PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any four out of remaining five

Q. No.		Question and Answer	Marks
1.	(a)	**Moon Ltd. is a dealer in electronic appliances. The Company has a centralized warehouse at the outskirts of Mumbai. The Auditors of the company M/s JK Associates normally attend the physical verification of stocks carried out by the Management at the end of the financial year. However, on account of certain disturbances in the region, the physical inventory counting could not be carried out at the year end. The stock taking is decided to be done by management at some other date subsequently, after a month.** **In the light of the above facts:** **Enumerate the audit procedures to be considered by M/s JK Associates, if physical inventory counting is conducted at a date other than the date of the financial statements with reference to the relevant Standard on Auditing.**	5
		Answer: Audit Procedures to be carried out if physical inventory counting is conducting at a date other the date of financial statements: SA 501 "Audit Evidence – Specific Considerations for Specific Items", requires from the auditor that when inventory is material to the financial statements, he shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting, unless impracticable, to: (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; (ii) Observe the performance of management's count procedures; (iii) Inspect the inventory; and (iv) Perform test counts. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures as specified above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date and the final inventory records are properly recorded include: 1. Whether the perpetual inventory records are properly adjusted. 2. Reliability of the entity's perpetual inventory records. 3. Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.	

Q. No.		Question and Answer	Marks
1	(b)	**You are the auditor of PQR Ltd. which is in the business of supplying food products to various airline companies operating aircrafts in domestic circle only. As per terms of agreement with airlines, the company need to stock various non-perishable food items for coming one month (average holding of inventory to the tune of INR 75 Crores). Also the payment terms have been settled and the company receives payment in 45 days after the supply of goods. Everything was going-on well till the end to March 2020 when pandemic Covid hit the world and everything came to a standstill. Aviation sector was hit hard and there were no flights from April 2020 onwards. Consequently, the business of PQR Ltd. also got severely affected and the scheduled supplies of goods to airlines also were not made. Also, the liquidity position of airline companies got hit and the scheduled payments were also not received on due dates. As the auditor of PQR Ltd. what audit procedures would you perform to ensure that all subsequent events are considered, so that financial statements for the year ended 31.03.2020 represent true and fair view?**	5
		Answer: Audit Procedures on subsequent Events: • SA 560 "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. • As per SA 560 the term, Subsequent Events may be defined as the events occurring between the dates of balance sheet and audit report and the facts that become known to the auditor after the date of the auditor's report. • The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. • The auditor's procedures on subsequent events shall include the following: (a) Obtaining an understanding of the procedures through which management has identified subsequent events. (b) Inquiring of management and, TCWG as to occurrence of subsequent events which might affect the financial statements. (c) Reading minutes of management & TCWG meetings that have been held after the date of the financial statements. (d) Reading the entity's latest subsequent interim financial statements, if any. • When, as a result of the procedures performed as required the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.	

Q. No.		Question and Answer	Marks
1	(c)	**GS & Co., Chartered Accountants, have been appointed Statutory Auditor of MAP Ltd. for the F.Y. 2019-20. The audit team has completed the audit and is in the process of preparing audit report.** **Management of the company has also prepared draft annual report. Audit in-charge was going through the draft annual report and observed that the company has included an item in its Annual Report indicating downward trend in market prices of key commodities/raw material as compared to previous year. However, the actual profit margin of the company as reported in financial statements has gone in the reverse direction. Audit Manager discussed this issue with partner of the firm who in reply said that auditors are not covered with such disclosures made by the management in its annual report, it being the responsibility of the management.** **Do you think that the partner is correct in his approach on this issue.** **Discuss with reference to relevant Standard on Auditing the Auditor's duties with regard to reporting.**	4
		Answer: Auditor's responsibilities as to Other Information included in Annual Report: SA 720 "The Auditor's Responsibilities relating to Other Information" deals with the auditor's responsibilities relating to Other Information, whether financial or non-financial information included in an entity's annual report. **Requirements of SA 720 as to obtaining the other information**: The auditor shall: (a) Determine which documents comprises the annual report, and the entity's planned manner and timing of the issuance of such documents; (b) Make appropriate arrangements with management to obtain in a timely manner, the documents comprising the annual report. **Requirements of SA 720 as to considering the Other information**: The auditor shall read the other information and, in doing so shall: (a) Consider whether there is a material inconsistency between the other information and the financial statements. As the basis for this consideration, the auditor shall, to evaluate their consistency, compare selected amounts or other items in the other information with such amounts or other items in the financial statements; and (b) Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit. While reading the other information, the auditor shall remain alert for indications that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated. **Conclusion**: Considering the requirements of SA 720 as stated above, it can be concluded that partner is not correct in his approach.	

