

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 :

- (a) 'X' stands surety for 'Y' for any amount which 'Z' may lend to Y from time to time during the next three months subject to a maximum of ₹ 150,000. One month later X revokes the guarantee, when Z had lent to B ₹ 15,000. Referring to the provisions of the Indian Contract Act, 1872 decide whether 'X' is discharged from all the liabilities to 'Z' for any subsequent loan. What would be your answer in case 'Y' makes a default in paying back to 'Z' the money already borrowed i.e. ₹ 15,000?
- (b) S delivered his car to M for repairs. M completed the work, but did not return the car to S within reasonable time, though S repeatedly reminded M for the return of car. In the meantime a big fire occurred in the neighborhood and the car was destroyed. Decide whether M can be held liable under the provisions of the Indian Contract Act. 1872.
- (c) S started "self service" system in his shop. X entered the shop, took a basket and after taking articles of his choice into the basket reached the cashier for payments. The cashier refuses to accept the price. Can S be compelled to sell the said articles X ? Decide.
- (d) H lends a sum of ₹ 15,000 to D, on the security of two shares of a Limited Company on 1st April 2011. On 15th September, 2011, the company issued two bonus shares. D returns the loan amount of ₹ 15,000 with interest but H returns only two shares which were pledged and refuses to give the two bonus shares. Advise D in the light of the provisions of the Indian Contract Act, 1872.
- (e) Mr. D of RB Textile Ltd. enters into a contract with RS Garments Show Room for supply of 1,000 pieces of Cotton Shirts at ₹ 300 per shirt to be supplied on or before 31st December, 2011. However, on 1st November, 2011 RB Textiles Ltd informs the RS Garments Show Room that he is not willing to supply the goods as the price of Cotton shirts in the meantime has gone upto ₹ 350 per shirt. Examine the rights of the Retail Garments Show Room in this regard.
- (f) B holds agricultural land on a lease granted by A, the owner. The land revenue payable by A to the Government being in arrear, his land is advertised for sale by the Government. Under the Revenue law, the consequence of such sale will be termination of B's lease. B, in order to prevent the sale and the consequent termination of his own lease, pays the Government, the sum due from A. Referring to the provisions of the Indian Contract Act, 1872 decide whether A is liable to make good to B, the amount so paid ?
- (g) G's goods were seized by Custom Authorities. Whether this is bailment under Indian Contract Act, 1872?
- (h) In an agreement between P and Q, there is a condition that they will not institute legal proceeding against each other without consent. Is the contract valid or void?

- (i) R sent a consignment of goods worth ₹ 160,000 by railway and got railway receipt. He obtained an advance of ₹ 80,000 from the bank and endorsed and delivered the railway receipt in favour of the bank by way of security. The railway failed to deliver the goods at the destination. The bank filed a suit against the railway for ₹ 160,000. Decide in the light of provisions of the Indian Contract Act, 1872, whether the bank would succeed in the said suit?
- (j) Z transferred his house to his daughter P by way of gift. The gift deed, executed by Z, contained a direction that P shall pay a sum of ₹ 15,000 per month to Q (the sister of the executant). Consequently P executed an instrument in favour of Q agreeing to pay the said sum. Afterwards, P refused to pay the sum to Q saying that she is not liable to Q because no consideration had moved from her. Decide with reasons under the provisions of the Indian Contract Act, 1872 whether P is liable to pay the said sum to Q.

Answers 1.

- (a) The problem as asked in the question is based on the provisions of the Indian Contract Act 1872, as contained in Section 130 relating to the revocation of a continuing guarantee as to future transactions which can be done mainly in the following two ways :

1. *By Notice* : X continuing guarantee may at any time be revoked by the surety as to future transactions, by notice to the creditor.
2. *By death of surety* : The death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee, so far as regards future transactions. (Section 131).

The liability of the surety for previous transactions however remains.

Thus applying the above provisions in the given case, X is discharged from all the liabilities to Z for any subsequent loan.

Answer in the second case would differ i.e. X is liable to Z for ₹ 15,000 on default of Y since the loan was taken before the notice of revocation was given to Z.

- (b) The problem asked in the question is based on the provisions of section 160 and 161 of the Indian Contract Act 1872. Accordingly, it is the duty of the bailee to return or deliver the goods bailed according to the bailor's directions, without demand, as soon as the time for which they were bailed has expired, or the purpose for which they were bailed for any loss, destruction of the goods from that time (Section 161), notwithstanding the exercise of reasonable care on his part. Therefore, applying the above provisions in the given case, Mahesh is liable for the loss, although he was not negligent, but because of his failure to deliver the car within a reasonable time (*Shaw & Co. v. Symmons & Sons*).

- (c) The offer should be distinguished from an invitation to offer. An offer is the final expression of willingness by the offeror to be bound by his offer should the party chooses to accept it. Where a party, without expressing his final willingness, proposes certain terms on which he is willing to negotiate, he does not make an offer, but invites only the other party to make an offer on those terms. This is the basic distinction between offer and invitation to offer.

The display of articles with a price in it in a self-service shop is merely an invitation to offer. It is in no sense an offer for sale, the acceptance of which constitutes a contract. In this case, X in selecting some articles and approaching the cashier for payment simply made an offer to buy the articles selected by him. If the cashier does not accept the price, the interested buyer cannot compel him to sell. [*Fisher V. Bell (1961) Q.B. 394 Pharmaceutical society of Great Britain V. Boots Cash Chemists*].

- (d) As per provisions of Section 163(4) of the Indian Contract Act, 1872, "in the absence of any contract to the contrary, the bailee is bound to deliver to the bailor, any increase or profit which may have accrued from the goods bailed."

Applying the provisions to the given case, the bonus shares are an increase on the shares pledged by D to H. So H is liable to return the shares along with the bonus shares and hence D the bailor, is entitled to them also.

- (e) In the given problem RB Textiles Ltd has indicated its unwillingness to supply the cotton shirts on 1st November 2011 itself when it has time upto 31st December 2011 for performance of the contract of supply of goods. It is therefore called anticipatory breach of contract. Thus RS Garments show room can claim damages from RB Textiles Ltd immediately after 1st November, 2011, without waiting upto 31st December 2011. The damages will be calculated at the rate of ₹ 50 per shirt i.e. the difference between ₹ 350 (the price prevailing on 1st November) and ₹ 300 the contracted price.

- (f) Yes, A is bound to make good to B the amount so paid. Section 69 of the Indian Contract Act, 1872, provides that "A person who is interested in the payment of money which another is bound by law to pay, and who therefore pays it, is entitled to be reimbursed by the other. In the given case has made the payment of lawful dues of A in which B had an interest. Therefore, B is entitled to get the reimbursement from A.

- (g) Yes, the possession of the goods is transferred to the custom authorities. Therefore bailment exists and section 148 of Contract Act, 1872 is applicable.

- (h) An agreement in restraint of legal proceedings is void as per Section 28 of the Indian Contract Act, 1872.

- (i) As per Sections 178 and 178A of the Indian Contract Act, 1872 the deposit of title deeds with the bank as security against an advance constitutes a pledge. As a pledge, a banker's rights are not limited to his interest in the goods pledged. In case of injury to the goods or their deprivation by a third party, the pledgee would have all such remedies that the owner of the goods would have against them. In *Morvi Mercantile Bank Ltd. vs. Union of India*, the Supreme Court held that the bank (pledgee) was entitled to recover not only the amount of the advance due to it, but the full value of the consignment. However, the amount over and above his interest is to be held by him in trust for the pledgor. Thus, the bank will succeed in this claim of ₹ 160,000 against Railway.

- (j) As per Section 2 (d) of the Indian Contract Act, 1872, in India, it is not necessary that consideration must be supplied by the party, it may be supplied by any other person including a stranger to the transaction.

The problem is based on a case "*Chinnaya Vs. Ramayya*" in which the Court clearly observed that the consideration need not necessarily move from the party itself, it may move from any person. In the given problem, the same reason applies. Hence, P is liable to pay the said sum to Q and cannot deny her liability on the ground that consideration did not move from Q.

Q. 2. (a) What is meant by Anticipatory Breach of Contract?

- (b) What do you understand by "Agency by Ratification"? What is the effect or ratification?**

- (c) What is meant by 'Undue Influence'?**

- (d) State the circumstances where under an agent is personally liable to a third party for the acts during the course of agency?**

- (e) When a contract need not be performed?**

Answer 2. (a)

Anticipatory breach of contract occurs when the promisor refuses altogether to perform his promise and signifies his unwillingness even before the time for performance has arrived. In such a situation the promisee can claim compensation by way of loss or damage caused to him by the refusal of the promisor. For this, the promisee need not wait till the time stipulated in the contract for fulfillment of the promise by the promisor is over.

Answer 2. (b)

A person may act on behalf of another without his knowledge or consent. Later on such another person may accept the act of the former or reject it. If he accepts the act of the former done without his consent, he is said to have ratified that act and it places the parties in exactly the same position in which they would have been if the former had later's authority at the time he made the contract. Likewise, when an agent exceeds the authority bestowed upon him by the principal, the principal may ratify the unauthorised act.

Effect of Ratification : The effect of ratification is to tender the acts done by one person (agent) on behalf of another (principal), without his (principal's) knowledge or authority, as binding on the other person (principal) as if they had been performed by his authority (Section 196: Indian Contract Act, 1872).

Further, ratification relates back to the date when the act was done by the agent. This means the agency comes into existence from the moment the agent first acted and not from the time when the principal ratified the act.

