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FOR CS PROFESSIONAL EXAM PREPARATION

CS Professional 2024 Question Paper · Internal and Forensic Audit

EXAM
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Question Paper

SUBJECT
Internal and Forensic Audit

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NEW SYLLABUS

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Roll No. .....

OPEN BOOK EXAMINATION

Time allowed : 3 hours

Maximum marks : 100

Total number of questions : 6

Total number of printed pages : 16

NOTE : *Answer **ALL** Questions.*

PART-I

1. Ultra Chem Industries, a leading manufacturer of high-grade polymer compounds, operates an advanced facility that produces a variety of products, including its flagship item, Poly Flex. This fine polymer powder is packaged in 25 kg bags through a highly automated process, with an online check weigher ensuring that each bag meets the specified weight requirements. The company has set a tolerance limit of 50 grams per 25 kg bag for any deviations. During a routine review, the internal auditor manually weighed a sample of Poly Flex bags using a standalone scale. The findings were concerning : a significant number of bags were overfilled by more than 50 grams. Despite this, the plant's functional head dismissed the issue as a statistical aberration, arguing that the company's compensatory controls, such as random manual weighments, would catch and correct any significant discrepancies. He thus downplayed the need for immediate corrective action.

In addition to these operational challenges, Ultra Chem Industries had recently launched a new product line, Fiber Flex, a special-grade polymer fiber developed with imported technology. Unfortunately, Fiber Flex failed to meet quality standards and was rejected by the market, leading to the shutdown of the manufacturing plant. The materials used in Fiber Flex production,

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including fiber intermediaries, imported chemicals, and catalysts, have since remained unused and undisposed of for several years, posing potential environmental and safety risks.

Meanwhile, M/s Sharma & Associates, the internal auditor for Ultra Chem Industries, was conducting an audit of the company's payroll system. The audit's primary objective was to ensure that all employee payments, outstanding amounts, and liability balances were accurately accounted for in the financial statements. During this audit, the internal auditor identified a potential risk : some payroll liabilities might have been omitted or inaccurately recorded. To mitigate this risk, the auditor reviewed payroll records, verified subsequent payments to employees, and assessed the completeness of accrued liabilities to ensure that all payroll obligations were properly reflected in the financial statements.

Given these challenges, several key questions arise, you are requested to answer the following :

(*a*) In light of the weighment discrepancies observed by the internal auditor, what steps should be taken to address the potential overfilling issue in the Poly Flex packaging process ?

(*b*) As the internal auditor, what advice would you give to Ultra Chem Industries regarding the disposal of the unused fiber intermediaries, chemicals, and catalysts from the discontinued Fiber Flex product line ?

(*c*) What specific internal audit procedures should be implemented to ensure that the payroll process is correctly followed and that all related liabilities are accurately recorded in Ultra Chem Industries Ltd.'s financial statements ?

(*5 marks each*)

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2. (*a*) Zen Ltd. is a manufacturer of ready-made garments. During the year 2021-22, they have opened two new branches and there is a substantial increase in their sales. The management has appointed CA Mr. A to review the internal control system of the company as they feel that there are lapses in the control environment of the company. What is included in the control environment and what will the auditor evaluate in order obtain an understanding of the control environment ?

(*5 marks*)

(*b*) An internal auditor was assigned to conduct a comprehensive audit of a healthcare facility. During the audit, the auditor discovered significant inefficiencies in the patient care process, including medication errors, long wait times, and patient dissatisfaction. The auditor presented detailed recommendations to the hospital administrator, suggesting improvements in staff training, patient communication, and quality assurance.

However, the hospital administrator, who had been in his position for over two decades, was resistant to change. He viewed the auditor's recommendations as a personal attack on his leadership. The administrator began to undermine the auditor's authority, questioning his expertise and dismissing his findings. This created a tense atmosphere within the facility, with the auditor feeling isolated and undervalued.

How should the internal auditor approach the situation with the administrator to ensure that their recommendations are considered and implemented, while maintaining a constructive working relationship ?

(*5 marks*)

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(*c*) Tech Nova, once celebrated as a rising star in the financial technology sector, offered electronic payment and risk management services globally. In 2023, investigative reports accused Tech Nova of inflating revenue and profits through deceptive accounting practices. Initially, Tech Nova denied these claims and initiated an internal investigation. However, by August 2024, the company revealed that ₹ 15,000 crore was missing from its accounts. This admission led to a significant drop in Tech Nova's stock price and its eventual collapse. The scandal highlighted concerns about the reliability of financial reporting, auditing, and the need for enhanced transparency.

How can risks related to misleading financial reporting be mitigated, and why should potential funding challenges be a focus in internal audits ?

