



IPCC – November 2017

AUDIT

Test Code – 8024

Branch (MULTIPLE) (Date : 18.06.2017)

(50 Marks)

Note: All questions are compulsory.

Question 1 (6 marks)

(a) Services not to be rendered by the auditor: (2/3rd mark for each point)

Section 144 of the Companies Act, 2013 is a new provision which prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

- (i) Accounting and book keeping services;
- (ii) Internal audit;
- (iii) Design and implementation of any financial information system;
- (iv) Actuarial services;
- (v) Investment advisory services;
- (vi) Investment banking services;
- (vii) Rendering of outsourced financial services;
- (viii) Management services; and
- (ix) Any other kind of services as may be prescribed.

Question 2(6 marks)

Capital Expenditure: A capital expenditure is that which is incurred for the under mentioned purposes-

- (i) Acquiring fixed assets, i.e., assets of a permanent or a semi -permanent nature, which are held not for resale but for use with a view to earning profits. **(2 Marks)**
- (ii) Making additions to the existing fixed assets. **(1 mark)**
- (iii) Increasing earning capacity of the business. **(1 mark)**
- (iv) Reducing the cost of production. **(1 mark)**
- (v) Acquiring a benefit of enduring nature of a valuable right. **(1 mark)**

Question 3(4 marks)(1 mark for each point)

External Confirmation Procedures:

- (i) **Determining the Information to be confirmed or Requested:** External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".
- (ii) **Selecting the Appropriate Confirming Party:** Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.
- (iii) **Designing Confirmation Requests:** The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

- (iv) **Follow-Up on Confirmation Requests:** The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request

Question 4(8 marks)

(a) Issue of Shares for Consideration Other Than Cash:

- (i) Study of the contract pursuant to which the issue is made to determine how many shares are agreed to be issued and for what value and the nature and other details of the consideration. **(1 mark)**
- (ii) Examination of the prospectus to see the substance of the contract and the relevant terms of the issue including the mode of payment of the purchase consideration in case of an issue to a vendor of the business or pay-ability of commission to the underwriters or pay-ability of the preliminary expenses. **(1 mark)**
- (iii) Examination of the Board's minutes to see the adoption of the relevant contract, the decision to issue shares for a consideration other than cash and the actual allotment of shares. **(1/2 mark)**
- (iv) Ensuring that proper accounting entry has been passed to record the acquisition of the assets or the business or payment of the expenses (any of these may constitute the consideration) on the one hand and the issue of shares on the other. Incidentally, if any premium or discount is involved, that ensure appropriate adjustment entry has been passed therefore. **(1/2 mark)**

Sometimes, in view of the nature of transaction, it may be difficult to know whether an allotment is for cash or for a consideration other than cash, for instance, allotment of shares in adjustment of a debt owed by the company. In such a case, if the allotment is made in adjustment of *bonafide* debt payable in money at once, the allotment should be considered as against cash. **(1/2 mark)**

This position should be kept in view when inquiring into matters stated in section 143 (1) of the Companies Act, 2013. Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash. **(1/2 mark)**

(b) Splitting of Shares of Face Value from ` 10 to ` 1 per share:

- (i) Confirm that alteration was authorized by articles. **(1 mark)**
- (ii) Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained. **(1 mark)**
- (iii) Verify also with reference to Form No. SH-7 filed with the ROC. **(1 mark)**
- (iv) Verify that alteration had been effected in copies of Memorandum Articles, etc. **(1/2 mark)**
- (v) Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein. **(1/2 mark)**

Question 5(8 marks)

Auditing the Accounts of a Hotel:

The business of running a hotel is very much dissimilar to running an industrial unit for manufacturing of products. It is a service oriented- industry. The business is characterized by handling of large amounts of liquid cash , inventory of foods providing a variety of services, and keeping watch on customers to ensure that they do not leave hotel without settling the dues. In view of these, the following matters require special attention by the auditor.

(i) Internal Control: (2 marks)

Pilferage is one of the greatest problems in any hotel and it is extremely important to have a proper internal control to minimize the leakage. The following points should be checked-

- (a) Effectiveness of arrangement regarding receipts and disbursements of cash.
- (b) Procedure for purchase and inventory stocking of various commodities and provisions.
- (c) Procedure regarding billing of the customers in respect of room service, telephone, laundry, etc.
- (d) System regarding recording and physical custody of edibles, wines, cigarettes, crockery and cutlery, linen, furniture, carpets, etc.
- (e) Ensure that trading accounts are prepared preferably weekly, for each sales point. A scrutiny of the percentage of profit should be made, and any deviation from the norms is to be investigated.