Answer 2. (c)

Section 16 of the Indian Contract Act, 1872, states that a contract is said to be induced by undue influence where the relations subsisting between the parties are such that the parties are in a position to dominate the will of the other and used that position to obtain an unfair advantage over the other.

A person is deemed to be in that position :

- (i) where he holds real or apparent authority over the other or stands in a fiduciary relation to him;
- (ii) where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of old age, illness or mental or bodily distress.
- (iii) where a man who is in position to dominate the will of the other enters into contract with him and the transaction appears to be unconscionable, the burden of proving that it is fair, is on him, who is in such a position.

When one of the parties who has obtained the benefits of a transaction is in a position to dominate the will of the other, and the transaction between the parties appears to be unconscionable, the law raises a presumption of undue influence [section 16(3)]. Every transaction where the terms are to the disadvantage of one of the parties need not necessarily be considered to be unconscionable. If the contract is to the advantage of one of the parties but the same has been made in the ordinary course of business the presumption of undue influence would not be raised.

Answer 2. (d)

Under the following circumstances an agent is personally liable.

1. When he represents that he has authority to act on behalf of his principal, but who does not actually possess such authority or who has exceeded that authority and the alleged employer does not ratify his acts. Any loss sustained by a third party by the acts of such a person (agent) and who relies upon the representation is to be made good by such an agent.
2. Where a contract is entered into by a person apparently in the character of agent, but in reality on his own account, he is not entitled to required performance of it.
3. Where the contract expressly provides for the personal liability of the agent.

4. When the agent signs a negotiable instrument in his own name without making it clear that he is signing as an agent.
5. Where the agent acts for a principal who cannot be sued on account of his being a foreign Sovereign, Ambassador, etc.
6. Where the agent works for a foreign principal.
7. Where a Government Servant enters into a contract on behalf of the Union of India in disregard of Article 299 (1) of the Constitution of India, In such a case the suit against the agent can be instituted by the third party only and not by the principal (*Chatturbhuj v. Moheshwar*).
8. Where according to the usage of trade in certain kinds of business, agents are personally liable.
9. Where his authority is coupled with interest, he can be sued only to the extent of his interest in the subject matter.

Answer 2. (e)

A contract need not be performed under following circumstances :

- (i) When performance becomes impossible.
- (ii) When parties to contract agree to substitute it with a new one or rescind it or alter it. (Sec. 6)
- (iii) 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)
- (iv) When a person at whose option it is voidable, rescinds it (Sec. 64)
- (v) When the promisee refuses or neglects to provide reasonable facilities to the promisor for performance of the promise. (Sec.67)
- (vi) When the contract is illegal.

Q. 3. (a) A sold his car to B for ₹ 175,000. After inspection and satisfaction, B paid ₹ 87,500 and took possession of the car and promised to pay the remaining amount within a month. Later on A refuses to give the remaining amount on the ground that the car was not in a good condition. Advise A as to what remedy is available to him against B.

(b) C contracts to sell D, by showing sample, certain quantity of butter described as 'Made in Gokul'. The butter when delivered matches with the sample, but is not 'Made in Gokul'. Referring to the provisions of Sale of Goods Act, 1930 advise the remedy, if any, available to D.

(c) R an agent of a buyer, had obtained goods from the Railway organization and loaded the goods on his truck. In the meantime, the Railway organization received a notice from P, a seller, for stopping goods in transit as the buyer had become insolvent. Referring to the provisions of the Sale of Goods Act, 1930 decide whether the Railway organization can stop the goods in transit, as instructed by the seller?

(d) K the owner of a Fiat car wants to sell his car. For this purpose he hand over the car to M, a mercantile agent for sale at a price not less than ₹ 100, 000. The agent sells the car for ₹ 75, 000 to B, who buys the car in good faith and without notice of any fraud. M misappropriated the money also. K sues B to recover the Car. Decide given reasons whether K would succeed.

Answer 3. (a)

As per the section 55 of the Sale of Goods Act, 1930 an unpaid seller has a right to institute a suit for price against the buyer personally. The said Section lays down that—

- (i) Where under a contract of sale the property in the goods has passed to buyer and the buyer wrongfully neglects or refuses to pay for the goods, the seller may sue him for the price of the goods [Section 55(1)].

- (ii) Where under a contract of sale the price is payable on a certain day irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price. It makes no difference even if the property in the goods has not passed and the goods have not been appropriated to the contract [Section 55(2)].

This problem is based on above provisions. Hence, A will succeed against B for recovery of the remaining amount. Apart from this Suraj is also entitled to :

- (1) Interest on the remaining amount.
- (2) Interest during the pendency of the suit.
- (3) Costs of the proceedings.

Answer 3. (b)

D has a remedy to repudiate the contract. According to section 15 of the Sale of Goods Act, 1930, when the goods are sold by sample as well as by description, there shall be an implied condition that the goods shall correspond to the sample as well as description. In this case, C supplied ghee which did correspond with the sample but was not correspond to the description of 'Made in Gokul'. Hence the D has the right to repudiate the contract.

Answer 3. (c)

The right of stoppage of goods in transit can be exercised only so long as the goods are in the course of transit. In the given case the transit was at an end as soon as the agent of the buyer obtained goods from the Railway Organisation. Therefore Railway Organisation cannot act as instructed by the seller, who has lost the right of stoppage of the goods in transit as provided in Section 30 of the Sale of Goods Act, 1930.

Answer 3. (d)

The problem in this case is based on the provisions of the Sale of Goods Act, 1930 contained in the proviso to Section 27. The proviso provides that a mercantile agent is one who in the customary course of his business, has, as such agent, authority either to sell goods, or to consign goods, for the purpose of sale, or to buy goods, or to raise money on the security of goods [Section 2(9)]. The buyer of goods from a mercantile agent, who has no authority from the principal to sell, gets a good title to the goods if the following conditions are satisfied :

- (1) The agent should be in possession of the goods or documents of title to the goods with the consent of the owner.
- (2) The agent should sell the goods while acting in the ordinary course of business of a mercantile agent.
- (3) The buyer should act in good faith.
- (4) The buyer should not have at the time of the contract of sale notice that the agent has no authority to sell.

In the instant case, M, the agent, was in the possession of the car with K's consent for the purpose of sale. B, the buyer, therefore obtained a good title to the car. Hence, K in this case, cannot recover the car from B. A similar decision, in analogous circumstances, was taken in *Folkes v. King*.

Q. 4. (a) What are the consequences of "destruction of goods" under the Sale of Goods Act, 1930, where the goods have been destroyed after the agreement to sell but before the sale is affected.

(b) Point out the differences between the transactions of "Sale" and "hire-purchase" in the light of the provisions of the Sale of Goods Act, 1930.

(c) What are the rules relating to the transfer of ownership of goods sent 'on approval, or sale or return' basis?

(d) At an auction sale, H made the highest bid for an article of Y. State the legal position in the following cases :

Case I : If H withdrew the bid before the fall of hammer though he knew that one of the condition of the sale was bid once made cannot be withdrawn'.

Case II : If H appointed two persons A and B , to bid on his behalf. The sale was notified subject to a right to bid.

Answer 4. (a)

Destruction of Goods-Consequences :

- (i) In accordance with the provisions of the Sale of Goods Act, 1930 as contained in Section 7, a contract for the sale of specific goods is void if at the time when the contract was made; the goods without the knowledge of the seller, perished or become so damaged as no longer to answer to their description in the contract, then the contract is void ab initio. This section is based on the rule that where both the parties to a contract are under a mistake as to a matter of fact essential to a contract, the contract is void.
- (ii) In a similar way Section 8 provides that an agreement to sell specific goods becomes void if subsequently the goods, without any fault on the part of the seller or buyer, perish or become so damaged as no longer to answer to their description in agreement before the risk passes to the buyer. This rule is also based on the ground of impossibility of performance as stated above.
- It may, however, be noted that section 7 & 8 apply only to specific goods and not to unascertained goods. If the agreement is to sell a certain quantity of unascertained goods, the perishing of even the whole quantity of such goods in the possession of the seller will not relieve him of his obligation to deliver the goods.

Answer 4. (b)

Following are the differences between sale and hire purchase :

Sale	Hire Purchase Agreement
1. Ownership is transferred from the seller to the buyer as soon as the contract is entered into.	1. Ownership is transferred from the seller to the hire-purchaser only when a certain agreed number of instalments are paid.
2. The position of the buyer is that of the owner.	2. The position of the hire-purchaser is that of the bailee.
3. The buyer cannot terminate the contract and as such is bound to pay the price of the goods.	3. The hire-purchaser has an option to terminate the contract at any stage, and cannot be forced to pay the further instalments.
4. If the payment is made by the buyer in instalments, the amount payable by the buyer to the seller is reduced, for the payment made by the buyer is towards the price of the goods.	4. The instalments paid by the hire-purchaser are regarded as hire charges and not as payment towards the price of the goods till option to purchase the goods is exercised.
5. The Sale agreements are governed by the Sales of Goods Act, 1930.	5. The hire-purchase agreements are governed by the Hire-Purchase Act, 1972.

Answer 4. (c)

Goods sent 'on approval' basis mean those goods in respect of which the buyer has option either to return or retain.

