be performed under following circumstances :

(a) When performance becomes impossible.(Sec.56)

(b) When parties to contract agree to substitute it with a new one or rescind it or alter it. (Sec.62)

(c) When the promisee waives or remits the performance of promise made to him, wholly or in part or extends the time of performance or accepts any other satisfaction for it. (Sec.63)

(d) When a person at whose option it is voidable, rescinds it (Sec. 64)

(e) When the promisee refuses or neglects to provide reasonable facilities to the promissor for performance of the promise. (Sec.67)

(f) When the contract is illegal.

Sale of Goods Act :

(vi) The term 'property' denotes only ownership in Sale of Goods Act. In case of sale the property in the goods passes from seller to buyer. This means ownership passes from seller to buyer even though the seller may retain the possession of the goods sold. If the goods are destroyed after sale while still in possession of the seller, the buyer has to bear the loss as risks follows ownership and not possession.

(vii) Delivery is defined under the act as 'a voluntary transfer of possession from one person to another.' (Sec.(2)) As per Section 33, delivery of goods sold may be effected by doing anything which parties agree to be treated as delivery. Thus delivery of goods may be :

(i) Actual or physical delivery- Physical possession of goods is handed over to buyer from seller.

(ii) Symbolic delivery- In this case delivery involves transfer of some symbol that signifies real possession or control of goods. For example, endorsement of Railway Receipt, delivery of godown key etc.

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

(A) When buyer holding the goods as bailor holds them as his own.

(B) When seller holding the goods, holds them as bailee of the buyer.

(C) When third person holding the goods on behalf seller, now agrees to hold them on behalf of buyer.

(viii) A lien is a right to retain possession of goods until payment of price.[Sec. 46(1)(a)].It is available to unpaid seller in possession of goods where —

(i) the goods have been sold without any stipulation as to credit;

(ii) the terms of credit have expired for goods sold on credit;

(iii) the buyer has become insolvent. [Sec.47(2)]

Industrial Laws :

(ix) Standard family' means a family consisting of worker , his or her spouse, and two children below the age of fourteen years making in all three 'adult consumable units.' One 'adult consumable unit' means consumption unit of a male above 14 years of age. The consumption unit of a female above 14 years of age and that of child under 14 years of age shall be taken at the rate of 0.8 and 0.6 repectively of one adult unit.

(x) To settle an EPF account one has to resign or retire from establishment and apply for settlement of EPF in Form-19. If the member has not attained 55 years of age at the time of exit, he should not work in any covered establishment for a period of two months from exit date.

In case of death of a member,his family members/Nominee have to apply In Form-20 for settlement of EPF.

(xi) Lay off and retrenchment carry different meaning under Industrial Dispute Act as follows :

Lay off	Retrenchment
(i) Means failure, refusal or inability of an employer to give employment to a workmen whose name appear in muster rolls of his establishment and who has not been retrenched.	It is termination of service of a workman for any reason other than as a punishment by way of disciplinary action but doesnot include : (a) VRS (b) Retirement on reaching the age of superannuation. (c) Termination due to non renewal of contract. (d) Termination on the ground of illness.
(ii) U/s 2(kkk) of Industrial Dispute Act	(ii) U/s 2(oo) of Industrial Dispute Act
(iii) Worker is entitled to compensation which is 50%of Basic+DA payable to him in case he was not laid of for all days of lay-off excluding weekly holidays.	Compensation is 15 days average pay for each year of completed service or part there of in excess of six months.

(xii) Disablement implies loss of capacity to work or move. Disablement leads to loss or reduction in earning capacity of workman. Disablement may be partial or total.

Further it may be temporary or permanent.

Partial disablement reduces the earning capacity of workman as a result of some accident. It may be temporary or permanent. Temporary partial disablement reduces the earning capacity of workman in any employment in which he was engaged at the time of employment.

Permanent partial disablement reduces the earning capacity in every employment the worker was capable of doing at the time of employment.

Total disablement u/s 2(1) (l) means worker becomes incapable in performing any work which he could perform before accident. Total disablement is deemed to result from every injury specified in Part I of Schedule I or combination of injuries specified in Part II resulting in loss of earning capacity to the extent of 100% or more.