(*5 marks*)

3. (*a*) XY Ltd., a company specializing in the manufacturing of rugs, is planning to expand and diversify its operations. To ensure better governance, the management has intensified its focus on internal controls. They have consulted with the statutory auditors to identify the necessary steps to ensure that the statutory audit is risk-based and concentrates on areas posing the greatest risk to the achievement of the company's objectives. The management is particularly interested in understanding the key steps and phases involved in a Risk-Based Audit and seeks advice on how to approach the risk assessment phase of the audit to address the company's specific needs.

(*5 marks*)

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(*b*) Bank Safe Ltd. holds a significant portion of its assets in the form of advances to various borrowers. Given the diverse range of advances, the internal audit team is tasked with evaluating the bank's internal controls, particularly focusing on the approval and monitoring processes of these advances. The team is also responsible for conducting substantive audit procedures to assess the accuracy and completeness of the advances recorded. Moreover, with a number of advances potentially at risk, the team needs to evaluate the recoverability of these funds, considering the financial stability of the borrowers and any collateral held by the bank.

What critical aspects should the internal auditor consider while assessing the effectiveness of Bank Safe Ltd.'s internal controls and the overall recoverability of its advances ?

(*5 marks*)

(*c*) While auditing the procurement processes at DEF Industries, the Internal Auditor, Ms. Pranati, follows the documented audit work plan, which emphasizes contract compliance. Midway through the audit, she discovers discrepancies in supplier payment terms that could suggest favouritism. Addressing this would require significant changes to the audit focus and plan. Ms. Pranati must decide how to incorporate this new information into her audit execution without derailing the original scope, ensuring the audit remains both effective and aligned with the company's priorities.

What steps should Ms. Pranati plan and implement to adjust the audit execution effectively in light of the newly discovered payment discrepancies, while still adhering to the original audit objectives ?

(*5 marks*)

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Attempt all parts of either Q. No. 4 or Q. No. 4A

4. (*a*) WWW Limited, a company specializing in mobile spare parts, operates showrooms across the country. In FY 2020-21, the company transitioned from a manual accounting system to a computerized system using SAP. Recognizing the importance of ensuring the new system's effectiveness, WWW Limited appointed ABC & Associates, as internal auditor, known for their expertise in system audits, to evaluate the company's IT environment and controls.

During their audit, ABC & Associates identified several critical exceptions in WWW Limited's IT environment and controls. Despite these significant findings, the management of WWW Limited believes that since they are operating in an automated environment, understanding the detailed workings of the system is optional for auditors.

Do you agree with WWW Limited's management that understanding the automated environment is optional for auditors ? Justify your answer by discussing the importance of IT system knowledge in an audit.

(*5 marks*)

(*b*) While auditing MNOP Technologies, the internal auditor observed the payroll process in detail, from managing employee records to the final disbursement of salaries. During the review, the team illustrated how data flows through various stages, highlighting critical checkpoints like authorization of payroll changes and verification of bank transfers.

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The auditor took the time to map out these steps visually, identifying discrepancies between the procedures shown and the company's written policies. This exercise revealed potential risks such as unauthorized changes to payroll data and inadequate segregation of duties, which could lead to errors or fraud.

How does visually mapping out the steps in a process help an internal auditor in identifying weaknesses, and what are the key advantages of using such a method during an audit ?

(*5 marks*)

(*c*) Green Tech Solutions, a company specializing in renewable energy products, has appointed you as the Internal Auditor for the year 2023-24. During your review of the internal controls within the Sales Department, you observed the following work division :

(*i*) One officer manages the sales ledger and processes cash receipts.

(*ii*) Another official handles the dispatch of products and issues delivery notes.

(*iii*) A third officer oversees customer accounts and issues receipts.

As the Internal Auditor, you are required to assess the internal check system within the company's internal control framework. Do you believe the work is properly divided at Green Tech Solutions ? If not, why ?

(*5 marks*)

OR (Alternative to Q. No. 4)

4A. (*i*) Ms M. Singh has been appointed as an internal auditor of Life Care Insurance Ltd. She observed that few insurance policies have been sold by the company in the last month of the financial year ending 31st March, 2024. While recognizing income in

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the income statement of the company, it is the responsibility of Ms. M. Singh to make an assessment of the reasonability of the risk pattern managed by the management. Also, it is to be ensured by her that Life Care Insurance Ltd. should not issue policies, if the risk is not established before the closure of the F.Y. 2023-24. Indicate the circumstances when the company should not issue the policy documents.

(*5 marks*)

(*ii*) K. Ltd. secured a ₹ 700 lakh term loan from a nationalized bank in 2017 for the construction of a factory, with the loan to be repaid in seven equal instalments of ₹ 100 lakhs starting from 31st March 2018. Due to delays in the construction process, the company temporarily invested the loan funds in short-term deposits. While K. Ltd. successfully repaid the 2018 and 2019 instalments, it defaulted on the payments for 2020, 2021, 2022, 2023 and 2024. As the internal auditor of K. Ltd, what is your responsibility assuming that company has sought reschedule of loan ?