The rules relating to transfer of ownership of such goods are as follows :

Case	Time of transfer of ownership
(i) When the buyer signifies his approval or acceptance to the seller.	When approval or acceptance is communicated to the seller.
(ii) When the buyer does any other act of adoption.	When act of adoption is done.
(iii) When the buyer fails to return the goods: (A) If time has been fixed for return of goods. (B) If no time has been fixed for return of goods.	(A) On expiry of fixed time. (B) On expiry of reasonable time. What is reasonable time is a question of fact depending on circumstances of each case.

Answer 4. (d)

Case I : H's bid was an offer to buy and he was entitled to withdraw his bid before the sale is completed as per express provision of Section 64(2). [*Payne v. Cave*]

Case II : It amounts to fraud and sale is voidable at the option of the buyer because the seller could appoint only one person to bid on his behalf. [Sec 64(3) and Sec 64(6)]. Here the intention of the seller was not to protect his interest but to raise the price. [*Thornett v Haines*].

Q. 5. (a) Employees of an electricity generation station claimed that their unit is covered under the definition of 'factory' considering the process of transforming and transmission of electricity generated at the power station as a 'manufacturing process. Will their claim succeed?

(b) FBG Ltd. was running in continuous losses for 5 years. As a result, the company's financial position worsened. The company declared lay-off of 10 of its employees. The employees protested the lay-off. Is this action of employer justified?

(c) An electrician, who had to go frequently to a heating room from a cooling plant, contracted pneumonia which resulted in his death. Is the employer liable to pay compensation under the Employees Compensation Act, 1923?

Answer 5. (a)

As per section 2(k) of The Factories Act, 1948, manufacturing process means any process for-

- (i) Making, altering, repairing, ornamenting, finishing, packing, oiling, washing, cleaning, breaking-up, demolishing, or otherwise treating or adapting any article or substance with a view to its use, sale, transport, delivery or disposal, or
- (ii) Pumping oil, water, sewage or any other substance; or
- (iii) Generating, transforming or transmitting power; or
- (iii) Composing types for printing, printing by letter press, lithography, photogravure or other similar process or book binding; [Ira-6] [Ira-7 or Ira-7]
- (iv) Constructing, reconstructing, repairing, refitting, finishing or breaking up ships or vessels; (Inserted by the Factories (Amendment) Act, 1976, w.e.f. 26-10-1976.)
- (v) Preserving or storing any article in cold storage;

Process undertaken at electricity generating station, substation transferring and transmitting electricity is not a manufacturing process and are not thus factory- [*Delhi Electricity Supply Undertaking vs. Management of DESU*, AIR (1973)SCC 365].

Answer 5. (b)

As per section 2(kkk) of the Industrial Dispute Act **lay-off** - means failure, refusal or inability of an employer to give employment to a workman (a) whose name is borne on the muster –rolls of his industrial establishment, and (b) who has not been retrenched. The failure, refusal or inability of an employer to give employment may be due to- (1) shortage of coal, power, or raw materials, (2) the accumulation of stocks (3) breakdown of machinery (4) natural calamity or any other connected reasons.

In the given problem, because of continuous losses, the company's financial position worsened. The company declared lay-off of 10 of its employees. The words 'for any other reason' used in the definition is analogous to the reasons given in the definition. But the cause stated by the company is not covered under the definition. As such, the action of the employer is not justified. Similar observation was made in *J. K. Hosier vs. LAT of India*.

Answer 5. (c)

According to Section 3 of the Employees Compensation Act, 1923, employer is liable to pay compensation if personal injury is caused in course of employment. The course of employment is not interrupted by intervals of rest.

In the given problem, an employee had to frequently go into a heating room and from there to a cooling room in course of his duties. He suffered pneumonia and died. This is out of employment and employer is liable to pay compensation. [*Indian News Chronicle Ltd. vs Lazarus*(1951) 3 FJR 190]

Q. 6. (a) F failed to give details of travelling expenses on account of tour inspite of several reminders. His company deducted the amount of tour advance from F's salary after expiry of 3 months. Is the company justified under the *Payment of Wages Act, 1936*?

(b) X, an out worker prepared goods at his residence and later on supplied these goods to the M/s ABC. Is he an employee under the *Minimum Wages Act, 1948*?

(c) Y, on retirement withdrew the entire amount of his accumulation in the provident fund. Later on, he was re-appointed for a fixed tenure. The PF Inspector claimed contribution in respect of salary paid to Y. Is the demand made by PF Inspector tenable in law under *The Employees 'Provident Funds and Miscellaneous Provisions Act, 1952*?

Answer 6. (a)

According to Sec. 7(2) f and Sec. 12 of the Payment of Wages Act, 1936 no recovery can be made of such advances given for travelling expenses. The recovery of such advance is governed by rules made by appropriate Government in this regard. So the company on its own cannot make such recovery.

Answer 6. (b)

As per section 2(i) of the Minimum Wages Act, 1948 an "employee" means any person who is employed for hire or reward to do any work, skilled or unskilled, manual or clerical, in a scheduled employment in respect of which minimum rates of wages have been fixed; and includes an out- worker to whom any articles or materials are given out by another person to be made up, cleaned, washed, altered, ornamented, finished, repaired, adapted or otherwise processed for sale for the purposes of the trade or business of that other person where the process is to be carried out either in the home of the out- worker or in some other premises not being premises under the control and management of that other person; and also includes an employee declared to be an employee by the appropriate Government; but does not include any member of the Armed Forces of the 2 [Union].

So X is an employee under the Minimum Wages Act, 1948.

Answer 6. (c)

An employee who has been member of PF, withdrew the full amount of his accumulations is an 'excluded employee.' However, once he is reappointed in connection with work of the company, he attracts definition of 'employee' and the Act becomes applicable to him afresh. In *Harrison Malayalam Ltd. and Ors vs. RPFC & Ors.* (CAL H.C) 2001 I LLJ 1160, the company was held liable to cover an employee who took VRS and later appointed for a lump sum basis. Thus the demand made by authorities is tenable.

Q. 7. (a) Referring the provisions of the Payment of Bonus Act, 1965, state whether the following persons are entitled to bonus under the Payment of Bonus Act, 1965 :

- (i) An apprentice;
 - (ii) An employee dismissed on the ground of misconduct;
 - (iii) A temporary workman;
 - (iv) A piece-rated worker.
- (b) G absented himself from duty without applying for leave and left the job. When he claimed gratuity, the company refused to pay gratuity quoting his absence from duty without proper leave resulted in break in service. Will he get gratuity?
- (c) P has take an insurance policy on his life. While he was travelling in a car with his friend, accidentally the car caught fire and all the occupants including the driver were seriously injured. Later on, P succumbed to the injuries in hospital. His wife filed a claim with insurance company which was refused on the ground that the driver did not have a valid licence. She filed a case with the Consumer Disputes Redressal Forum. Will she succeed? Decide with relevant case law, if any.

Answer 7. (a)

- (i) An Apprentice is not entitled to bonus [*Wheel RIM Co. Vs. Govt. of Tamil Nadu* (1971)]
- (ii) An employee dismissed on the ground of misconduct is disqualified for any is not entitled to bonus. [*Pandian Roadways Corporation Ltd. Vs. Presiding Officer* (1996)]
- (iii) A temporary workman is entitled to bonus on the basis of the total number of days worked by him.
- (iv) A piece-rated worker is entitled to bonus. [*Mathurads Kani Vs. L.A. Tribunal* (1958)]

Answer 7. (b)

Section 2A of the Payment of Gratuity Act, 1972 provides that an employee shall be said to be in continuous service for a period if he has, for that period, been in uninterrupted service, including service which may be interrupted on account of sickness, accident, leave, absence from duty without leave (not being absence in respect of which an order 3 [treating the absence as break in service has been passed in accordance with the standing orders, rules or regulations governing the employees of the establishment), lay-off, strike or a lock-out or cessation of work not due to any fault of the employee, whether such uninterrupted or interrupted service was rendered before or after the commencement of this Act.

Therefore G is eligible and will get Gratuity.

Answer 7. (c)

The facts of the case are similar to that of *Jitendra Kumar vs. Oriental Insurance Co. Ltd.* In this case, The Supreme Court has held that the Insurance Company cannot refuse claim of P's wife as he has taken life insurance and on event of his death irrespective of the fact whether the person who was driving the car had valid licence or not had nothing to do with policy of life insurance. Hence, P's wife case is maintainable and she is entitled to receive the claim i.e the insured amount on event of P's death.

Q. 8. (a) What do you understand by the terms 'premises' and 'precincts' under the Factories Act, 1948.

(b) Explain the terms 'Arbitration' and 'Conciliation' for resolution of industrial dispute under the Industrial Dispute Act, 1947.

Answer 8. (a)

Premises means the building or shed where the factory machineries are set up and manufacturing process are carried on. Precincts means the surrounding areas like open space inside the factory boundary, roads, gardens, open godowns etc where the workers move inside the factory boundary.

Answer 8. (b)

Arbitration: A process in which a neutral third party listens to the disputing parties, gathers information about the dispute, and then takes a decision which is binding on both the parties. The conciliator simply assists the parties to come to a settlement, whereas the arbitrator listens to both the parties and then gives his judgement.

Advantages of Arbitration :

- It is established by the parties themselves and therefore both parties have good faith in the arbitration process.
- The process is informal and flexible in nature.
- It is based on mutual consent of the parties and therefore helps in building healthy Industrial Relations.

Disadvantages :

- Delay often occurs in settlement of disputes.
- Arbitration is an expensive procedure and the expenses are to be shared by the labour and the management.
- Judgment can become arbitrary when the arbitrator is incompetent or biased.