Q. No.		Question and Answer	Marks
2.	(a)	**Mr. X, while conducting audit of PQR Ltd, comes across certain transactions which according to him are significant transactions with related parties and identified to be outside the entity's normal course of business. Guide Mr. X with examples of such transactions and to understand the nature of significant transactions outside the entity's normal course of business.**	5
		Answer: Examples of transactions outside the entity's normal course of business: SA 550 "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Accordingly, if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures, the auditor shall inquire of management about: (a) The nature of these transactions; and (b) Whether related parties could be involved. Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. **Examples of transactions outside the entity's normal course of business:** (a) Complex equity transactions, such as corporate restructurings or acquisitions. (b) Transactions with offshore entities in jurisdictions with weak corporate laws. (c) The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged. (d) Sales transactions with unusually large discounts or returns. (e) Transactions with circular arrangements, for example, sales with a commitment to repurchase. (f) Transactions under contracts whose terms are changed before expiry.	

Q. No.		Question and Answer	Marks
2	(b)	**M/s PC & Co., Chartered Accountants are the statutory auditors of various categories of companies and bodies corporate. In exercise of the powers conferred under sub-sections (2) and (4) of section 132, of the Companies Act, 2013 the Central Government made the National Financial Reporting Authority Rules, 2018 (NFRA Rules) (MCA Notification dated 13 November 2018). The audit firm seeks your guidance on the applicability of those categories of companies and bodies corporate which are covered by NFRA Rules.**	5
		Answer: Companies and Bodies Corporate governed by NFRA: (a) companies whose securities are listed on any stock exchange in India or outside India; (b) unlisted public companies ⇒ having paid-up capital of not less than ₹500 crores or ⇒ having annual turnover of not less than ₹1,000 crores or ⇒ having, in aggregate, outstanding loans, debentures and deposits of not less than ₹500 crores as on the 31st March of immediately preceding financial year; (c) insurance companies, banking companies, companies engaged in the generation or supply of electricity, companies governed by any special Act for the time being in force or bodies corporate incorporated by an Act in accordance with clauses (b), (c), (d), (e) and (f) of sub-section (4) of section 1 of the Act; (d) any body corporate or company or person, or any class of bodies corporate or companies or persons, on a reference made to the Authority by the Central Government in public interest; and (e) a body corporate incorporated or registered outside India, which is a subsidiary or associate company of any company or body corporate incorporated or registered in India as referred to in clauses (a) to (d), if the income or net worth of such subsidiary or associate company exceeds 20% of the consolidated income or consolidated net worth of such company or the body corporate, as the case may be, referred to in clauses (a) to (d).	

Q. No.		Question and Answer	Marks
2	(c)	**Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto:** **CA. Dice had signed the Balance sheet of QR Ltd. for the year ended 31st March, 2019 which failed to give disclosure of the charge created for Rs. 4.35 crores against the Corporate Guarantee given in favour of a Group Company. The Balance Sheet size of the company filed with the Registrar of Companies was Rs. 26.12 crores.**	4
		Answer: Failure to exercise due diligence and to obtain necessary information: • Clause 2 of Part I of Second Schedule of CA Act, 1949 states that a CA in practice shall be guilty of professional misconduct if he Certifies or submits in his name or in the name of his firm a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another CA in practice. • Clause 7 of Part I of Second Schedule of CA Act, 1949 stats that a CA in practice shall be deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties". • In the present case, CA Dice, did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he signed the balance sheet of QR Ltd. in which disclosure of the charge created for Rs. 4.35 crores against the Corporate Guarantee given in favour of a Group Company is not made. **Conclusion:** Mr. Z will be held guilty of professional misconduct as per clauses 2 and 7 of Part I of Second Schedule of Chartered Accountant Act, 1949. ***Note: Alternate Answer possible on the basis of Clause 5 and 6 of Part I of Second Schedule of Chartered Accountant Act, 1949, taking suitable assumptions.***	