(xiii) The total amount of deductions which may be made in a wage period u/s 7(2) from the wages of any employed person should not exceed 75% of wages earned if such deductions are made wholly or partly for payment to co-operative societies under Sec. 7(2)(j). In any other case, the total deductions should not exceed 50% of total wages earned during the wage period[Sec.7(3)]. Where total deductions authorized under Sec. 7(2) exceeds 75% or 50% as the case may be, the excess may be recovered in such a manner as prescribed [Provisio to Sec. 7(3)]

(xiv) Section 2(16) of the Payment of Bonus Act, 1965 defines 'establishment in public sector' to mean an establishment owned, controlled or managed by :

(a) a Government company as defined in Section 617 of the Companies Act, 1956;

(b) a Corporation in which not less than 40% of its capital is held (whether singly or taken together) by -

(i) the Government; or

(ii) the Reserve Bank of India; or

(iii) a Corporation owned by the Government or the Reserve Bank of India.

The provisions of the Payment of Bonus Act, 1965 do not ordinarily apply to an establishment in public sector. However, if the following two conditions are satisfied by such establishment in any accounting year, the provisions of the Act shall apply to such establishment as they apply to an establishment in the private sector :

(i) If in any accounting year, an establishment in the public sector sells goods produced or manufactured by it or renders any services, in competition with an establishment in private sector; and

(ii) the income from such sale or services is not less than 20% of the gross income of the establishment in public sector in that year. (Section 20)

(xv) As per Sec. 15 of Minimum Wages Act, an employee is entitled to receive the minimum wages fixed by the day even if he has worked for less than requisite number of hours constituting a normal working day except –

(i) where his failure to work was result of his unwillingness to work;

(ii) such other cases as may be prescribed.

So the employer cannot reduce the minimum rate of wages fixed by a day at his will.

(xvi) Section 4(5) of Payment of Gratuity Act states that an employee is entitled to receive better terms of gratuity than envisaged by the Act under any agreement, award or contract with his employer. This has been observed by Supreme Court in State of Punjab v. Labour Court, Jalandhar, A.I.R (1979) S. C. 1981, that though the Act enacts complete code regarding payment of gratuity, it doesnot prohibit an employee from getting better terms of gratuity. The law only provides guidelines for minimum gratuity.

Other Laws :

(xvii) According to Section 2(1)(b) of the Act, 'complainant' means—

(i) a consumer;

(ii) any voluntary consumer association registered under the Companies Act, 1956 or any other Act for the time being in force ;

(iii) the Central Government or State Government, making a complaint;

(iv) one or more consumers where all have the same interest;

(v) legal heir or representative of a consumer in case of his death (The clause has been introduced vide Consumer Protection (Amendment), Act, 2002.

(xviii) The problem stated in the question is based on the provisions of the Negotiable Instruments Act as contained in Section 53. The section provides: 'Once a negotiable instrument passes through the hands of a holder in due course, it gets cleansed of its defects provided the holder was himself not a party to the fraud or illegality which affected the instrument in some stage of its journey. Thus any defect in the title of the transferor will not affect the rights of the holder in due course even if he had knowledge of the prior defect provided he is himself not a party to the fraud. (Section 53).

Thus applying the above provisions it is quite clear that B who originally induced C in obtaining the bill of exchange in question fraudulently, cannot succeed in the case. The reason is obvious as B himself was a party to the fraud.

(xix) The Competition Commission while inquiring whether the company XYZ Ltd. enjoys a dominant position or not under Section 4 of the Competition Act, 2002 will take the following factors into account :

(a) market share of the enterprise

(b) size and resources of the enterprise

(c) size and importance of the competitors

(d) economic power of the enterprise including commercial advantages over competitors.

(e) vertical integration of the enterprises or sale or service net work of such enterprises.

(f) dependence of consumers on the enterprise.

(g) monopoly or dominant position whether acquired as result of any statute or by virtue of being a Government company or a public sector undertaking or otherwise.