There are two types of arbitration:

Voluntary Arbitration : In voluntary arbitration the arbitrator is appointed by both the parties through mutual consent and the arbitrator acts only when the dispute is referred to him.

Compulsory Arbitration : Implies that the parties are required to refer the dispute to the arbitrator whether they like him or not. Usually, when the parties fail to arrive at a settlement voluntarily, or when there is some other strong reason, the appropriate government can force the parties to refer the dispute to an arbitrator.

Conciliation refers to the process by which representatives of employees and employers are brought together before a third party with a view to discuss, reconcile their differences and arrive at an agreement through mutual consent. The third party acts as a facilitator in this process. Conciliation is a type of state intervention in settling the Industrial Disputes. The Industrial Disputes Act empowers the Central & State governments to appoint conciliation officers and a Board of Conciliation as and when the situation demands.

Conciliation Officer : The appropriate government may, by notification in the official gazette, appoint such number of persons as it thinks fit to be the conciliation officer. The duties of a conciliation officer are :

- (i) To hold conciliation proceedings with a view to arrive at amicable settlement between the parties concerned.
- (ii) To investigate the dispute in order to bring about the settlement between the parties concerned.
- (iii) To send a report and memorandum of settlement to the appropriate government.
- (iv) To send a report to the government stating forth the steps taken by him in case no settlement has been reached at.

The conciliation officer however has no power to force a settlement. He can only persuade and assist the parties to reach an agreement. The Industrial Disputes Act prohibits strikes and lockouts during that time when the conciliation proceedings are in progress.

Q. 9. (a) How do you define 'disablement' under the Workmen's Compensation Act, 1923?

(b) On whom does the responsibility for payment of wages lie under the Payment of Wages Act, 1936?

Answer 9. (a)

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) (I) 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.

Answer 9. (b)

Every employer shall be responsible for payment to persons employed by him of all wages required to be paid under the Payment of Wages Act, 1936 (Sec 3). But in the case of persons employed (otherwise than by a contractor) in factories, industrial establishments or upon railways, the following persons shall also be responsible for the payment of wages :

- (i) in factories if a person has been named as the manager of the factory under clause (f) of sub-section (1) of section 7 of the Factories Act, 1948;
- (ii) in industrial or other establishments if there is a person responsible to the employer for the supervision and control of the industrial or other establishments;
- (iii) upon railways (other than in factories) if the employer is the railway administration and the railway administration has nominated a person in this behalf for the local area concerned.
- (iv) in the case of contractor, a person designated by such contractor who is directly under his charge; and
- (v) in any other case, a person designated by the employer as a person responsible for complying with the provisions of the Act, the person so named, the person responsible to the employer, the person so nominated or the person so designated, as the case may be, shall be responsible for such payment.

Notwithstanding anything contained in sub-section(1), it shall be the responsibility of the employer to make payment of all wages required to be made under this Act in case the contractor or the person designated by the employer fails to make such payment.

Q. 10. (a) What is the procedure of fixing minimum wages under the Minimum Wages Act, 1948?

(b) Explain the provisions of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 relating to liability of a transferee employer in case of transfer of establishment by an employer.

Answer 10. (a)

Section 5 of the Minimum Wages Act, 1948 provides for fixing and revising minimum wages under the minimum wages which states that—

- (1) In fixing minimum rates of wages in respect of any scheduled employment for the first time under this Act or in revising minimum rates of wages so fixed the appropriate government shall either—
 - (a) appoint as many committees and sub-committees as it considers necessary to hold enquiries and advise it in respect of such fixation or revision as the case may be, or
 - (b) by notification in the Official Gazette, publish its proposals for the information of persons likely to be affected thereby and specify a date not less than two months from the date of the notification on which the proposals will be taken into consideration.
- (2) After considering the advice of the committee or committee appointed under clause (a) of sub-section (1) or as the case may be, all representations received by it before the date specified in the notification under clause (b) of that sub-section, the appropriate government shall by notification in the Official Gazette, fix or as the case may be revise the minimum rates of wages in respect of each scheduled employment and unless such notification otherwise provides it shall come into force on the expiry of three months from the date of its issue :

Provided that where the appropriate government proposes to revise the minimum rates of wages by the mode specified in clause (b) of sub-section (1) the appropriate government shall consult the Advisory Board also.

Answer 10. (b)

Liability of a transferee employer in case of transfer of establishment by the employer : (Section 17-B of the *Employees' Provident Funds and Miscellaneous Provisions Act, 1952*).

Where an employer in relation to an establishment, transfers that establishment in whole or in part by sale, gift, lease or licence or in any other manner whatsoever, the employer and the person to whom the establishment is so transferred shall jointly or severally be liable to pay the contribution and other sums due from the employer under any provisions of the Act of the Scheme or the Pension Scheme, as the case may be, in respect of the period up to the date of such transfer. It is provided that the liability of the transferee shall be limited to the value of the assets obtained by him by such transfer.

Section 17-B deals with the liability of transferor and transferee in regard to the money due under—

- (a) the Act; or
- (b) the Scheme;
- (c) Pension Scheme.

in the case of transfer of the establishment brought in by sale, gift, lease, or any other manner whatsoever, the liability of the transferor and the transferee is joint and several, but is limited with respect to the period upto the date of the transferor. Also the liability of the transferee is further limited to the assets obtained by him from the transfer of the establishment.

Q. 11. (a) Explain the provisions of the Payment of Bonus Act, 1965 relating to application of the Act to the establishments in public sector. What is the time limit within which payment of bonus due to an employee under the Act, be paid ?

(b) Explain the following terms in relation to the Payment of Gratuity Act, 1972:

- (i) Wages
- (ii) Rate of Gratuity.

(c) Who can file complaint under the Consumer Protection Act, 1986?

Answer 11. (a)

Application of the Act to the establishment in public sector : Section 20 of the Payment of Bonus Act, 1965 provides that if in any accounting year, an establishment in public sector may sell any goods produced or manufactured by it or it may render any services in competition with an establishment in private sector. And if the income from such sale or service or both is not less than 20% of the gross income of establishment in public sector, then the provisions of Bonus Act shall apply in relation to establishment in private Sector (Sub-section 1) Save as otherwise provided in Subsection (1), nothing in this Act shall apply to the employees employed by any establishment in the public sector (Sub-section2).

The time limit for a payment of bonus : The employer is bound to pay his employee bonus within one month from the date on which the award becomes enforceable or the settlement comes into operation, if a dispute regarding payment of bonus is pending before any authority under Section 22 of the Act. In other cases, however, the payment of the bonus is to be made within a period of 8 months from closing of the accounting. But this period of 8 months may be extended upto a maximum of 2 years by the appropriate Government or by any authority specified; by the appropriate Government. This extension is to be granted on the application of the employer and only for sufficient reasons.

Answer 11. (b)

- (i) The term wages as per sec. 2 of Payment of Gratuity Act, 1972 includes basic plus D.A but does not include bonus, commission, house rent allowance, overtime wages or any other allowance. The main feature of **wages** as described aforesaid is that it refers to payment made in cash and not in any other form. Thus supply of food at factory canteen free is not included in wages.
- (ii) Rate of Gratuity: Gratuity is payable @ 15 days wages for every year of completed service or part thereof in excess of six months. In case of seasonal industries it is payable @ 7 days wages for each season.

Answer 11. (c)

Complaints may be filed with the District Forum/State Commission/National Commission by :-

1. The consumer to whom such goods are sold or delivered or agreed to be sold or delivered or such service provided or agreed to be provided.
2. Any recognised consumer association, whether the consumer to whom goods sold or delivered or agreed to be sold or delivered or service provided or agreed to be provided, is a member of such association or not.
3. One or more consumers, where there are numerous consumers having the same interest with the permission of the District Forum, on behalf of or for the benefit of, all consumers so interested.
4. The Central or the State Government.

Every complaint filed shall be filed along with such amount of fee as may be prescribed.

Q. 12. (a) Limited Liability Partnership is distinct from limited partnership according to Limited Liability Partnership Act, 2008. Do you agree?

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

Answer 12. (a)

The statement is true. The distinction between the two are as follows:

Limited Liability Partnership	Limited Partnership
(i) Limited liability partnership is granted to all partners.	(i) Limited partnership is granted to a set of non managing partners only.
(ii) The law relating to partnership is not applicable.	(ii) The law relating to partnership is very much applicable

Answer 12. (b)

Under the Right to *Information Act, 2005* competent authority means—

- (i) the Speaker in the case of the House of the People or the Legislative Assembly of a State or a Union territory having such Assembly and the Chairman in the case of the Council of States or Legislative Council of a State;
- (ii) the Chief Justice of India in the case of the Supreme Court;
- (iii) the Chief Justice of the High Court in the case of a High Court;
- (iv) the President or the Governor, as the case may be, in the case of other authorities established or constituted by or under the Constitution;
- (v) the administrator appointed under article 239 of the Constitution.

The competent authority may, by notification in the Official Gazette, make rules to carry out the provisions of this Act.

Q. 13. (a) XYZ Ltd. made an initial public offer of certain number of equity shares. Examine whether these shares can be considered as 'Goods' under the Competition Act, 2002 before allotment.

(b) Promissory note dated 1st February, 2012 payable two months after date was presented to the maker for payment 10 days after maturity. What is the date of Maturity? Explain with reference to the relevant provisions of the 'Negotiable Instruments Act, 1881 whether the endorser and the maker will be discharged by reasons of such delay.