(*5 marks*)

(*iii*) 'Safe-Lock', a leading digital payment platform in Mexico, suffered a data breach that exposed the personal information of millions of users. A cyber security expert uncovered that Safe-Lock's database was being sold on the dark web. The breach was traced back to 'Un-Lock', a partner company responsible for customer verification. Un-Lock had stored user data in an unsecured cloud storage, accessible to anyone with the correct link. Safe-Lock faced criticism for failing to adequately monitor Un-Lock's security practices and for not responding to the expert's warning about the vulnerability. What key activities should internal auditors perform to ensure effective oversight of partner relationships and data security ?

(*5 marks*)

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PART-II

5. Case Study :

Medura Group, a prominent conglomerate in the tech sector, is known for developing and exporting software solutions, mobile applications, and cybersecurity tools. Medura Tech, the group's flagship company, has aggressively acquired start-ups' and mid-sized companies over recent years to expand its footprint. The group's subsidiaries and associates also export specialized software, hardware components, and IT consulting services to the USA, Europe, and other regions. To support this expansion. Medura relied on significant credit and banking facilities provided by a consortium of banks led by Global Fin Bank.

The group's Chief Financial Officer, Aryan, had been with Medura for over a decade, managing financial strategies and operations. His close relationship with management meant that his decisions were rarely questioned. As Medura continued to grow, it sought private equity investment. Innovate Capital, a leading PE fund, showed interest due to the group's impressive growth. To proceed, Innovate Capital hired Nexus Advisors to perform financial and operational due diligence. Nexus Advisors conducted a thorough evaluation and presented their findings to Innovate Capital. However, when Eva, the Chief Investment Officer of Innovate Capital, reviewed the report, she was deeply concerned. As she and her team discussed the findings, her colleague Sam highlighted several alarming issues :

(1) Global Fin Bank had been discounting Medura's export invoices against Letters of Credit (LCs) from reputable banks on behalf of international buyers, with proceeds credited to Medura's account on the same day. However, payment delays occurred, and the bank extended due dates at Medura's request.

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(2) Customs records revealed that many reported exports never happened. Software supposedly developed for export under Working Capital Credit was either not produced or sold domestically, or funds were misappropriated. Out of 2,100 outstanding invoices, 2,000 had no matching export records.

(3) Medura confirmed export completion to banks by submitting falsified certificates from auditors and accountants, along with inaccurate status reports.

(4) The audited financial statements showed inaccurate cash flow figures, failing to reflect the company's true financial state.

(5) One of Medura's subsidiaries had submitted the same export orders to several banks in the consortium, securing working capital credits without providing the necessary export documentation.

(6) Medura used fictitious export orders to hedge against foreign exchange receivables and payables, misleading the banks.

(7) Most receivables were from foreign buyers, but payments came from third parties, indicating that goods might have been sold to alternate buyers at renegotiated prices. The company also submitted fake and forged export invoices for discounting.

(8) The creditor list included fabricated suppliers, artificially inflating purchases and payables to create a misleading financial position.

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Alarmed by these findings, Eva informed Innovate Capital's management, leading them to withdraw from the investment. Additionally, Eva anonymously notified Global Fin Bank about the fraudulent activities. Global Fin quickly convened a consortium meeting and appointed Suresh, a forensic auditor, to investigate.

Questions :

(*a*) What procedural lapses did the bank's branch commit when discounting Medura's export invoices ?

(*5 marks*)

(*b*) What follow-up mechanisms and controls should banks have implemented to monitor foreign bills discounting according to regulatory guidelines ?

(*5 marks*)

(*c*) In a consortium banking arrangement, what additional measures should the Lead Bank take to review the credit facilities granted to Medura Group ?

(*5 marks*)

(*d*) Is Medura's auditor's claim that they were merely following management's instructions justified ? Discuss potential legal consequences for the auditors.

(*5 marks*)

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Attempt all parts of either Q. No. 6 or Q. No. 6A

6. (*a*) During XYZ Corporation's annual audit, the auditor found the financial statements unusually consistent with the prior year despite significant market and operational changes. Although management was cooperative, the auditor suspected management override of controls and performed additional audit procedures. By focusing on areas prone to manipulation, such as revenue recognition and expense recording, the auditor identified inconsistencies. Further investigation revealed that management had deliberately inflated revenue to meet financial targets, secure loans, and boost stock prices, bypassing internal controls. The audit team used forensic accounting techniques to trace these discrepancies, confirming the manipulation.

How can auditors enhance their techniques to better identify and address risks of material misstatement due to potential management override of controls ?

