SUGGESTED ANSWERS JANUARY 2026

PAPER 5: AUDITING AND ETHICS - INTERMEDIATE COURSE

PAPER – 5: AUDITING AND ETHICS

Part I – Multiple Choice Questions

Case Scenario 1

Skill Edge Learning Pvt. Ltd. is a fast growing company providing online learning and digital testing solutions to schools and colleges. The company conducts computer- based exams and offers interactive e-learning content.

For the financial year 2024-25, Skill Edge decided to appoint M/s T & Associates as its new statutory auditor, replacing the previous auditor, CA S. As per the professional requirement M/s T & Associates sent a formal communication to CA S before accepting the engagement. However, CA S did not respond to the communication.

During the audit planning phase, the engagement partner CA T fixed the tolerable misstatement limit at ₹ 1,00,000 for verifying the company's revenue from online courses. Later, after reassessing the overall materiality, the partner increased the limit to ₹ 2,00,000. A newly joined audit assistant was unsure how this change will affect the sample size for testing revenue transactions.

While examining "Intangible Assets" in Skill Edge's books, the auditor reviewed the following expenditures:

(i) ₹ 6 lakhs spent on in-house research to create a unique student performance database intended to enhance marketing effectiveness.

(ii) ₹ 5 lakhs paid for software integrated with a computerized learning device - the device cannot function without this software.

(iii) ₹ 3 lakh spent on standalone accounting software used by the finance department.

The auditor had to evaluate whether the accounting treatment of these items complied with AS-26 Intangible Assets.

Meanwhile, the promoters of Skill Edge set up a new venture, Smart Trade LLP, to trade in refurbished computers and digital devices sourced from Skill Edge's old test centres. Before registration, they consulted CA S to understand the difference between a traditional partnership, an LLP, and a private Ltd company. He *explained that an LLP provides limited liability to its partners, functions as a separate legal entity, and must be registered under the Limited Liability Partnership Act, 2008 with the appropriate authority.*

In August 2025, Mr. Piyush, the partner in-charge of finance at Smart Trade LLP contacted CA S to conduct the audit for FY 2024-25 and complete the statutory filings-unaware about the prescribed due dates for filings.

*Based on the above facts, answer the following questions: (**1 to 5**)*

1. *CA S has failed to respond to incoming auditors. In this regard, choose the most appropriate option.*

   (A) It was unethical on the part of outgoing auditors for failing to respond to communication made by incoming auditors. It is violation of the principle of objectivity governing professional ethics.

   (B) It was unethical on the part of outgoing auditors for failing to respond to communication made by incoming auditors. It is violation of the principle of professional behaviour governing professional ethics.

   (C) The outgoing auditor is not required to respond unless the client asks.

   (D) It was unethical on the part of outgoing auditors for failing to respond to communication made by incoming auditors. It is violation of the principle of professional competence and due care governing professional ethics. ***(2 Marks)***

2. *In the given case scenario, if the tolerable misstatement is increased to ₹ 2,00,000 how will it affect the audit sample size?*

   (A) Sample size will increase.

   (B) Sample size will decrease.

   (C) Sample size will remain unchanged.

   (D) No relationship exists between the two. ***(2 Marks)***

3. *Which of the following conclusions about Skill Edge's intangible asset expenditure is most appropriate under AS 26?*

   (A) All three items should be recognized as intangible assets.

   (B) Only items (i) and (iii) qualify as intangible assets.

(C) *Item (i) should be expensed, item (ii) treated as part of fixed assets; item (iii) recognized as an intangible asset.*

(D) *Item (i) should be expensed; items (ii) and (iii) recognized as intangible assets.* ***(2 Marks)***

4. *Which of the following correctly describes the statutory framework applicable to Smart Trade LLP?*

   (A) *An LLP must have at least two designated partners who must obtain a Director Identification Number (DIN), and it is registered with the Registrar of firms.*

   (B) *An LLP must have at least two partners, of which one must be designated and it is registered with the Ministry of Corporate Affairs (MCA).*

   (C) *An LLP must have at least two designated partners who must obtain a Designated Partner Identification Number (DPIN), and it is registered with the Registrar of Companies.*

   (D) *An LLP must have a minimum of three partners, and only one is required to hold a Designated Partner Identification Number (DPIN) and it is registered with the Registrar of Companies.* ***(2 Marks)***

5. *If Piyush approaches CA S in August 2025 for the audit and filings of FY 2024-25, which outcome is correct?*

   (A) *Annual Return filing will be delayed as every LLP would be required to file annual return in FORM 11 with ROC within 60 days of closure of financial year.*

   (B) *Annual Return filing will be delayed as every LLP would be required to file annual return in FORM 11 with ROC within 30 days of closure of financial year.*

   (C) *Annual Return filing will not be delayed as every LLP would be required to file annual return in FORM 11 with ROC within 6 months of closure of financial year.*

   (D) *No delay since filings can be done anytime.* ***(2 Marks)***

Case Scenario - II

Fresh Farm Foods Ltd., a reputed food processing company, engaged Ravi & Mehta Chartered Accountants, to provide limited assurance on its Social Responsibility Report for the year ended 31st March 2025.