Answer 13. (a)

Section 2(i) of Competition Act, 2002 defines 'goods' as follows:

'Goods' means goods as defined the Sale of Goods Act, 1930 and includes –

- (i) products manufactured, processed or mined;
- (ii) debentures, stock and shares after allotment
- (iii) in relation to goods supplied, distributed or controlled in India, goods imported into India.

Hence, debentures and shares can be considered as 'goods' within the meaning of section 2(i) of Competition Act, 2002 only after allotment and not before allotment.

Answer 13. (b)

If a promissory note is made payable a stated number of months after date, it becomes payable three days after the corresponding date of months after the stated number of months (Section 23 read with Section 22 Negotiable Instruments Act 1881). Therefore- in this case the date of maturity of the promissory note is 4th April, 2012.

In this case the promissory note was presented for payment 10 days after maturity. According to Section 64 of Negotiable Instruments Act read with Section 66, a promissory note must be presented for payment at maturity by on behalf of the holder. In default of such presentment, the other parties the instrument

(that is, parties other than the parties primarily liable) are not liable to such holder. The indorser is discharged by the delayed presentment for payment. But the maker being the primary party liable on the instrument continues to be liable.

Q. 14. (a) Explain the term 'designated partners' under LLP Act, 2008.

(b) Explain 'third party information' under RTI Act, 2005.

Answer 14. (a)

Designated partners is defined in Section 7 of LLP Act, 2008.

- (1) Every limited liability partnership shall have at least two designated partners who are individuals and atleast one of them shall be a resident in India :

Provided that in case of a limited liability partnership in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such bodies corporate shall act as designated partners.

Explanation : For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less than one hundred and eighty-two days during the immediately preceding one year.

- (2) Subject to the provisions of sub-section (1),—
- (i) if the incorporation document—
 - (a) specifies who are to be designated partners, such persons shall be designated partners on incorporation; or
 - (b) states that each of the partners from time to time of limited liability partnership is to be designated partner, every partner shall be a designated partner;
 - (ii) any partner may become a designated partner by and in accordance with the limited liability partnership agreement and a partner may cease to be a designated partner in accordance with limited liability partnership agreement.
- (3) An individual shall not become a designated partner in any limited liability partnership unless he has given his prior consent to act as such to the limited liability partnership in such form and manner as may be prescribed.
- (4) Every limited liability partnership shall file with the registrar the particulars of every individual who has given his consent to act as designated partner in such form and manner as may be prescribed within thirty days of his appointment.
- (5) An individual eligible to be a designated partner shall satisfy such conditions and requirements as may be prescribed.
- (6) Every designated partner of a limited liability partnership shall obtain a Designated Partner Identification Number (DPIN) from the Central Government and the provisions of sections 266A to 266G (both inclusive) of the Companies Act, 1956 shall apply mutatis mutandis for the said purpose.

Answer 14. (b)

This is dealt in Section 11 of the RTI Act, 2005.

- (1) Where a Central Public Information Officer or a State Public Information Officer, as the case may be, intends to disclose any information or record, or part thereof on a request made under this Act, which relates to or has been supplied by a third party and has been treated as confidential by that third party, the Central Public Information Officer or State Public Information Officer, as the case may be, shall, within five days from the receipt of the request, give a written notice to such third

party of the request and of the fact that the Central Public Information Officer or State Public Information Officer, as the case may be, intends to disclose the information or record, or part thereof, and invite the third party to make a submission in writing or orally, regarding whether the information should be disclosed, and such submission of the third party shall be kept in view while taking a decision about disclosure of information :

Provided that except in the case of trade or commercial secrets protected by law, disclosure may be allowed if the public interest in disclosure outweighs in importance any possible harm or injury to the interests of such third party.

- (2) Where a notice is served by the Central Public Information Officer or State Public Information Officer, as the case may be, under sub-section (1) to a third party in respect of any information or record or part thereof, the third party shall, within ten days from the date of receipt of such notice, be given the opportunity to make representation against the proposed disclosure.
- (3) Notwithstanding anything contained in section 7, the Central Public Information Officer or State Public Information Officer, as the case may be, shall, within forty days after receipt of the request under section 6, if the third party has been given an opportunity to make representation under sub-section (2), make a decision as to whether or not to disclose the information or record or part thereof and give in writing the notice of his decision to the third party.
- (4) A notice given under sub-section (3) shall include a statement that the third party to whom the notice is given is entitled to prefer an appeal under section 19 against the decision.

Q. 15. (a) The Central Government has formed the opinion that Mr. RX (A member of the Competition Commission of India) has abused his position which may be prejudicial to public interest as a member of the commission. Examine the powers of the Central Government in this regard.

(b) Who is a holder in due course of a Negotiable Instrument? In what respects does he differ from a holder?

Answer 15. (a)

Section 11(2) (e) of the Competition Act, 2002 empowers the Central Government to remove by an order, a member of the Competition Commission of India from his office if such member has abused his position as to render his continuance in office prejudicial as a member of competition commission. However provision of Section 11(3) of the said act puts some restrictions on such powers of the Central Government. According to this section, in case as stated in the question, Central Government wants to remove a member or the Competition Commission from his office on the above ground, it has to make a reference to the Supreme Court. The Supreme Court shall hold an enquiry in accordance with the procedure formulated by it and then report that the member in question ought to be removed from his office on such ground. Thus the Central Government can remove a member of Competition Commission from his office by following the above procedure.

Answer 15. (b)

Holder In Due Course: It means any person who, for consideration became its possessor before the amount mentioned in it became payable. In the case of an instrument payable to order, 'holder in due course' means any person who became the payee or endorsee of the instrument before the amount mentioned in it became payable. In both the cases, he must receive the instrument without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title. In other words, holder in due course means a holder who takes the instrument bona fide for value before it is overdue, and without any notice of defects in the title of the person, who transferred it to him. Thus a person who claims to be 'holder in due course' is required to prove that :

1. on paying a valuable consideration, he became either the possessor of the instrument if payable to order;

2. he had come into the possession of the instrument before the amount due thereunder became actually payable; and
3. he had come to possess the instrument without having sufficient cause to believe that any defect existed in the title of transferor's from whom derived his title.

Distinction between Holder & Holder in Due Course :

1. A holder may become the-possessor or payee of an instrument even without consideration, whereas a holder in due course is one who acquires possession for consideration.
2. A holder in due course as against a holder, must become the possessor payee of the instrument before the amount thereon become payable.
3. A holder in due course as against a holder, must have become the payee of the instrument in good faith i.e., without having sufficient cause to believe that any defect existed in-the transferor's title.



SECTION - II (Auditing)

Q. 16. Comment on the following statements based on legal provisions :

- (a) Audit is concerned with ethics of business.
- (b) In auditing, the concept of materiality can be judged only in relative context.
- (c) Contingent Liabilities do not form part of Balance Sheet, hence need not be verified.
- (d) Auditing in depth means checking all the transactions in minute details.
- (e) All expenses /losses incurred during construction period should be capitalized including abnormal losses.
- (f) Test check approach and random sampling approach are same.
- (g) Auditor should qualify audit report if any Secret Reserve is created.
- (h) When separate Branch Auditors are appointed, the company auditor need not visit the branches.
- (i) For ascertaining minority interest, there is a need to distinguish between capital and revenue profits of subsidiary.
- (j) Assets given on lease should be disclosed as part of fixed assets in the financial statements of the lessor.
- (k) The principal auditor of a limited company is entitled to rely on the work of another auditor of its component part.
- (l) Contingent Gains are recognized in Financial Statements.
- (m) Audit in EDP environment is easier as the Trial Balance always tallies.
- (n) When the auditor doesn't agree with Financial Statements on certain grounds he gives 'disclaimer' of opinion.
- (o) In the Balance Sheet of the Company , Debenture to be redeemed during the subsequent year are shown under the head " Current Liabilities and Provisions".

Answer 16.

- (a) The statement is false. Audit is not concerned with ethics of business unless the business itself is illegal or unlawful.
- (b) The statement is true. Materiality can be judged only in relative context. In a small business, Rs 5000/- may be a material amount, whereas in a giant undertaking, Rs. 50,000 may not be so material as to merit a separate disclosure.
- (c) 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.
- (d) The statement is false. Auditing in depth means the tracing of a transaction through its various stages from origin to conclusion, examining the supporting records at each stage and ascertaining whether all the requirements laid down in the system of internal check have been complied with.

- (e) The statement is false. Abnormal losses during construction period should not be capitalized but should be written off over a period of 3-5 years after commencement of production.
- (f) The statement is false. Test check approach is different from random sampling approach. Test check is based on intuition while random sampling approach is scientific verification on selective basis. In case of test check samples drawn may be biased but in statistical random sampling, samples are based on random number tables, so there will be no element of bias.
- (g) Auditor should carefully examine the necessity of creating Secret Reserve and need not qualify the audit report if it is found that intention of the company is honest and the amount is reasonable.
- (h) It is totally at the discretion of the company auditor as to whether he should visit the branches and to the degree he would rely on branch auditors' report. The company auditor is however not responsible for work done by branch auditor.
- (i) The statement is false. Minorities are concerned with their stake in the Holding Company. Their right consists in share capital, and reserves and surplus. To ascertain minority interests neither capital profit nor revenue profit is necessary.
- (j) The statement is false. The lessor cannot account for assets given on financial lease as all risks and refunds incidental to the ownership of such assets stand transferred to the lessee. He has to treat lease amount receivable from lessee as 'Receivables' on the asset side of the Balance Sheet.
- (k) The statement is true. The principal auditor may adopt the remarks and qualifications of the auditor of component part if he is satisfied with work done by the other auditor. Otherwise, if he is not satisfied, the principal auditor can draft his report of the entity as a whole after verifying the accounts including component part. In practice, The principal auditor will discuss the issues with the other auditor about the nature of remarks and finalize his report for entity as a whole.
- (l) The statement is false. As per para 12 of AS 4, contingent gains should not be recognised in the financial statements till it is realized.
- (m) In today's complex business environment, the importance of trial balance in an audit has to be gauged 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 judgment to be exercised by the auditor. So responsibility of auditor will still remain even in an EDP environment.
- (n) The statement is false. When the auditor states that he is unable to form an opinion for want of necessary evidence, the it is 'disclaimer' of opinion.
- (o) The statement is false. The amount should be shown under the first sub- head under "Secured Loans" irrespective of the due date of redemption as per Part – I, Schedule VI of the Companies Act, 1956.