Q. No.		Question and Answer	Marks
3.	(a)	**In the course of statutory Branch audit of KS Bank Ltd, you observe that some borrower accounts have been regularised before Balance sheet date by payment of overdue amount. Narrate the audit procedures to be carried out with special focus on the Classification of advances and Provisioning for Non-Performing assets of the Branch.**	5
		Answer: Audit procedure as to Classification of advances and Provisioning for Non-Performing assets: (i) Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery. (ii) Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly. As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness based on the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status. It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date. The date of NPA is significant to determine the classification and hence specific care be taken in this regard. NPA should be recognized only based on concept of Past Due/ Overdue concept, and not based on the Balance Sheet date.	

Q. No.		Question and Answer	Marks
3	(b)	**CA. N has been appointed as an auditor of TRP Ltd. While conducting the audit he has identified some deficiencies in the Internal control. He needs to determine whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency" and has to communicate them in writing to those charged with Governance and management on a timely basis. Guide CA. N with some examples of matters to be considered while determining 'significant deficiency' in internal control with reference to relevant SA.**	5
		Answer: Matters to be considered while determining significant deficiency: SA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" defines the term significant deficiency in internal control as a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit. **Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include**: (i) The likelihood of the deficiencies leading to material misstatements in the financial statements in the future. (ii) The susceptibility to loss or fraud of the related asset or liability. (iii) The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates. (iv) The financial statement amounts exposed to the deficiencies. (v) The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.	

Q. No.		Question and Answer	Marks
3	(c)	**Mr. Kushal, a practicing Chartered Accountant has signed the GST Audit Reports, Tax Audit Reports u/s 44AB of the Income tax Act, 1961 for the financial year 2019-20 that are filed online using Digital Signature and without generating UDIN on the ground that there is no field for mentioning UDIN on digitally signed online reports. Is the contention of Mr. Kushal valid? Give your comments with reference to the Chartered Accountants Act, 1949 and schedules thereto.**	4
		Answer: Contravening Provisions of the Act/Regulations/Guidelines: • As per Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct under, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council. • In exercise of the powers conferred on it under Item No. (1) of Part- II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India made it mandatory for the members of the Institute in practice to generate Unique Document Identification Number (UDIN) for all GST and Tax Audit Reports w.e.f. 1st April, 2019. • In the present case, Mr. Kushal, a practicing Chartered Accountant has signed the GST Audit Reports, Tax Audit Reports u/s 44AB of the Income tax Act, 1961 for the financial year 2019-20 that are filed online using Digital Signature and without generating UDIN on the ground that there is no field for mentioning UDIN on digitally signed online reports. **Conclusion**: Contention of Mr. Kushal is not valid as non-generating of UDIN amounts to professional misconduct under Clause 1, Part II of Second Schedule.	

Q. No.		Question and Answer	Marks
4.	(a)	**PQ Limited, a listed entity, is in the business of manufacturing of specialty chemicals. The company has appointed CA Jazz as CFO of the company. CA Jazz is concerned about compliance with the provisions of laws and regulations that determine the reported amounts and disclosure in financial statements of PQ Limited. Accordingly, CA Jazz wants to implement such policies and procedures that can assist him in the prevention and detection of non-compliance with laws and regulations. Help CA Jazz by citing examples of such policies and procedures.**	5
		Answer: Examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations: SA 250 "Consideration of Laws and Regulations in an audit of Financial Statements" states that it is the responsibility of management, with the oversight of TCWG, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations: 1. Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements. 2. Instituting and operating appropriate systems of internal control. 3. Developing, publicising and following a code of conduct. 4. Ensuring employees are properly trained and understand the code of conduct. 5. Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it. 6. Engaging legal advisors to assist in monitoring legal requirements. 7. Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.	