(h) entry barriers including barriers such as regulatory barriers, financial risk, high capital cost of entry, marketing entry barriers, technical entry barriers, economies of scale, high cost of substitutable goods or services for consumers.

(i) countervailing buying power.

(j) market structure and size of market.

(k) social obligations and size of market.

(l) relative advantage, by way of contribution to the economic development, by the enterprise enjoying a dominant position having or likely to have an appreciable adverse effect on competition.

(m) any other factor which the commission may consider relevant for the enquiry.

(xx) A limited liability partnership is not bound by any act of a member in dealing with a person if –

(a) the member in fact has no authority to act for the limited liability partnership by doing that thing;

(b) the person knows that the member has no authority or doesnot know or believe him to be a member of limited partnership.

(xxi) 'Information' means any material in any form, including records, documents, file notings, memos, emails, opinions, advices, press releases, circulars, orders, log books, contracts, reports, papers, samples, models, data, material held in any electronic form and any information relating to a private body which can be accessed by a Public Authority under any law.

SECTION - II
(Auditing)

Q. 1. Comment on the following based on legal provisions :

(i) Auditing begins where accountancy ends.

(ii) Contingent liabilities do not form part of the Balance Sheet, and hence neednot be verified.

(iii) Through Audit Engagement letter the auditee communicates to the auditor of his appointment.

(iv) Section 228 of the Companies Act deals with appointment of Branch Auditor.

(v) Sundry debtors of ABC Ltd. as on 31-3-09 include Rs.15lakhs from DEF Ltd., who have been declared as insolvent on 10-4-09.

(vi) XYZ Ltd utilises a part of Revaluation Reserve created for issue of bonus shares. The auditor gave a clean audit report.

(vii) By obtaining inventory valuation certificate from management, the auditor is no longer responsible for verifying Closing Stock.

(viii) Internal Audit is an important management tool.

(ix) Existence of internal check reduces the liability of auditor.

(x) CARO 2003 is applicable to all Indian Companies.

(xi) Audit programme is a guideline to internal auditor.

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

(xiii) Management audit can be conducted by a practicing C.A. only.

(xiv) Tagging and Tracing technique is better than Integrated Test Data facility.

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

Answers 1.

(i) Accountancy involves the following activities :

- Preparation of Trial Balance
- Passing of rectification entries and incorporation of adjustment entries
- Preparation of Profit and Loss A/c
- Preparation of Balance Sheet.

After the accountancy work is completed, the duty of the auditor starts. An auditor has to verify the entries passed by the accountant and give his opinion on final accounts prepared by the accountant after scrutinising the accounts with help of vouchers, documents, and information provided to him. So it is true that auditing starts where accountancy ends.

(ii) The auditor should verify that a proper disclosure about contingent liabilities is made in the financial statements as a footnote to the Balance Sheet as contingent liabilities may become actual liabilities on happening or not happening of certain events. As per para 68 of AS-29 an organisation should disclose for each class of contingent liabilities separately on Balance Sheet date. So the above statement is false.

(iii) Audit engagement letter is a communication issued by auditor to the auditee (the client) expressing therein *inter alia,* the fact of acceptance of his audit engagement, the objectives and scope of his audit, the extent of auditor's responsibilities and management responsibility for compilation of accounting, application of accounting principles, standards, fees. So the above statement is false.

(iv) Section 228 presumes that normally the company auditor shall be appointed as branch auditor. However if general meeting of the company decides to have a separate branch auditor, Section 228(3) requires that the meeting should appoint the branch auditor out of eligible categories or authorise the Board of Directors to appoint one in consultation with company auditor.

(v) According to AS 4, "Contingencies and Events Occurring after the Balance Sheet Date", any significant event occurring after the date Balance Sheet date but before the date of approval of financial statements by the Board, requires adjustments to assets/liabilities as on the date of Balance Sheet in case additional evidence is available in respect of conditions existed on the date of the balance sheet. In this case, the debtors balance has to be suitably adjusted since conditions existed on the date of the balance sheet in respect of which additional evidence has been provided by the insolvency of DEF Ltd. Thus, the auditor must ascertain that requirements of AS 4 have been followed.