(ii) Room Sales and Cash Collections: (2 marks)

- (a) There are various sales points scattered in a hotel and sales are both for cash and credit. The control over cash is very important. The charge for room sales is made from the guest register, and tests are to be carried out to ensure that the correct numbers of guests are charged for the exact period of stay. Any difference between the rate charged to the guests and standard room rent is to be investigated to see that it is properly authorized.
- (b) The total sales reported with the total bills issued at each sales point have to be reconciled.
- (c) Special care must be taken in respect of bills issued to customers who are staying in the hotel, because they may not be required to pay the bills immediately in cash but at a future date or by credit cards. Billing is to be done room-wise. It must be ensured that all customers pay their bills on leaving the hotel or within specified dates.

(iii) Inventory: (1 mark)

The inventories in a hotel are all saleable item like food and beverages. Therefore, following may be noted in this regard:

- (a) All movement and transfer of inventories must be properly documented.
- (b) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.
- (c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
- (d) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.
- (e) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories

(iv) Fixed Assets: (1/2 mark)

The fixed assets should be properly depreciated, and the Fixed Assets Register should be updated.

(v) Casual Labour: (1/2 mark)

In case the hotel employs a casual labour, the auditor should consider, whether adequate records have been maintained in this respect and there is no manipulation taking place. The wages payment of the casual labour must also be checked thoroughly.

- (vi) The compliance with all statutory provisions, and compliance with the Foreign Exchange Regulations must also be verified by the auditor, especially because hotels offer facility of conversion of foreign exchange to rupees. **(1 mark)**

(vi) Other special aspects are to be verified as under- (1 mark)

- (a) Consumption shown in various physical inventory accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.
- (b) All payments to the foreign collaborator, if any, are to be checked.
- (c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.
- (d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, boutiques, and special shows should be verified with the arrangements made.
- (e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.
- (f) The occupancy rate should be worked out, and compared with other similar hotels, and with previous year. Material deviations should be investigated.
- (g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.
- (h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.
- (i) Apart from control over inventory of edibles, control over issue and physical inventory of linen crockery, cutlery, glassware, silver, toilet items, etc. should be verified.
- (j) The auditor should verify the restaurant bills with reference to KOT (Kitchen order Ticket).
- (k) The auditor should ensure that all taxes have been included in the client's bills.
- (l) Computation and payment of salaries and wages vis -a-vis number of employees must be checked.

Question 6(8 marks)

While conducting an audit, the auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. One such area involves verification of liabilities, in general, and contingent liabilities in particular. In such cases, it is advisable for the auditor to obtain a written representation from the management as to the fact whether all contingent liabilities have been disclosed and are complete in all respects. The fact remains that it is the management which is responsible for preparation of financial information. **(1 Mark)**

Therefore, it would be in order to obtain an appropriate certificate from the management that it has approved the financial information prepared by them. Now section 134(5) of the Companies Act, 2013 provides that the Board shall have to give a statement that financial statements are their responsibility. **(1 mark)**

SA-580, "Written Representations", deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. **(2 marks)**

Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions. The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
- (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

It makes it absolutely clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available. **(4 Marks)**

Question 7 (4 Marks)

a. Incorrect -

According to section 142 of the Companies Act, 2013, the remuneration of subsequent auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. **(1 Mark)**

b. Incorrect -

As per AS 4 on "Contingencies and Events Occurring After the Balance Sheet Date", events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions. **(2 Marks)**

c. Correct -

According to section 139(6) of the Companies Act, 2013, in the case of failure of the Board to appoint the auditor, it shall inform the members of the company. **(1 Mark)**

Question 8(6 Marks)

Removal of Auditor before Expiry:

- i) As per sub-section (1) of Section 140 of the Companies Act, 2013, an auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the prior approval of the Central Government in that behalf as per Rule 7 prescribed under Companies (Audit & Auditors) Rules, 2014:
 - (a) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
 - (b) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
 - (c) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution. **(3 Marks)**
- ii) It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard. **(1 Mark)**
- iii) In the instant case, the first auditor was removed by the company before the expiry of his term without obtaining approval of the Central Government. **(1 Mark)**
- iv) Therefore, it may be concluded that the action of the company for removal of the auditor before expiry of term is not justified and auditor may be removed from his office only by following the above mentioned procedure. **(1 Mark)**