Q. No.		Question and Answer	Marks
4	(b)	**CA. Vimal is the auditor of Excellent Ltd., a parent company which presents Consolidated Financial Statements. The management of Excellent Ltd. has provided the list of the components included in the Consolidated Financial Statements. As an auditor of Consolidated Financial Statements, CA Vimal has to verify that all the components have been included in the Consolidated Financial Statements and review the information provided by the management in identifying the components. State the procedures to be followed by CA. Vimal in respect of completeness of this information.**	5
		Answer: Procedures to be followed by auditor to verify completeness of information provided by Parent Entity: Auditor of Consolidated Financial Statements should review the information provided by the management of the parent identifying the subsidiaries, associates and joint ventures. In respect of completeness of this information, the auditor should perform the following procedures: (i) review his working papers for the prior years for the known subsidiaries, associates and joint ventures; (ii) review the parent's procedures for identification of subsidiaries and joint ventures; (iii) review the investments to determine the shareholding in other entities; (iv) review the joint venture and other relevant agreements entered into by the parent; (v) review the statutory' records maintained by the parent, for example register required under section 186 of the Companies Act, 2013. The auditor should also identify the changes in the shareholding that might have taken place since the last audit.	

Q. No.		Question and Answer	Marks
4	(c)	**In the course of audit of MM Ltd. for the financial year ended 31st March, 2019, your audit team has identified the following matter:** **An amount of Rs. 4 Lakh per month for the marketing services rendered is paid to M/s. MG Associates, a partnership firm in which Director of MM Ltd. is also a managing partner, with a profit-sharing ratio of 30%. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by Rs. 1.50 Lakh per month. Whilst the transaction was accounted in the financial statements based on the amounts paid, no separate disclosure has been made in the notes forming part of the accounts.** **Give your comments for reporting under CARO 2016.**	4
		Answer: Reporting of Related Party Transactions under CARO, 2016: • Auditor is required to report the matter as per Para 3(xiii) of CARO 2016 which requires him to report "whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards". • In the present case, an amount of Rs. 4 Lakh per month for the marketing services rendered is paid to M/s. MG Associates, a partnership firm in which Director of MM Ltd. is also a managing partner, with a profit-sharing ratio of 30%. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by Rs. 1.50 Lakh per month. Whilst the transaction was accounted in the financial statements based on the amounts paid, no separate disclosure has been made in the notes forming part of the accounts. **Conclusion**: Auditor should report under para 3(xiii) of CARO, 2016, as one of related party transaction amounting ₹4 lakhs per month i.e. in lieu of marketing services has been noticed of which amount ₹1.50 lakh per month is exceeding the arm's length price has not been disclosed highlighting the same as related party transactions as per AS 18.	

Q. No.		Question and Answer	Marks
5.	(a)	**The management auditor has to analyse the nature and causes of behavioural problems in the discharge of the review function and to arrive at possible solutions to overcome these problems. As a management auditor of Real Limited, how will you demonstrate in arriving at a solution to behavioural problems and create an atmosphere of trust and friendliness, so that audit reports will be understood in their proper perspective?**	5
		Answer: Arriving at a solution to behavioral problems in management audit: To arrive at a solution to behavioural problems and create an atmosphere of trust and friendliness, so that audit reports will be understood in their proper perspective, management auditor may demonstrate in the following manner: **1. Constructive criticism:** It is essential that the auditor should concentrate only on constructive criticism. He should also make obvious in his report the value of his comments in tangible terms. Only then would suggestions carry weight with the auditees and they will feel convinced that the auditor has been objective in his remarks in the report. **2. Reporting methods:** To achieve this objective, the auditor has to make a concerted effort to convey effectively his role by adopting a friendly but firm tone in his report. It is always possible to disagree without being disagreeable, to criticise without being critical. The reports should concentrate on areas which need improvement rather than listing inefficiencies and deficiencies in performance of the auditee. **3. Participative approach -** It is well established that auditor's reports have better acceptability if the improvements suggested are discussed with those who have to implement them and made to feel that they have participated in the recommendations made for improvements. On the other hand, it has been observed that either oral or written appreciation of the auditee's achievements not only encourages the auditees to develop a friendly attitude towards the auditors but look forward to their guidance in a more receptive fashion.	

Q. No.		Question and Answer	Marks
5	(b)	**BG Limited is a large-sized listed company. The Board of directors have constituted Nomination and Remuneration committee comprising of non-executive and independent directors. The management seeks your advice on the composition and role of the committee. Elucidate the composition and role of Nomination and Remuneration committee as per SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.**	5

Answer: Composition and role of Nomination and Remuneration committee:

Regulation 19 of SEBI (LODR) Regulations, 2015 deals with the composition of Nomination and remuneration Committee.

