PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

*Question No. **1** is compulsory*

*Answer any **four** from the rest*

Question 1

(a) Moon Ltd. is a dealer in electronic appliances. The Company has a centralised 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 Marks)***

(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 needs 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 of 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 Marks)

(c) GS & Co., Chartered Accountants, have been appointed Statutory Auditors 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 Marks)***

Answer

(a) As per SA 501 "Audit Evidence- Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.

For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes.

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor, JK Associates, shall perform the following procedures:

(A) 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; and

(B) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

In addition to above, auditor shall also 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, or dates, 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.

(b) As per SA 560 "Subsequent Events", 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 is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required in above paragraph so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto.

Being the auditor of PQR Ltd, to ensure that all subsequent events are considered so that financial statements for the year ending 31.03.2020 represent true and fair view, the auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed as required above, 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.

(c) Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists:

As per SA 720, "The Auditor's Responsibility in Relation to Other Information", Descriptions of trends in market prices of key commodities or raw materials is an example of amounts or other Items that may be Included in the other information.

The auditor's discussion with management about a material inconsistency (or other information that appears to be materially misstated) may include requesting management to provide support for the basis of management's statements in the other information. Based on management's further information or explanations, the auditor may be satisfied that the other information is not materially misstated. For example, management explanations may indicate reasonable and sufficient grounds for valid differences of judgment.

Auditor's duties with regard to reporting in the given case are given hereunder:

As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

Contention of the partner of the firm that auditors are not concerned with such disclosures made by the management in its annual report, is incorrect.

Question 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 Marks)***

(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 Marks)

(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 ` 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 ` 26.12 crores. ***(4 Marks)***

Answer

(a) In the given case of PQR Ltd, Mr. X, while conducting audit has come across certain significant related party transaction which are identified to be outside the entity's normal course of business. Mr. X wants guidance through examples of such significant transactions which are given in SA 550

As per SA 550 "Related Parties", examples of transactions outside the entity's normal course of business may include:

1. Complex equity transactions, such as corporate restructurings or acquisitions.

2. Transactions with offshore entities in jurisdictions with weak corporate laws.
3. The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
4. Sales transactions with unusually large discounts or returns.
5. Transactions with circular arrangements, for example, sales with a commitment to repurchase.
6. Transactions under contracts whose terms are changed before expiry.

(b) As per NFRA rules, NFRA shall have power to monitor and enforce compliance with accounting standards and auditing standards, oversee the quality of service under sub-section (2) of section 132 or undertake investigation under sub-section (4) of such section of the auditors of the following class of companies and bodies corporate:

(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 rupees five hundred crores or having annual turnover of not less than rupees one thousand crores or having, in aggregate, outstanding loans, debentures and deposits of not less than rupees five hundred 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 section 1 (4) of the Companies Act, 2013;

(d) any body corporate or company or person, or any class of bodies corporate or companies or persons, on a reference made to the NFRA 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) above, 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) above.

(c) **Failure to Disclose Material Facts:** As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement not misleading where he is concerned with that financial statement in a professional capacity.

It may be observed that this clause refers to failure to disclose a material fact, which is known to him, in a financial statement reported on by the auditor. It is obvious, that before a member could be held guilty of misconduct, materiality has to be established. The determination of materiality has been provided in SA 320, "Materiality in Planning and Performing an Audit".

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain, among other points, that Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both.

In this case, CA Dice has signed a Balance Sheet which failed to give disclosure of ₹ 4.35 crores (considered material fact applying above SA 320 principle) against the corporate guarantee given in favour of a Group Company. Size of Balance Sheet of QR Ltd is ₹ 26.12 crore.

This material fact has to be disclosed in the financial statements. Keeping in view the above, he is attracted by the provisions of professional misconduct under Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Question 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 Marks)***

(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 Marks)***

(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 Marks)***

Answer

(a) The Audit procedures that need to be carried out with special focus on classification of advances and provisioning for NPAs of KS Bank Ltd, in which the auditor has observed that some borrower accounts have been regularized before balance sheet date by payment of overdue amount shall be carried out as under :

(i) 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.

(ii) 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.