(*5 marks*)

(*b*) Z. Electronics Pvt. Ltd. filed a claim under an employee dishonesty insurance policy, which covers losses due to the dishonest acts of permanent employees. The company's business model required buyers to make advance payments before goods were dispatched from the warehouse. In this instance, Z. Electronics claimed a loss of ₹ 42 lakhs, allegedly misappropriated by an employee, Ranjan. Goods worth ₹ 44 lakhs were invoiced for just ₹ 4 lakhs to a customer named Vishal. The incident occurred on June 15th, 2023, when the team was under immense pressure to meet targets, leading

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Ranjan's superior to overlook the invoicing discrepancy. Upon investigation, the warehouse manager confirmed receiving a written memo from the sales team, as per standard practice, and was unaware of the payment shortfall.

The forensic auditor conducted a thorough investigation to assist the insurance company in evaluating the claim. Imagine and describe how the forensic auditor aided the insurer in this case.

(*5 marks*)

(*c*) At Oceanic Plastics Ltd., three anonymous complaints were discovered in the employee suggestion box, alleging that the company's internal financial controls over cash management are weak and that the head cashier is embezzling funds. You are appointed as a forensic auditor to investigate the validity of these complaints, focusing on both the potential weaknesses in the cash management system and the accusations against the head cashier.

What red flag indicators should the forensic auditor look for to assess the credibility of the complaints ?

(*5 marks*)

(*d*) Delta Corporation, a prominent textile manufacturer based in South India, secured substantial loans from a consortium of banks to modernize its spinning and weaving units. The project was aimed at enhancing production capacity to meet growing domestic and export demand. During the implementation phase, the project cost escalated significantly, necessitating additional funding from the lenders. However, due to unforeseen economic challenges and intense competition, the company faced operational difficulties

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and subsequently defaulted on its loan obligations. Consequently, a forensic audit was commissioned to investigate the reasons behind the default and assess the financial health of the company.

How should the forensic auditor approach the investigation of financial distress in a textile manufacturing company following a capacity expansion ? What key areas should the audit findings focus on to assess the viability of the expansion project and identify any irregularities or fraudulent activities contributing to the loan default ?

(*5 marks*)

OR (Alternative to Q. No. 6)

6A. (*i*) Anand Sons Consulting, a well-established consulting firm in India, offers a range of professional services, including consulting, valuation, taxation, and forensic audits. The firm's teams are composed of highly qualified and experienced professionals, each specializing in a specific service line. The Managing Partner is considering expanding the firm's offerings to include audit services and convened a meeting with the Leads of each service line to discuss this potential venture. During the meeting, the Forensic Audit Lead contended that, "Forensic Auditing covers a broad spectrum of activities, with terminology not strictly defined in regulatory guidance". In this context, answer the following statement :

"Forensic Auditing covers a broad spectrum of activities with terminology not strictly defined in regulatory guidance."

(*5 marks*)

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(*ii*) Mr. Kapoor is expert in assessing the anti-fraud controls for a construction company that has experienced several incidents of fraud related to the quality of raw materials supplied. These frauds have led to substandard construction projects, raising concerns about the integrity of the procurement and quality assurance processes. Mr. Kapoor is now considering various methods to detect and prevent such frauds in the future and is looking into the appropriate corrective actions.

As an expert, you are required to advise Mr. Sharma on how a forensic auditor should plan their investigation to uncover the root causes of these quality issues and ensure the effectiveness of anti-fraud controls.

(*5 marks*)

(*iii*) Alpha Tech Solutions, a local firm specializing in electronic gadgets, noticed a decline in its sales volume in October 2021 after the Operations Manager flagged the issue. Two employees, X and Y, are responsible for selling two popular products : the premium Apex Tablets and the budget-friendly Streamline Laptops. The company received anonymous tips about the sudden lavish lifestyles of X and Y. Suspecting potential collusion and fraudulent activities, the company assigns you as the forensic auditor to investigate.

What types of fraudulent activities would you consider and suggest methodology of investigation ?

(*5 marks*)

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(*iv*) A customer had a bank account in the Mumbai branch. The bank noted that the customer, an Indian resident, was living in London and regularly transferred funds to foreign accounts. He used his email (Yahoo account) to send instructions and signed the required forms. Unfortunately, the customer's Yahoo account was hacked by a fraudster, who sent an email from the customer's official email-Id to the bank, requesting a transfer of ₹ 10 lakhs to a Hong Kong account. Since the bank had processed similar transfers before, it executed the transaction. When the customer later reviewed his account, he discovered the unauthorized debit. Upon investigation, it was revealed that the Yahoo account had been hacked. The bank, needing to compensate the customer, filed a claim with its insurer. How can a forensic auditor assist the insurer in this case ?

(*5 marks*)

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