(1) The board of directors shall constitute the nomination and remuneration committee as follows:

  (a) the committee shall comprise of atleast three directors;

  (b) all directors of the committee shall be non-executive directors; and

  (c) at least 50% of the directors shall be independent directors and in case of a listed entity having outstanding SR equity shares, 2/3rd of the nomination and remuneration committee shall comprise of independent directors.

(2) The Chairperson of the nomination and remuneration committee shall be an independent director.

Role of the nomination and remuneration committee:

It shall be as specified in **Part D of the Schedule II**.

(1) Formulation of the criteria for determining qualifications, positive attributes and independence of a director and recommend to the board a policy relating to, the remuneration of the directors, KMP and other employees;

(2) Formulation of criteria for evaluation of performance of independent directors and the board;

(3) Devising a policy on diversity of board;

(4) Identifying persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, and recommend to the board of directors their appointment and removal;

(5) whether to extend or continue the term of appointment of the independent director, on the basis of the report of performance evaluation of independent directors.

(6) recommend to the board, all remuneration, in whatever form, payable to senior management.

Q. No.		Question and Answer	Marks
5	(c)	**Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto: Mr. Vineet, a chartered accountant in practice, created his own website in attractive format and highlighted the contents in purple colour. The website also displayed the nature of assignments handled along with the names of clients without such requirement from any of the regulator. He also circulated the information contained in the website through e-mail to acknowledge public at large about his expertise. However, he did not intimate his website address to the Institute.**	4
		Answer: Hosting Details on Website: • As per guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant of the firm can create its own website using any format subject to guidelines. • As per guidelines, there is no restriction on the use of colours. However, the name of clients and fees charged from them is not permitted to be appear on the website. • Disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator. • It is also a requirement that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific pull request. • Further, there is no requirement to intimate the website address to the Institute. Members are only required to comply with the website guidelines issued by Council of ICAI. **Conclusion**: In the present case, Mr. Vineet is guilty of professional misconduct as name of clients are displayed on the website without any requirement of regulator, and website information is circulated through e-mail.	

OR

Q. No.		Question and Answer	Marks
5	(c)	**CA Vipin has been appointed as Statutory Auditor by IG Insurance Co. Ltd. for 3 of its branches for the F.Y. 2019-2020. Insurance Company is using a 'software called "Applied Epic" wherein all transactions (policy issuance, premium receipts, expense of insurance company, incomes, assets and liabilities) are recorded and financial statements generated at the end of the financial year. CA Vipin not technically equipped and well versed with technology, decided to follow traditional manual auditing approach and started the audit. He is of the view that understanding and using the auditee's automated environment is optional and not required. Do you agree with the approach and views of CA Vipin.?**	4

Answer: Auditing in an Information Technology Environment:

- The Information Technology environment does not materially affect the scope and objectives of an audit. However, in view of the computerisation in general and the insurance industry in particular, the auditor has to familiarise himself with the IT environment in insurance companies. He should gain an understanding to the workflow of various important transactions.
- The auditor may select a few transactions of each type and trace them through the system, i.e., identify the audit trail. This would help him in not only understanding flow of transactions and manner of processing but it will also provide him evidence as to whether the results of processing are correct.
- Where the auditor is satisfied about the design and operation of the IT system, he may limit the extent of his checking of transactions in so far as those aspects are concerned, where the IT system has in-built control.
- The auditor should seek a written representation from the management about any changes in the IT systems that have taken place during the year. Where different systems have been in operation during the year, the auditor should separately examine the efficacy of each such system. The auditor should also obtain a written representation from the management that there have been no changes in the system during the year other than those specified.

Alternate Answer:

- Understanding of the automated environment of a company is required as per SA 315. The auditor's understanding of the automated environment should include the following:
  - (a) The applications that are being used by the company;
  - (b) Details of the IT infrastructure components for each of the application;
  - (c) The organisation structure and governance;
  - (d) The policies, procedures and processes followed;
  - (e) IT risks and controls.
- The auditor is required to document the understanding of a company's automated environment as per SA 230.