(iii) Where the account indicates inherent weakness based in the data available, the account shall be deemed as a NPA.

Classification and Provision

a. Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery.

b. Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.

c. 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.

d. The date of NPA is significant to determine the classification and hence specific care be taken in this regard.

e. NPA should be recognized only based on concept of Past Due/ Overdue concept, and not based on the Balance Sheet date.

(b) As per SA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", significant deficiency in internal control means a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgement, is of sufficient importance to merit the attention of those charged with governance.

Examples of matters that **CA N, auditor of TRP Ltd** may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

(1) The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.

(2) The susceptibility to loss or fraud of the related asset or liability.

(3) The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.

(4) The financial statement amounts exposed to the deficiencies.

(5) The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.

(6) The importance of the controls to the financial reporting process; for example:

- General monitoring controls (such as oversight of management).
- Controls over the prevention and detection of fraud.
- Controls over the selection and application of significant accounting policies.
- Controls over significant transactions with related parties.
- Controls over significant transactions outside the entity's normal course of business.
- Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

(7) The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

(8) The interaction of the deficiency with other deficiencies in internal control.

(c) Non Generation of UDIN: Whereas, to curb the malpractice of false/certification/attestation by the unauthorized persons and to eradicate the practice of bogus certificates and to save various regulators, banks, stakeholders etc. from being misled, the Council of the Institute decided to implement an innovative concept to generate Unique Document Identification Number (UDIN) mandatorily for all kinds of the certificates/GST and tax audit reports and other attest function in phased manner, for which members of the ICAI were notified through the various announcements published on the website of ICAI at the relevant times.

In exercise of the powers conferred on it under clause 1 of Part II of the Second Schedule to the Chartered Accountants Act,1949, the Council of the Institute of Chartered Accountants of India issued the following guidelines for information of public and necessary compliance by members of the Institute-

A member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions undertaken/signed by him which are made mandatory from the following dates through announcements published on the website of the ICAI-

- For all Certificates w.e.f. 1st February,2019.

- For all GST and Tax Audit Reports w.e.f. 1st April, 2019.
- For all other Audit, Assurance and Attestation functions, w.e.f. 1st July, 2019.

Conclusion: UDIN will be applicable to GST & Tax Audit Reports signed by Mr. Kushal for the financial year 2019-20 that are filed online using Digital Signature. In case where there is no field for mentioning UDOIN on digitally signed online reports, UDION has to be generated and communicated to "Management" or "Those Charged with Governance" for disseminating it to the stakeholders from their end.

Hence he will be held guilty under Clause 1 of Part II of the Second Schedule to the Chartered Accountants Act,1949.

Alternative Answer

According to Clause (9) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

This clause implies that the audit should be performed in accordance with "generally accepted procedure of audit applicable to the circumstances" and if for any reason the auditor has not been able to perform the audit in accordance with such procedure, his report should draw attention to the material departures from such procedures. What constitutes "generally accepted audit procedure" would depend upon the facts and circumstances of each case, but guidance is available in general terms from the various pronouncements of the Institute is issued by way of statements and Guidance Notes and SAs to members.

A member of the Institute in practice shall generate Unique Document Identification Number (UDIN) for all kinds of the certification, GST and Tax Audit Reports and other Audit, Assurance and Attestation functions undertaken/signed by him.

In the given case, Mr. Kushal has signed the GST Audit Reports, Tax Audit Reports under section 44AB of the Income Tax Act, 1961 for the F.Y.2019-20 and also has filed online using Digital Signature without generating UDIN on the ground that there is no field for mentioning UDIN on digitally signed online reports. Applying the above clause, UDIN provision etc. to the given case, Mr. Kushal would be held guilty of professional misconduct.

Question 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 Marks)***

(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 Marks)***

(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:*

All amount of ` 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 ` 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 Marks)***

Answer

(a) In PQ Ltd, listed entity, CA Jazz has been appointed as CFO. PQ Ltd is in the business of manufacturing of specialty chemicals. CA Jazz is concerned about compliance with the provisions of Laws and regulations and wants to implement such policies and procedures that would assist him in prevention and detection of non-compliance with laws and regulations. CA Jazz is specifically wanting examples of types of policies and procedures that PQ Ltd may implement so that relevant laws and regulations are properly complied with. Such examples of policies and procedures are given in SA 250.