In case of non-observance of the same, the auditor should qualify the report.

(vi) As per SEBI guidelines for issue of bonus shares, Revaluation Reserve cannot be utilised for the said issue. So the auditor should have given a qualified report.

(vii) Closing Stock is a important asset and may be used to fabricate profit and give misleading balance sheet and hence an auditor is required to take lot of care and caution while verifying closing stock. So the auditor cannot escape his responsibility by obtaining certificate from management.

(viii) Internal Audit involves systematic and continuous examination and reporting of systems and operations of an organization and helps management in decision making. It ensures compliance of CARO 2003. Thus internal audit is an important tool in hands of management.

(ix) The existence of a good internal check system reduces to a great extent the work of the auditor but does not reduce his liability. To what extent an auditor should depend upon the internal check system will depend on his tact, skill, experience and judgement.

(x) The following Indian Companies are exempted from the provisions of CARO :

- A Banking Company
- An Insurance Company
- A company licensed to operate as per provisions of Sec. 25 of Companies Act.
- A private limited company whose paid up capital and reserves is less than Rs. 50 Lacs.
- A private limited company whose annual turnover is less than Rs. 5 crores.

The order is applicable to foreign companies incorporated outside India but having places of business in India.

(xi) An audit programme is a detailed plan of action prepared by the auditor specifying methods and procedures to be followed for completing the assignment by available staff within stipulated time. It acts as a guideline to the auditor in developing the appraisal and review techniques suitable to meet organisational objectives.

(xii) 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.

(xiii) Management audit can be conducted by –

(a) Company Talent–which includes

1) Administrative staff

2) Audit committee.

(b) Outside Management Consultants who may be C.As, Cost Accountants or management consultants.

(c) Company talents as well as outside Management consultants

As such it is not necessary that management audit can be conducted by practicing C.As only.

(xiv) The technique involves tagging the client's input data in such a way that relevant information is displayed at key points. It uses the actual data, and so the question of elimination of 'special entries test data designed under Integrated Test Data Facility does not arise.

The hard copy, so produced is available only to the auditor. This enables the auditor to examine transactions at the intermediate steps in processing. The advantage of the tagging and tracing approach lies in the use of actual data and elimination of the need for reversing journal entries. The disadvantage is that the erroneous data will not necessary be tagged. An effective combination approach may be to use the ITF approach (integrated test facility) for a few hypothetical transactions and the tagging and tracing approach to follow line data through a complex system.

(xv) In today's complex business environment, the importance of trial balance in an audit has to be gauzed not from the view point of arithmetical accuracy but the nature of transaction to be recorded which in fact have become very complex. The emergence of new forms of financial instruments like option and futures, derivatives, off-balance sheet financing, etc. have given rise to further complexities in recording and disclosure of transactions. A tallied Trial Balance may still contain errors of omissions like omission of certain entries, compensating errors, duplication of entries, etc. In an audit besides the tallying of a trial balance, there are also other issues like estimation of depreciation, valuation of inventories, etc. which still require judgement to be exercised by the auditor. So responsibility of auditor will still remain even in an EDP environment.

Q. 2. (1) ''The concept of evidence is fundamental to auditing. Discuss 'management representation' as audit evidence.

Answer 2. (1)

The management representation as an audit evidence :

(a) During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to some specific enquiries.

(b) The auditor also should obtain representation from management, where considered appropriate and necessary.

(c) The management representation is taken to corroborate audit evidence, but representations by management can not be a substitute for other audit evidences that the auditor could reasonably expect to be reasonably available.

(d) In certain cases, where knowledge of facts is confined to management, a representation by management may be the only audit evidence, which can reasonably be expected to be available.

(e) If a management representation is contradicted by an available other audit evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by management.

Q. 2. (2) The concept of 'materiality' is not always related to financial implications. State your views.

Answer 2. (2)

The concept of 'materiality' also depends on :

(a) Regulatory or law considerations. For example, the appointment of directors is not according to law, the remuneration paid to them is a material item even if the financial implication is low

(b) Materiality is also decided as to the degree of relevance in relation to the overall accounts or in relation to the group to which it relates or in relation to the classes of transactions to which it pertains.