Q. 17. (a) The Board of Directors of FBG Ltd. refused to Minute Book to the Statutory Auditor on the ground of secrecy. State the legal position.

- (b) Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.**

Answer 17. (a)

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.

Answer 17. (b)

In planning and performing his examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are :

- (i) Weaknesses in the design of internal control system and non-compliance with the laid down control procedures, e.g., a single person is responsible for the receipt of all letters and marking it to the relevant sections or two persons are responsible for receipt of letters but the same is not followed in actual practice, etc.
- (ii) Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees, frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc.
- (iii) Unusual pressures within the entity, for example, industry is doing well but the company is not performing all right, heavy dependence on a single line of product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc.
- (iv) Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.
- (v) Problems in obtaining sufficient and appropriate audit evidence, e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc.

Q. 18. As an auditor, how will you vouch and/or verify the following?

- (a) Receipt of capital subsidy**
- (b) Provision for income tax**
- (c) Deferred Revenue Expenditure**
- (d) Sales Commission Expenditure**
- (e) Purchase return**

Answer 18. (a)

Receipt of Capital Subsidy :

- (i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
- (ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

- (iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- (iv) Check relevant entries for receipt of subsidy.
- (v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

Answer 18. (b)**Provision for Income Tax :**

- (i) 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.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) 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.

Answer 18. (c)**Deferred Revenue Expenditure :**

This is a type of revenue expenditure, whose benefit extends to more than one accounting year during which it is actually incurred. Accountancy principles require that only that part of the expenditure which is pertaining to the accounting period should be debited to the profit and loss account of the year. Remaining amount should be carried forward in the balance sheet and it should be written off against the future income, depending upon the number of years during which the benefit of expenditures is likely to be enjoyed. This type of expenditure is known as deferred revenue expenditure. Part of such revenue expenditure is to be treated as assets for the purpose of disclosure in the balance sheet for the time till the benefit of such expenditure is fully exhausted.

Some examples of deferred revenue expenditure are expenditure on an advertisement campaign to launch a product in the market, discount allowed on subscription to debentures, development expenses in the case of mines and plantations, etc. While verifying deferred revenue expenditure, this may satisfy himself that :

- (i) it is proper to defer the expenditure;
- (ii) the period of amortisation of the expenditure is reasonable;
- (iii) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;
- (iv) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue / other benefits related to the expenditure continue to exceed the amount of unamortized expenditure.

Answer 18. (d)**Sales Commission Expenditure :**

- (i) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes, the commission should be in accordance with the terms and conditions as specified.

- (ii) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.
- (iii) Ensure that the sales in fact have taken place and the same has been charged to profit and loss account.
- (iv) Compare the amount incurred in previous years with reference to total turnover.

Answer 18. (e)

Purchase Return :

- (i) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.
- (ii) Verify by reference to relevant corresponding record in goods outward book or the stores records. Further, the figures in these documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.
- (iii) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.
- (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

Q. 19. As an auditor, comment on the following situations :

- (a) In the course of audit of a trade, you noticed that although there is no change in either selling or purchase price of the goods, there is considerable increase in Gross Profit Ratio in comparison to previous year. What matters would you examine to assess the reason for such increase?**
- (b) The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year.**

Answer 19. (a)

In assessing the reason for considerable increase in Gross Profit Ratio, the auditor should examine the followings :

- (i) Under valuation of opening stock due to non-inclusion of certain items or applying lower rate to one or more items of stock.
- (ii) Over valuation of closing stock either by the inclusion of fictitious items or over valuing some of the items of Stock.
- (iii) Change in the method of valuation of opening and closing stock. For example, opening stock was valued at lower of cost and market value, whereas closing stock has been valued at market price which is higher than cost.
- (iv) Goods sold but not delivered are included in stock.
- (v) Goods delivered last year but sales invoice raised in current year.
- (vi) Recording of fictitious sales to boost up profits.
- (vii) Goods returned to supplier awarding dispatch and included in closing stock.
- (viii) Goods returned by customers but not debited to sales return and included in closing stock.
- (ix) Inclusion in the closing stock of goods received for sale on approval or consignment basis.
- (x) Treatment of goods sent on consignment basis as regular sales.
- (xi) Non-provision of outstanding expenses like wages, carriage inward etc.
- (xii) Wrong allocation of expenses in Trading and Profit & Loss Account.

Answer 19. (b)

Semi-finished goods being composite part of the inventories, normally, constitute significant item in case of any entity. It is the duty of the auditor to ensure that entire inventories which are owned by the enterprise exist on that date and valuation thereof is also proper. Since the semi-finished goods belong to the company, it is necessary to ensure that the same have been included for in valuation of inventories. The auditor should also obtain direct confirmation about the quantity of inventories lying with the processors at the end of the year. Also, the auditor should see that the valuation has been made properly with reference to the stage of completion in respect of work-in-process inclusive of expenses incurred in sending the goods for processing. In case, the amount happens to be material, such stock may be disclosed separately as stocks with processors.

Q. 20. Give your comments and observations on the following :

- (a) Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses.**
- (b) A sum of ₹ 10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing ₹ 12,00,000. The amount is credited to the Purchases Account.**

Answer 20. (a)

The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS 10 on 'Accounting for Fixed Assets' requires that "an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution". Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

Answer 20. (b)

AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period. The claim for loss of goods in transit is arising out of ordinary activities of the enterprise as a part of its normal course of business. However, the cost of goods lost in transit is only ₹ 10,00,000 while the insurance money received is ₹ 12,00,000. Purchases Account need not be credited since it would distort the purchases done during the year and as also the gross profit. Therefore, entire amount of ₹ 12 lacs needs to be taken to profit and loss account under an appropriate head. This is an income arising from an ordinary activities of the enterprise but having regard to amount involved and exceptional nature, a separate disclosure be made in the profit and loss account. Such disclosure would enable the users to understand the performance of an enterprise for the period.

Q. 21. As an auditor, how will you verify the following?

- (a) Retirement Gratuity to Employees.**
- (b) Discounted bills receivable dishonoured**
- (c) Plant and machinery**
- (d) Purchase of quoted investment**

Answer 21. (a)

Retirement Gratuity to Employees :

- (i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.
- (ii) Verify computation of liability of gratuity on the aggregate basis.
- (iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.
- (iv) See that the annual premium has been charged to Profit and Loss account.
- (v) Ensure that the accounting treatment is in accordance with AS 15, "Accounting for Retirement Benefits in the Financial Statements".

Answer 21. (b)

Discounted Bills Receivable Dishonoured :

- (i) Obtain the schedule of discounted bills receivable dishonoured.
- (ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.
- (iii) Verify the bills receivable returned by the bank along with bank's advice.
- (iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the debtor is also debited.
- (v) Check that bank commission, if any, charged by the bank has been recovered from the party.

Answer 21. (c)

Plant and machinery :

- (i) Verify the existence of plant and machinery by reference to documentary evidence available and by evaluation of internal controls. Plant and machinery in existence at the commencement of the year is normally verified by examining the schedule of plant and machinery and the fixed assets register. Acquisition during the year can be verified by reference to the Board's minutes, purchase invoice and entry in the fixed assets register.
- (ii) Vouch the cost price of any plant and machinery including freight and insurance plus any cost of installation with relevant invoices, etc. The auditor should verify that due provision for depreciation has been made. When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value. The mode of disclosure in the balance sheet should also be seen. Check that requirement of relevant accounting standards, viz., AS 6, AS 10, etc. regarding accounting treatment, presentation and disclosures have been followed.
- (iii) See that the various items of plant and machinery possessed by the client at the year end are recorded in the financial ledger and in the fixed assets register. Proper inquiry should be made to ensure that plant and machinery scrapped, destroyed or sold during the year has been properly adjusted in the books of account as also in the fixed assets register. If on physical verification material discrepancies are found, the auditor should see that the discrepancies have been properly adjusted in the books of account.
- (iv) Comment on physical verification made by the management. Under the Companies Auditor's Report Order applicable to companies, physical verification of the fixed assets including plant and machinery is the responsibility of the management. This they can do by examination of physical verification instruction programme and working papers.