As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements",

The following are examples of the types of policies and procedures PQ Ltd. may implement to assist in the prevention and detection of non-compliance with laws and regulations:

i. Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.

ii. Instituting and operating appropriate systems of internal control.

iii. Developing, publicizing and following a code of conduct.

iv. Ensuring employees are properly trained and understand the code of conduct.

v. Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.

vi. Engaging legal advisors to assist in monitoring legal requirements.

vii. Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

(b) A parent which presents consolidated financial statements is required to consolidate all its components in the consolidated financial statements other than those for which exceptions have been provided in the relevant accounting standards under the applicable financial reporting framework.

The auditor should obtain a listing of all the components included in the consolidated financial statements and review the information provided by the management of the parent identifying the components. The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet criterion for exclusion.

In the given case, Excellent Ltd has provided the list of components included in the consolidated financial statements (CFSs). CA Vimal shall verify that all the components have been included in the CFSs.

Further, in respect of completeness of this information, CA Vimal should perform the following procedures:

i. review his working papers for the prior years for the known components;

ii. review the parent's procedures for identification of various components;

iii. make inquiries of the management to identify any new components or any component which goes out of consolidated financial statements;

iv. review the investments of parent as well as its components to determine the shareholding in other entities;

v. review the joint ventures and joint arrangements as applicable;

vi. review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group;

vii. review the statutory records maintained by the parent, for example registers under section 186, 190 of the Companies Act, 2013;

viii. Identify the changes in the shareholding that might have taken place during the reporting period.

(c) **According to clause (xiii) of Para 3 of CARO, 2016, 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.

Therefore the duty of the auditor, under this clause is to report

i. Whether all transactions with the related parties are in compliance with section 177 and 188 of the Companies Act,2013:

ii. Whether related party disclosures as required by relevant Accounting Standards (AS 18, as may be applicable) are disclosed in the financial statements.

In the Instant case, MG Associates is a related party and also rendering marketing services to MM Ltd. in return of Consideration of ₹ 4 Lakhs which is related party transaction. No separate disclosure has been made in the notes to accounts in this context, which was required to be made.

In view of above, **Auditor shall report under the above clause as under:**

1. Nature of the related party relationship and the underlying transaction-**MG Associates is a partnership firm in which Director of MM Ltd is also a managing partner**, with a profit sharing ratio of 30 %. Payment of ₹ 4 Lakhs to MG Associates is a related party transaction.
2. Amount involved is Consideration for the Marketing services rendered by MG Associates (₹ 4 Lakhs p.m.) is higher than the arm's length pricing by ₹ 1.50 Lakh p.m. (₹ 18 Lakhs p.a.)

Question 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 Marks)***

(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 Marks)

(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 Marks)***

OR

(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?

Answer

(a) The auditors, if they were to adopt the role of accuser or secret agency of the management to try upon the happenings of the auditee division, they would be unwelcome. Relations between the auditor and the auditee may improve if the auditor acts and is perceived as a professional advisor and consultant.

Management auditor of Real Limited shall demonstrate, in arriving at a solution, behavioral problems in the discharge of the review function.

In this case, there is a need to demonstrate to the extent possible that:

1. the audit is part of an overall programme mandated by higher- level authority to meet higher-level organizational needs for both protection and maximum constructive benefit.
2. the objective of the review is to provide maximum service in all feasible managerial dimensions.
3. the review will be conducted with minimum interference with regular operations of the operating personnel.
4. the responsible officers will be kept fully informed and have an opportunity to review findings and recommendations before any audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

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 criticize 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.

The participative approach to the internal audit process has proved to be success. Feelings of hostility disappear giving room to feelings of mutual trust. Team spirit is developed. Proposed recommendations are discussed with the auditee and such modifications as may be mutually agreed upon are incorporated.