(c) Improper description, for example, of accounting policy in the notes, is a material misstatement that may affect economic decisions.

(d) Even insignificant items in terms of quantity may be material in special circumstances. For example, it is not the quantum of deviation but presence of the deviation itself may be material factor to determine the correct functioning of logic in a system (computer) driven accounting areas.

(e) An item whose impact in present is insignificant but whose effect in future may be significant may be a material item.

Q. 3. How do you verify the following?

(a) Bills payable

(b) Recovery of Bad-debts written off

(c) Goods sent on sale or return basis

(d) WIP

(e) Expenses on foreign travel.

Answer 3. (a)

Bills Payable :

These are acknowledgements of debts payable. To verify them, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding bills have been correctly disclosed.

Steps involved in their verification are :

(i) The auditor should verify the payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.

(ii) All the entries in the Bills Payable Book should be entered in Bills Payable Account. The auditor should also confirm that the liability in respect of the bills has been correctly recorded.

(iii) Reconciliation should be made in respect of the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.

(iv) Confirmation to be obtained from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.

(v) The charge, if any, created on any asset for the due payment of bills should be appropriately disclosed.

Answer 3. (b)

Recovery of Bad-debts written off —

(i) The total amount of bad debts to be ascertained.

(ii) All recoveries of bad debts have been properly recorded in the books of account to be ensured.

(iii) Notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.

(iv) Credit Manager's file for the amount received and deposit of the said amount into the bank promptly to be verified.

Answer 3. (c)

Goods sent on sale or return basis :

(i) The auditor should ensure that a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) The price of such goods is to be unloaded from the sales account and the debtor's record. The memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) It should be ensured that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.

(iv) The stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, should be included in the closing stock.

Answer 3. (d)

WIP :

The auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. Cost sheets of work-in-progress should be verified as follows :

(i) The cost sheets are to be duly attested by the works engineer and works manager.

(ii) The correctness of the cost as disclosed by the cost records to be verified with respect to quantities and cost of materials, wages and other charges included in the cost sheets by reference to the records maintained in respect thereof

(iii) The unit cost or job cost as shown by the cost sheet to be compared with the standard cost or the estimated cost.

(iv) The allocation of overhead expenses should be made on a rational basis.

The cost sheet to be compared in detail with that of the previous year. If they vary materially the cause has to be investigated.

Answer 3. (e)

Expenses on foreign travel.

(i) T.A. bills submitted by the employees stating the details of tour, details of expenses, etc.should be examined carefully.

(ii) The tour programme should be properly authorised by the competent authority.

(iii) Checking of the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill, hotel bills with reference to the internal rules for entitlement of the employees and also making sure that the bills have been properly passed.

(iv) The tour report should be enclosed with the T.A. bill. The tour report shows the purpose of the tour. The tour report should be in conformity with the authorization letter.

(v) Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange should be present. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Part I of Schedule VI to the Companies Act, 1956.

Q. 4. XYZ LTD. is engaged in manufacturing and supply of tyres to ABC Automobile Ltd. As per terms of supply, full price of the goods are not released by ABC Automobile Ltd. but 10% thereof is retained and paid after one year, if there is satisfactory performance of the tyres supplied. XYZ Ltd. accounted for only 90% of the invoice value as sale at the time of supply and balance 10% was accounted as sale in the year of receipt of payment.

Answer 4.

As per 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 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 XYZ Ltd to ABC Automobile Ltd., on the basis of invoice and delivery of material. Therefore, XYZ 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 collectibility 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.

Q. 5. SGH & Co., chartered accountants were appointed as the auditors of a public limited company in their Annual General Meeting. Various term lending institutions held 47% of the paid up capital of the company.

Answer 5.

As per Sec.224 A of the Companies Act, 1956 in case of companies in which not less than 25% of the subscribed capital is held whether singly or in any combination by –

(a) A public financial or a Government company or the Central Government or any state government; or

(b) Any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of subscribed share capital; or

(c) A nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment of an auditor in the Annual General Meeting shall be made only by passing a special resolution. So SGH & Co. should have been appointed by special resolution to this effect. The appointment as such is null and void.