Q. No.		Question and Answer	Marks
6.	(a)	**CA Nadar is conducting the statutory audit of RHL Ltd., a non-banking financial company. It has branches in various parts of India. The company with a focus on housing finance, has outstanding non-convertible debentures worth Rs 150 Crores. The company reportedly missed interest payments of INR 15 Crores on its debts because of inadequate liquidity. As a result, RHL Ltd. faced a series of downgrades by rating agencies on its debts over the past two months. Rating was cut to D from A4 implying that the company was in default or expected to be in default soon. What aspects CA Nadar should look into in relation to the activity of mobilization of public deposits (particularly in relation to downgrading of credit facilities) by RHL Ltd?**	5
		Answer: Aspects to be looked into with respect to mobilization of public deposits: 1. **Credit Rating**: Obtain a copy of the credit rating assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it. In the event of a downgrading of credit rating, the auditor should bear in mind that the NBFC will have to reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame. 2. **Interest and Brokerage payments**: Test checks the interest and brokerage calculations to ascertain that the NBFC has not paid in excess. 3. **Written Application**: Examine whether the NBFC has accepted or renewed any public deposit only after a written application form the depositor in the specified form. 4. **Deposit Register**: Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors. 5. **Repayment of deposits**: Check whether the NBFC is regularly paying its deposits on due dates. 6. **Custody of investments**: Check whether the investments made in approved liquid assets have been lodged in safe custody with a designated bank. Obtain a certificate from the bank to that effect. 7. **Submission of Accounts**: Ascertain whether audited statement of accounts together with a copy of the auditor's report and director's report thereon have been submitted within prescribed time limit from the date of holding the AGM. 8. **Filing of Annual return**: Check whether the NBFC has filed its annual return in specified time.	

<table>
<tr><th colspan="2">Q. No.</th><th>Question and Answer</th><th>Marks</th></tr>
<tr><td>6</td><td>(b)</td><td>In the course of audit of Quick Ltd, you suspect that the management has made misstatements in the financial statements intentionally to deceive the users and to succumb to pressures to meet market expectations. Elucidate how the fraudulent financial reporting may be accomplished and also discuss the techniques of committing fraud by management overriding controls.</td><td>5</td></tr>
<tr><td></td><td></td><td>Answer: Means of accomplishing Fraudulent Financial reporting:
SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", deals with auditor's responsibilities in relation to fraud while performing the audit. Auditor is primarily concerned with those frauds that causes material misstatement in financial statements.
Fraudulent financial reporting may be accomplished by the following:
(a) Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
(b) Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
(c) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.
Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:
1. Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
2. Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
3. Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
4. Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
5. Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
6. Altering records and terms related to significant and unusual transactions.</td><td></td></tr>
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Q. No.		Question and Answer	Marks
6	(c)	**CA Robo has been appointed as Forensic Auditor by BMY Bank Limited for one of its borrowal accounts WRONG Ltd. CA Robo started the audit by first reviewing the transactions of the borrower in Bank statement as per Bank records to identify any hidden patterns in that information. She had to review huge volume of data, as the number of transactions per day were in hundreds and the data was to be reviewed for the last three years. So, she was stuck up as to how to proceed further to identify any hidden patterns in information, if any. Guide CA Robo, suggesting which technique to be used for identifying any hidden patterns in the information.**	**4**
		Answer: Technique to be used for identifying hidden patterns: Detecting fraud is difficult, especially frauds involving material financial statement misstatements, which occur only in about 2% of all financial statements. Fraud is generally concealed and often occurs through collusion. Normally, the documents supporting omitted transactions are not kept in company files. False documentation is often created or legitimate documents are altered to support fictitious transactions. While fraud detection techniques will not identify all fraud, the use of sound techniques can increase the likelihood that misstatements or defalcations will be discovered on a timely basis. In the given situation, CA Robo can use Data Mining technique. **Data Mining Technique**: It is a set of assisted techniques designed to automatically mine large volumes of data for new, hidden or unexpected information or patterns. Data mining techniques are categorized in three ways: Discovery, Predictive modelling and Deviation and Link analysis. It discovers the usual knowledge or patterns in data, without a predefined idea or hypothesis about what the pattern may be, i.e. without any prior knowledge of fraud. It explains various affinities, association, trends and variations in the form of conditional logic.	