(b) Advice to the Management of BG Limited on the Composition of Nomination and Remuneration Committee

i. The Board of Directors of every listed public company shall constitute the Nomination and Remuneration Committee which shall comprise of at least three directors, all of whom shall be non-executive directors and at least half shall be independent directors,

ii. However, in case of a listed entity having outstanding SR equity shares, two thirds shall comprise of independent directors.

iii. Chairperson of the committee shall be an independent director. It may be noted that the Chairperson of the company (whether executive or nonexecutive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such committee.

Advice to the Management of BG Limited on the Role of Nomination and Remuneration Committee.

The role of such committee shall, inter-alia, include the following:

(i) Formulation of the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board of Directors a policy, relating to the remuneration of the directors, key managerial personnel and other employees;

(ii) Formulation of criteria for evaluation of performance of independent directors and the Board of Directors;

(iii) Devising a policy on Board diversity;

(iv) 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 their appointment and removal;

(v) 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.

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

(c) Circulating Information Contained in Own Website: As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

1. However, the guidelines approved by the Council of the Institute of Chartered Accountants of India permit creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. Hence there is no misconduct as per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

2. The chartered accountant or firm, as per the guidelines, should ensure 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. Mr. Vineet has circulated the information contained in the website through e-mail to public at large. Therefore, he is guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the said Act.

3. Nature of assignments handled (to be displayable only on specific "pull" request). Names of clients and fee charged cannot be given without such requirement from any of the regulator. Mr. Vineet has displayed the nature of assignments handled along with the name of clients without such requirement from the regulator. Therefore, he is guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the said Act.

4. "The website address of the member be obtained on annual basis in the annual form required to be filed by the member while paying fee and the same be taken as entry on record." Thus guilty of professional misconduct

(c) As per SA315, understanding of the automated environment of a company is required. The auditor's understanding of the automated environment should include the following:

i. The applications that are being used by the company;

ii. Details of the IT infrastructure components for each of the application;

iii. The organisation structure and governance;

iv. The policies, procedures and processes followed;

v. IT risks and controls.

The auditor is required to document the understanding of a company's automated environment as per SA 230.

Thus the approach of CA Vipin is not correct considering the above mentioned requirements of SA 315 and SA 230.

Question 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 ₹ 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 Marks)***

(b) 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. ***(5 Marks)***

(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 Marks)***

Answer

(a) CA Nadar has to ascertain whether the company has complied with the following aspects in relation to the activity of mobilization of public deposits:-

i. The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. In the event of a upgrading/downgrading of credit rating, the auditor should bear in mind that the NBFC will have to increase/reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame and should ensure that the NBF Chas informed about the same to the RBI inwriting.

ii. In the event of downgrading of credit rating below the minimum specified investment grade, a non-banking financial company, being an investment and credit company or a factor, shall regularise the excess deposit as provided hereunder:

a. with immediate effect, stop accepting fresh public deposits and renewing existing deposits;

b. all existing deposits shall run off to maturity; and

c. report the position within 15 working days, to the concerned Regional Office of the RBI where the NBFC is registered.

d. No matured public deposit shall be renewed without the express and voluntary consent of the depositor.

(b) In the given case, management of Quick Ltd has made intentional misstatements to deceive the users in order to meet market expectations. Auditor is suspecting such intentional behavior of the management and in such situations, SA 240 discusses how fraudulent financial reporting may be accomplished and also discusses techniques of committing fraud by management overriding controls.

As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"

Fraudulent financial reporting may be accomplished by the following:

i. Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.

ii. Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.

iii. 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:

i. Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

ii. Inappropriately adjusting assumptions and changing judgments used to estimate account balances.

iii. Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

iv. Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.

v. Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

vi. Altering records and terms related to significant and unusual transactions.

(c) Data Mining Techniques:

i. Data mining techniqueis a set of assisted techniques designed to automatically mine large volumes of data for new, hidden or unexpected information or patterns.

ii. 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.

iii. It explains various affinities, association, trends and variations in the form of conditional logic.

iv. Data mining techniques are categorized in three ways: Discovery, Predictive modeling and Deviation and Link analysis.

In the given case of BMY Bank Ltd., CA Robo appointed as forensic auditor for its borrower, WRONG Ltd, shall use above stated data mining techniques to identify any hidden patterns of information.