Q. 6. The Board of Directors of BCD Ltd. refused to Minute Book to the Statutory Auditor on the ground of secrecy. State the legal position.

Answer 6.

Section 227 of the Companies Act, 1956 states that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit.

In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

So it is essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.

Q. 7. The shareholders of LMN Ltd. filed a complaint against the auditor that he has failed to send a copy of Audit Report to them.

Answer 7.

Section 227 of the Companies Act, 1956 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to shareholders of the company. The auditor's duty concludes once he forwards his report to the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

Q. 8. No cost accounting records were maintained though GLF Ltd. is required to maintain the same. The statutory auditor did not make an observation as he is not the cost auditor.

Answer 8.

Section 209(1)(d) of the Companies Act, 1956 requires that every company shall maintain books of accounts containing particulars relating to the utilisation of material or labour or to other items of cost if such class of companies are notified by the Central Government.

As per the CARO, 2003 where maintenance of cost records have been prescribed by the Central Government, auditor of the company is specifically required to state whether such accounts and records as prescribed have been made and maintained.

Though the auditor is not required to conduct detailed audit but the auditor is expected to conduct a general review of the cost records to determine whether the prescribed accounts and records are *prima facie* complete. Therefore whether cost audit is ordered or not the auditor should report upon the non-maintenance of the cost records.

Q. 9. Discuss flow chart technique for evaluation of internal control system in an organization.

Answer 9.

A flow-chart is a graphic presentation of the flow of transactions and documents in an organisation. Evaluation of the internal controls forms an important part of the auditing process as it enables the auditor to know the weaknesses and strengths of the accounting system. A properly drawn up flow chart can provide a neat visual picture of the whole activities of the organization or department involving flow of documents and activities. More specifically it can show :

(i) at what point a document is raised internally or received from external sources;

(ii) the number of copies in which a document is raised or received;

(iii) the intermediate stages set sequentially through which the document and the activity pass;

(iv) distribution of the documents to various sections, departments or operations;

(v) checking authorisation and matching at relevant stages;

(vi) filing of the documents; and

(vii) final disposal status.

The flow-chart method provides the most concise but comprehensive way of recording the operating controls along with the flow of transactions and documents. In the flow-chart, a total and complete visual picture and control system is available and as such its reception in the human mind is direct. In drawing a flow-chart, organised and concentrated application of mind is essential to reflect the control system in a rational manner. Even in a large and complex organisation, the control system could be depicted by few sheets of neatly drawn flow-charts. However, in drawing the flow chart, the auditor has to take few precautions, e.g., flow-charts should not be lengthy and cumbersome, should be neat, should portray the flow completely with final disposal of papers and there should be proper use of symbols and lines. The auditor will be able to visually correlate the functions and the related controls and assess the adequacy and effectiveness thereof much quickly than a possibly in any other method.

Q. 10. Explain how following are dealt in Auditor's Report as per CARO :

(a) Fraud

(b) Transactions in which Directors are interested.

(c) Guarantees for loan taken by others.

(d) Sickness.

Answer 10.

(a) **Fraud :**

The auditor should state whether any fraud on or by the company has been noticed or reported during the year, if yes, the nature and the amount involved.

(b) **Transactions in which Directors are interested.**

Auditors statements are required on the following :

(i) Whether transactions that need to be entered into register in pursuance of Sec. 301 of Companies Act, have been entered.

(ii) Whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices relevant at that time.

These should be commented only when value of transactions exceed Rs. 5 crore.

(c) **Guarantees for loan taken by others.**

The auditor should comment whether the company has given any guarantee for loans taken by others from banks, financial institutions, the terms and conditions

of which are prejudicial to the interest of the company.

(d) **Sickness.**

The auditor should point out in case of a company incorporated for more than five years and having accumulated losses at the end of financial year amounting to more than 50% of net worth on whether it has incurred cash losses also in such financial year and in the financial year immediately preceding such financial year.