Answer 21. (d)**Purchase of Quoted Investment :**

- (i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., error cum-dividend/interest/right/bonus.
- (ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.
- (iii) Verify the amount paid towards purchase of investments.
- (iv) Trace the amount in the cheque book counterfoils and bank statements.
- (v) Obtain a schedule of investment from Management for physical verification at the year end.
- (vi) Verify the investment certificate to confirm title.
- (vii) Confirm compliance with statutory provisions such as 227(1A) and CARO, 2003 under section 227(4A) of the Companies Act, 1956.
- (viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

Q. 22. Comment on the following situations :

- (a) At an Annual General Meeting, Mr. B a retiring auditor claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. A, could not be proceeded with, due to Mr. A's death.
- (b) KBK Ltd. in which 24 per cent of the subscribed capital is held by a public financial institution at the time of issuing the notice for the Annual General Meeting, appoints AB & Co. as auditors by an ordinary resolution at the Annual General Meeting when the Public Financial Institution increased its stake in KBK Ltd. to 25 per cent of its subscribed capital.
- (c) At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?
- (d) The auditor of HGI Ltd. did not report on the matters specified in sub-section (1A) of Section 227 of the Companies Act, 1956, as he was satisfied that no comment is required.

Answer 22. (a)

Section 224(2) of the Companies Act, 1956 dealing with reappointment of auditors specifies that subject to the provisions of sub-section (1B) and section 224A, at any Annual General Meeting a retiring auditor, by whatsoever authority appointed, shall be re-appointed unless, *inter alia* :

"Where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or dis-qualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with."

However, it should be noted that even for the re-appointment of a retiring auditor, the passing of a resolution is essential. Section 224 of the Companies Act, 1956, requires that a resolution has to be passed by the company every year. In the absence of a resolution, the retiring auditor is not re-appointed automatically.

Thus, the claim of Mr B would not hold good.

Answer 22. (b)

Section 224A of the Companies Act, 1956 does not specify the date on which 25% of the subscribed share capital should be held by the specified institutions to require the appointment of the auditors by a special resolution.

The Department of Company Affairs has opined that the material date is the date of the AGM at which the special resolution is required to be passed. In some cases, it is possible that the shareholding of the specified bodies is less than 25% of the subscribed share capital of a company at the time of issuing the notice for the AGM, but exceeds this limit on the date of the AGM. In such a case, it is advisable for the company to adjourn the meeting, issue another notice to the members for appointment of auditors by special resolution and pass the special resolution at the adjourned meeting.

Hence, KBK Ltd. should appoint AB & Co. as auditors in the above mentioned manner.

Answer 22. (c)

Section 227(1) of the Companies Act, 1956 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit. These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence, any such resolution even if passed by entire body of shareholders is ultra vires and therefore void. In the case of *Newton vs. Birmingham Small Arms Co.*, it was held that any regulations which preclude the auditors from availing themselves of all the information to which they are entitled under the Companies Act, are inconsistent with the Act.

Answer 22. (d)

Section 227(1A) of the Act deals with duties of an auditor requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, personal expenses, etc. Since the law requires the auditor to make an enquiry, the auditor is not required to report on the matters specified in sub-section (1A) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of HGI Ltd. is correct in non-reporting on the matters specified in Section 227(1A).

Q. 23. As a Company Auditor, how would you deal with the following situations?

- (a) G Ltd. gave a guarantee to the Court for payment of excise dues of Rs.10 lacs for one of its subsidiaries. According to the company, since the guarantee was given on behalf of its subsidiary, no disclosure was required.
- (b) ANM Ltd. received a subsidy of Rs.1 crore for establishing an undertaking in the backward/notified area.
- (c) KBC Prakashan Ltd undertook repair and overhauling of its machinery at a cost of Rs.350 lakhs to maintain them in good condition and capitalised the amount as it is more than 25% of the original cost of the machinery.
- (d) Directors of SPW Ltd. declared a final dividend of 30% for 2011-12 in their meeting held on 11-8-2012.

Answer 23. (a)

G Ltd., in its books of account is required to record a contingent liability of Rs.10 lacs for the guarantee given by it for payment of excise dues of its subsidiary, to the Court. In the event, the subsidiary failed to meet its obligation, G Ltd. would be required to pay Rs.10 lacs to the authorities concerned.

AS 4 also states that the existence and amount of guarantees undertaken by an enterprise are generally disclosed in financial statements by way of a note, even though the possibility that the loss will occur, is remote.

Thus, the amount of any guarantee given by a company on behalf of its subsidiary is required to be stated and where practicable, the general nature of such contingent liability, if material, be specified. Accordingly, the views expressed by the company cannot be accepted.

Answer 23. (b)

The company had received a subsidy of ₹ 1 crore, for establishing an undertaking in the backward/notified area.

The accounting treatment of such subsidy shall depend upon the nature and purpose for which it has been given. As per AS 12 on "Accounting for Government Grants", the grant given for acquisition of fixed assets is in the nature of promoter's contribution.

As per facts of the case, the grant has been given with reference to the total investment in the undertaking by way of contribution towards its total capital outlay for the establishment of the undertaking which is having similar characteristics to those of promoter's contribution.

In such cases, no repayment is ordinarily expected and thus the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Accordingly, the amount of Rs.1 crore should be kept in a special reserve account and treated as a part of shareholders' funds.

Answer 23. (c)

The money spent on the repair and overhaul of the machinery can be treated as capital expenditure, irrespective of the amount, only if it results in increasing the earning capacity or reduction in the cost of production. In this case, neither the earning capacity has increased nor there is any reduction in the cost of production.

In the absence of both these criteria, it is to be treated as revenue expenditure. The mere fact that maintenance expenditure is more than 25% of the original cost of the machinery would not change its nature, i.e. in revenue expenditure.

If any expenditure of a revenue nature is treated as capital, then it would have the effect of inflating the profit for the year. Consequently, the auditor would be required to qualify his report.

Answer 23. (d)

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 SPW 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.

Q. 24. (a) Draft a 'checklist' for carrying out the "Buy Back of Own Securities."

(b) Draft an audit programme to audit the receipts of an amusement park owned by a partnership firm.

Answer 24. (a)

Section 77A of the Companies (Amendment) Act, 1999 contains elaborate provisions enabling a company to buy-back its own securities.

The auditor should ensure the compliance of all the provisions relating to buy-back and also see that proper accounting entries have been passed. Audit procedure to be followed may be as under :

- (i) Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.
- (ii) Check authorisation in the Articles of Association which is a prerequisite of any buyback.
- (iii) Examine special resolution passed in the general meeting authorising buyback.
- (iv) Ascertain that quantum of buy-back is either equal to or less than 25% of the total paid up share capital and free reserves but in case of buy-back of equity shares in any financial year it should not exceed 25% of its total paid-up equity capital in that financial year.
- (v) Check that the debt equity ratio should not be more than 2 : 1 except in cases where Central Government allows higher ratio for a class or classes of companies.
- (vi) Ensure that shares or other specified securities to be bought back should be fully paid-up.
- (vii) Buy-back should be completed within 12 months from the date of passing the special resolution.
- (viii) Ascertain that declaration of solvency in Form No.4A was filed with the SEBI and/or the Registrar of Companies before making buy-back but subsequent the passing of the special resolution.
- (ix) See that SEBI (buy-back of securities) Regulations, 1998 have been followed by listed company.

Answer 24. (b)

Audit programme for checking the receipts of an amusement park of a partnership firm.

- (1) The partnership deed should be first scrutinized.
- (2) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.
- (3) The internal control for collections from sale of tickets should be checked.
- (4) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.
- (5) Check the rough cash book and reconcile from the stock of ticket books issued, the cash to be collected each day.
- (6) Check that the cash balance and ticket sales from stock is daily checked by the manager.
- (7) Check that the collections are banked daily, the very next day.
- (8) See rates for each class and the ticket rates are as per current prices.
- (9) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.
- (10) Check the relation between the amounts of tax collected and sales.
- (11) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.
- (12) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.
- (13) The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.
- (14) Do surprise checking of cash balances.
- (15) See that cash collections are insured and the policy is in force.
- (16) Compute analytical ratios in respect of the receipts pattern i.e. on week ends, holidays, etc. and make comparisons to draw conclusions.

Q. 25. State the reporting requirements of Company Auditor in respect of the following under CARO-2003?

- (a) Inventory.**
- (b) Records of dealing in securities.**
- (c) Preferential allotment of shares.**
- (d) Internal control on purchases of Assets and Sale of Goods.**

Answer 25. (a)

Inventory : The auditor has to make following statements on verification and valuation of inventories.

- (i) Whether physical verification of Inventory has been conducted at reasonable intervals by the management.
- (ii) Are the procedures of physical verification of inventories followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported.
- (iii) Whether the company is maintaining proper records of inventory and whether any material discrepancies have been noted on physical verification and if so, whether the same have been properly dealt with in the books of account.

Answer 25. (b)

Records of Dealing in Securities : If the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made there in, also, whether the shares, securities, debentures and other investments have been held by the company in its own name, except to the extent of the exemption if any, granted under section 49 of the Companies Act.

Answer 25. (c)

Preferential Allotment of Shares : Whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under Section 301 of the Companies Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company.

Answer 25. (d)

Internal Control on Purchases of Assets and Sale of goods : Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business for the purchase of inventory and Fixed Assets, and the sale of goods? Whether there is a continuing failure to correct major weaknesses in internal control?

Q. 26. (a) Mention the special points in the case of an audit of the organisation from Incomplete Records.

(b) What points you would consider framing a system of Internal Check?

Answer 26. (a)

The examination of records and documents is one of the most important techniques through which an auditor collects evidence. Therefore, in case the records and documents maintained by an enterprise are incomplete, it would prove to be a great handicap to the auditor.

An auditor may face the situation of incomplete records under the following circumstances :

- (i) Where records are kept on single entry basis; or
- (ii) Where records are kept on double entry basis, but some of the records are destroyed accidentally, or are seized by authorities, or are otherwise not available for the auditors examination due to similar reasons.