Q. 11. Elaborate the principles of internal check system that should be followed with regard to cash payments.

Answer 11.

The principles to be followed are enumerated below :

(i) Making all payments through cheques except petty cash payments.

(ii) Segregating duties. The employee in charge of receipts should not be involved in making payments.

(iii) All payments should be duly authorized. Payments above Rs. 20000 should be tendered through crossed cheque.

(iv) The unused cheques should be under proper custody.

(v) The vouchers supporting payments should be stamped as 'paid' so that they are not presented twice.

(vi) Statement of dues received from creditors should be verified with invoices and ledger accounts before authorizing payments. Confirmation of accounts should be made with creditors.

(vii) Monthly or periodic payments should be always be made on fixed dates.

(viii) Bank reconciliation statements should be made atleast bimonthly to locate the difference between cash and bank book if any. The statement should be prepared by an independent person not in charge of receipts or payments.

Q. 12. What do you understand by Audit Note Book?

Answer 12.

Audit Note Book is maintained by the audit staff carrying out the actual audit work. Such book is a written record of queries made, replies received from clients, and correspondence entered into it. It helps the auditor in preparation of audit report. A separate note book should be maintained for each client. The important points noted in the book are as follows :

(i) List of books maintained by client.
(ii) Names of the officers, their powers, duties and responsibilities.
(iii) The technical terms used in the business.
(iv) Mistakes and errors detected and explanation obtained for them.
(v) The points which require further clarification and explanations.
(vi) Particulars of missing vouchers for which duplicates need to be obtained.
(vii) Accounting method followed by the client.
(viii) Any matter that requires further discussion with the auditor.
(ix) Notes and queries which might be helpful during subsequent audit.
(x) The points that have to be incorporated in audit report.
(xi) Dates of commencement and completion of audit.
(xii) Provisions in Articles affecting accounts and audit.

The book should be clear, concise and complete so that it act as a documentary evidence in favour of the auditor even after several years.

Q. 13. Can the Statutory Auditor rely upon the work of an Internal Auditor?

Answer 13.

According to AAS 7 (SA 610), "Relying Upon the Work of an Internal Auditor", the scope and objective of internal audit are dependent upon the size and structure of the entity and the requirements of its management. Internal audit is an integral part of internal control system prevailing in any organisation. Before placing any reliance upon the work of internal auditor, the statutory auditor may evaluate the work of internal auditor both in general and specific terms.

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

Q. 14. What do you understand by :
(i) Auditing around the computer?
(ii) Auditing through the computer ?

Answer 14. (i)

Audit Around the Computer : Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into account. Rather the principle of conventional audit like examination of internal controls and substantive testing is done. The auditor views the computer as a black box, as the application system processing is not examined directly. The main advantage of auditing around the computer is its simplicity. Audit around the computer is applicable in the following situations :

(i) The system is simple and uses generalised software that is well tested and widely used.
(ii) Processing mainly consists of sorting the input data and updating the master file in sequence.
(iii) Audit trail is clear. Detailed reports are prepared at key processing points within the system.
(iv) Control over input transactions can be maintained through normal methods, i.e. separation of duties, and management supervision.

Generalised software packages, like payroll and provident fund package, accounts receivable and payable package, etc. are available, developed by software vendors. Though the auditor may decide not to go in details of the processing aspects, if there are well tested widely used packages provided by a reputed vendor. However, he has to ensure that there are adequate controls to prevent unauthorised modifications of the package. However, it may be noted that all such generalised packages do not make the system amenable to audit. Some software packages provide generalised functions, that still must be selected and combined to achieve the required application system. In such a case, instead of simply examining the systems input and output, the auditor must check the system in depth to satisfy himself about such system. The main disadvantages of the system of auditing around the computer are :

(a) It is not beneficial for complex systems of large scale in very large multi unit, multi locational companies, having various inter unit transactions. It can be used only in case of small organisations having simple operations.

(b) It is difficult for the auditor to assess the degradation in the system in case of change in environment, and whether the system can cope with a changed environment.