Under the second circumstance, an ideal approach for carrying out audit would be that the auditor may direct the management of the enterprise to complete or reconstruct the accounting records, e.g., if vouchers are available but the cash book, journal and the ledger are not maintained, then the cash book, journal and ledger should be written up. However, if vouchers are also not available, then cash book/journal/ledger will have to be prepared by correlating the evidence available, e.g., memoranda records, bank statements, statements from outside parties, etc. Even though such books which are prepared may not be complete, but may still contain useful information for the auditor.

On the other hand, when books are maintained on single entry basis, then the management of the enterprise would be asked to write up the books, to the extent possible, as they would have been written up under double entry system.

In any case, the following steps would be required to conduct an audit :

- (i) Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single entry system, cash, bank, and personal accounts are maintained.
- (ii) Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.
- (iii) Check that all entries on the payment side of cash book are posted in the ledger.
- (iv) Confirming that all entries appearing in bank account are posted in the ledger.
- (v) Analyse personal accounts of debtors. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills dishonoured, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtors accounts.

Similarly, it would be necessary to analyse the creditors' accounts and post entries relating to credit purchase made, discounts earned, purchases returns, bills payable issued to suppliers, bills payable dishonoured, etc., to relevant accounts.

From an auditor's view point, the supervisory controls exercised by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination/ observation, management representation and perform analytical procedures.

Answer 26. (b)

The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check :

- (i) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.
- (ii) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
- (iii) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.
- (iv) Persons having physical custody of assets must not be permitted to have access to the books of account.
- (v) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.
- (vi) The system of Budgetary Control should be introduced.

- (vii) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.
- (viii) The financial and administrative powers should be sub divided very judiciously and the effect of such division should be reviewed periodically.
- (ix) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

Q. 27. An Audit of expenditure is one of the major components of Government Audit. In the context of "Government Expenditure Audit" write in brief, what do you understand by :

- (i) Audit against Rules and Orders**
- (ii) Audit of Sanctions**
- (iii) Audit against Provision of Funds**

Answer 27. (a)

Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below :

- (i) **Audit against Rules & Orders :** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority. It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of auditor is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that :
 - (a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;
 - (b) they are consistent with the essential requirements of audit and accounts as determined by the C & AG;
 - (c) they do not come in conflict with the orders of, or rules made by, any higher authority; and
 - (d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.
- (ii) **Audit of Sanctions :** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.
- (iii) **Audit against Provision of Funds :** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriation made.

Q. 28. (a) What are the review areas of an IS Auditor?

- (b) Discuss the control procedures which the auditor should adopt in applying CAAT (Computer Assisted Audit Technique) in an audit under EDP environment.**

Answer 28. (a)

The IS auditors may focus on following review areas :

- (i) **Computerised systems and applications** : The auditor should verify that systems and applications are appropriate to the users' needs, efficient and adequately controlled to ensure valid, reliable, timely and secure input, processing and output at current and projected levels of system activity.
- (ii) **Information Processing Facilities** : This facility must be controlled to ensure timely, accurate and efficient processing of applications under normal and potentially disruptive conditions.
- (iii) **Systems Development** : An IS auditor should ensure that systems under development meet the objectives of the organization, satisfy user requirements and provide efficient, accurate and cost effective systems and applications. The auditor should also ensure that these systems are written, tested and installed in accordance with generally accepted standards for systems development.
- (iv) **Management of Information Systems** : MIS must develop an organizational structure and procedures to ensure a controlled and efficient environment for information processing. This plan should also specify the computers and peripheral equipments required to support all functions in an economic and timely manner.
- (v) **Client/Server, Telecommunications and Intranets** : In a client/server environment, all applications that can be dedicated to a user are put on the client. All resources that need to be shared are put on the server. Auditors must ensure that controls are in place on the client as well as on the server and on the network. Auditors must provide the same level of control assurance in an Internet/Intranet environment as in a client/server environment, with special emphasis on TCP/IP and HTTP.

Answer 28. (b)

The common types of CAATs are audit software and test data. Audit software consists of computer programmes used by the auditor to process data of audit significance from the entity's accounting systems. It may consist of package programmes, purpose-written programmes and utility programmes. Regardless of the source of programme, the auditor should substantiate their validity for audit purposes prior to use. Test Data techniques on the other hand are used in conducting audit procedures by entering data (a sample transactions) into an entity's computer systems and comparing the results obtained with the predetermined results. Test data is used to test specific controls in computer programmes, such as, on line password and data access.

Controlling the CAAT Application : The use of a CAAT should be controlled by the auditor to provide reasonable detailed specifications of the CAAT have been met and that the CAAT is not improperly manipulated by the entity's staff. The specific procedures necessary to control the use of a CAAT will depend on the particular application in establishing audit control which require the auditor should consider the need to –

- (I) Approve the technical specifications and carry out a technical review of the work involving the use of the CAAT.
- (II) Review the entity's general IT controls which may contribute to the integrity of the CAAT, e.g., control over programme changes and access to computer files. When such controls cannot be relied upon to ensure the integrity of the CAAT, the auditor may consider processing the CAAT applications at another suitable computer facility.
- (III) Ensure appropriate integration of the output by the auditor into the audit process.

Procedures carried out by the Auditor to control Audit Software Application :

- (I) Participating in the design and testing of the computer programmes.
- (II) Checking the coding of the programme to ensure that it conforms with detailed programme specifications.

- (III) Requesting the entity's computer staff to review the operating system instructions to ensure that the software will run in the entity's computer installation.
- (IV) Running the audit software on small test files before running on the main data files.
- (V) Ensuring that the correct files were used, e.g. by checking with external evidence, such as control totals maintained by the user.
- (VI) Obtaining evidence that the audit software functioned as planned, for example, returning output and control information.
- (VII) Establishing appropriate security measures to safeguard against manipulations of the entity's data files.

The presence of the auditor is not necessarily required at the computer facility during the running of a CAAT to ensure appropriate control procedures. However, it may provide practical advantages, such as being able to control distribution of the output and ensuring the timely corrections of errors.

Procedures carried out by the Auditor to Control Test Data Applications :

- (I) Controlling the sequence of submissions of test data where it spans several processing cycles.
- (II) Performing test runs containing small amounts of test data before submitting the main audit test data.
- (III) Predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total.
- (IV) Confirming that the answered version of the programmes was used to process the test data.
- (V) Obtaining reasonable assurance that the programmes used to process the test data were used by the entity throughout the applicable audit period.

When using a CAAT, the auditor may require the co-operation of the entity's staff who have extensive knowledge of the computer installation. In such circumstances, the auditor should have reasonable assurance that the entity's staff did not improperly influence the results of the CAAT. Finally, the standard of working papers and retention procedures for a CAAT should be consistent with that on the audit as a whole. It may be convenient to keep the technical papers relating to the use of the CAAT separate from the other audit working papers. The working papers should contain sufficient documentation to describe the CAAT application.

Q. 29. (a) Mention the difference between 'audit report' and 'audit certificate.'

(b) Discuss flow chart technique for evaluation of internal control system in an organization.

Answer 29. (a)

A audit certificate is written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. A audit report on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. These words are fundamentally distinct from each other. Etymologically, the word 'certificate' is derived from Latin words certus (Certain) and facere (to make). So, the certificate connotes verification of certain and exact facts. However, the rendition of this type of statement is an impossible task and the auditor's duty indeed becomes onerous. The dictionary meaning of the word 'report' refers to formal account of results after an enquiry, examination or review given by an authorised person or group of persons.

In other words, when a certificate is issued, the auditor is responsible for the factual accuracy of what is contained therein. However, when a report is given, the auditor is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts and that it is arrived at by the application of due care and skill.

Answer 29. (b)

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. 30. (a) Why do we need Management Audit?**(b) What are the steps involved in carrying out management audit?****Answer 30. (a)**

The following are the circumstances wherein the management audit is useful—

- (i) To overcome the human limitations of Top Management.
- (ii) To improve the management's production.
- (iii) Circumstances of corporate planning deficiencies, organization's structured defects, ineffective management control system etc. warrants the necessity of management audit.
- (iv) In the circumstances of acquisition of another business entity, the acquiring organization needs to evaluate financial aspects, technical aspects and management aspects and analysis of these aspects takes the form of management audit.
- (v) Society at large likes to be assured that the top and middle level management discharge their functions efficiently and to the best advantage to the society, the management audit satisfy the different interest of groups like customers, employees, citizens, government etc. of the society and also guide the management in the application of scientific methods of business management for social well being.
- (vi) The statutory financial audit is generally annual and concerned with the past without having any forward approach. Statutory financial audit and internal audit along with statutory cost audit are essentially legalistic in terms of time given for its completion and nature of certification fails to provide the insight to the management in regard to unsuitability of structure to meet the entity's needs, poor leadership, inability to make decisions, poor vision and the enlightened managers

realizes this fact and feels the need of management audit to identify the problems and guidance to overcome them.

- (vii) Foreign collaborators, while investing in other organizations feel the necessity of management audit to ensure that the funds invested are to be used properly for growth and expansion.
- (viii) Financial institutions conduct the management audit, while participating in equities of a company to avoid possible losses arising from inefficient management.
- (ix) Company itself feels the need of management audit to assess its managers' performances and link an incentive system to the results of such assessment.
- (x) While advancing loans, banks like to get the management audit conducted.

Answer 30. (b)

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.