Answer 14. (ii)

Auditing Through the Computer : This approach involves actual use of computer for processing the information by auditor. The circumstances, where auditing through the computer is done are as follows :

(i) The organisation has developed either in house or through a reputed vendor, a software package suitable to its requirement, because of inability of a generalised package to cater to the complex nature of transactions.

(ii) The system processes very large volumes of output. This makes examination of validity of input and output difficult.

(iii) The major part of the internal control system in the organisation is in the computer system itself, as the majority of the records is processed through the computer. Examples are system in bank, insurance companies, online booking in case of Railway, etc.

(iv) The logic of the system is quite complex, and there is virtually no visible audit trail. The auditor has to use the computer to test the logic and controls existing within the system.

The auditor has to use the computer system itself for verification, for which he has to be sufficiently computer literate, and should have adequate technical knowledge and expertise. The auditor can through the computer, increase his performance, and can rely on the data processing by carrying out the required tests and applying his skill.

Q. 15. Write short note on :

(i) Desired audit risk

(ii) Utility Routine

(iii) Test packs.

Answer 15. (i)

The American Institute of Certified Public Accountants determined the level of risk to be adopted with help of following risk model :

Desired audit risk = Internal risk × Control risk × Detection risk

Internal risks represent the material loss or errors existing in some segment of the audit, before reliability of internal controls is considered.

Control risk means likelihood of internal controls in some part of audit cannot present, detect or correct the material losses or errors.

Detection risk means the audit procedures used in some part of audit will fail to detect the material losses or errors.

Answer 15. (ii)

Utility Routines are generally supplied by the computer manufacturer and are available for call up by the operating system. These routines play a key role in an electronic data processing. These are generalised programmes that perform necessary but routine jobs in a computer installation. These routines are sufficiently flexible to handle needs of all users. They are controlled by parameters to indicate the particular characteristics of the data or the requirements. Generally, three types of utility routines are made available by computer vendors-data set utilities, system utilities and independent utilities.

Answer 15. (iii)

Test pack is a technique to determine the correctness of the computer programming used to record transactions through the computer. Preparation of test pack requires a great deal of expertise. It may be prepared by the auditor himself with the help of the entity's staff or by the Internal Control department of the entity. Normally test packs are used where :

(i) a significant part of the control system is embodied in the programme;

(ii) there are gaps in audit trail making it difficult to trace output from input and to verify intermediate calculation; and

(iii) the volume of records is large, so that it may be more economical and more effective to use test packs rather than to trace the transactions manually.

Q. 16. Under what circumstances loss of Audit Trail occurs in an EDP environment?

Answer 16.

Loss of Audit Trail may happen due to the following reasons :

(i) Input documents may be non-existent when transactions are entered online.

(ii) Increase in speed of data processing.

(iii) Accounting transactions like discounts and interest calculations may be generated automatically by computer programmes without any visible authorisation.

(iv) Output reports may not be generated by the system.

(v) Programmed control procedures may provide visible evidence only on exception basis.

(vi) A printed report may contain only summary and supporting details retained in computer files.

Q. 17. Discuss the qualities a management auditor should possess.

Answer 17.

The management auditor should possess the following qualities :

(i) Ability to understand the nature and objectives and problems faced by the organisation.

(ii) He should have general understanding of different laws and regulations likeTax Laws, Company Laws etc.

(iii) Expert knowledge of management principles such as delegation of authority, management by exception, budgetary control, flow charts, etc.

(iv) Sufficient knowledge and experience in preparing and presenting reports to different levels of management.

(v) Working knowledge of engineering, costing, statistics, management accounting, industrial psychology etc.

(vi) Dynamic, tactfulness and a pleasing personality.

Q. 18. What are the steps involved in carrying out management audit?

Answer 18.

Management audit basically comprises of following three steps :

(i) Examination of management performance. This involves —
- Detailed diagnosis and study of activities.
- Determination of purpose and relationships.

(ii) Reporting defects and irregularities
- Looking for shortcomings
- Searching for problems

(iii) Presenting suggestions for improvement.
- Determination of alternatives
- Testing of effectiveness
- Ascertainment of solutions to problems
- Presenting methods of improvement.