The report prepared covered the company's initiatives on waste reduction, water conservation and community welfare. As part of the engagement, the assurance team visited multiple factory locations, reviewed internal sustainability data and interviewed employees and local community representatives. The engagement was carried out in accordance with the Standard on Assurance Engagements (SAEs) to evaluate whether the report was free from material misstatement.

While reviewing team behaviour during the engagement, the partner noted concerns regarding ethical and independence compliance, one team member had accepted significant gift and hospitality from the client and another had taken loan from the client. The partner decided to assess these matters in light of the ethical requirements.

Simultaneously, Ravi and Mehta were conducting the statutory audit of Fresh Farm Foods Ltd. for the same year. The company has finalized its financial statements for the year ended 31-03-2025, and in the board meeting held on 15th April 2025, the directors declared a dividend for the financial year 2024-25. During the audit, it was noted that the accountant had recognized the dividend as a liability as at 31st March 2025, on the reasoning that the dividend belongs to the year 2024-25.

The auditor must now determine whether recording such a dividend as a liability in the financial statement for the year ended 31st March 2025 is appropriate.

Based on the case study, answer the following questions: ***(6 to 9)***

6. *Which of the following best represents the three party relationship in this assurance engagement?*

   (A) Ravi & Mehta, internal audit staff and the CSR department.

   (B) Ravi & Mehta, management of Fresh Farm Foods Ltd., and the intended users of the report.

(C) *Ravi & Mehta, the company's board of directors and its external auditors*

(D) *Ravi & Mehta, employees interviewed during site visits and the intended users of the report.* ***(2 Marks)***

7. *Which actions should the Ravi & Mehta engagement partner take as per compliance with professional ethical requirements and independent principles?*

(i) *Obtain information from the firm to identify and evaluate the threats.*

(ii) *Evaluate whether the action create threats to independence.*

(iii) *Apply safeguards or eliminate threats to an acceptable level.*

(iv) *Report the issue directly to the client's CSR Committee for their resolution.*

(v) *Consider withdrawal from the engagement if threats remain unacceptable.*

(A) *(i), (ii) and (iii) only*

(B) *(i), (ii) (iii) and (v)*

(C) *(ii), (iii) and (v) only*

(D) *(i), (iv) and (v) only* ***(2 Marks)***

8. *Whether the dividend should be recognized as a liability in the financial statements of Fresh Farm Foods Ltd., as at 31st March 2025?*

(A) *Yes, it must be recognized in the same year irrespective of the date of declaration.*

(B) *No, the amount should be recognized equally between the two financial years.*

(C) *No, the dividend should not be recognized as a liability, instead the amount of proposed dividend should be appropriately disclosed.*

(D) *No, it should neither be recognized nor disclosed.* ***(2 Marks)***

9. *Acceptance of significant gift and hospitality from the client and loan taken from the client creates which type of ethical threats?*

(A) Advocacy and self-review threats respectively.

(B) Familiarity threats and Self Interest threats respectively.

(C) Intimidation and Advocacy threats respectively.

(D) Self Interest and Familiarity threats respectively. ***(2 Marks)***

Case Scenario - III

MN & Co., a firm of Chartered Accountants, was engaged to conduct the statutory audit of OP Ltd., a manufacturer of ready-made garments, for the financial year 2024-25. The audit was conducted with different team members assigned to specific areas of responsibilities:

(1) Ms. Nishi was responsible for audit documentation and the assembly of the audit file.

(2) Mr. Paras was handling the auditor's responsibilities related to the assessment of going concern and he noticed that OP Ltd.'s use of the going concern basis of accounting is appropriate but a material uncertainty exists.

(3) Mr. Sanjay was focusing on the auditor's responsibilities concerning deficiencies in internal control.

Each team member was tasked with ensuring compliance with applicable auditing standards in their respective areas to facilitate a thorough and effective audit process.

Based on above facts, answer the following questions: ***(10 to 12)***

10. Which of the following statements are correct regarding audit documentation and the assembly of the final audit file carried out by Ms. Nishi?

(i) The auditor shall prepare audit documentation after auditor's report but within 90 days after the date of the auditor's report.

(ii) Changes of any type can be made to the audit documentation during the final assembly process.

(iii) After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

(iv) The retention period for audit documentation ordinarily is no shorter than seven years from the date of the auditor's report.

(A) (i), (ii)

(B) (ii), (iii)

(C) (iii), (iv)

(D) (iv), (i) ***(2 Marks)***

11. *During the audit of OP Ltd. Mr. Paras concludes that the financial statements do not provide adequate disclosure of a material uncertainty related to going concern. What action should Mr. Paras take in this situation?*

(A) The auditor shall express an unmodified opinion.

(B) The auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

(C) The auditor shall express a qualified opinion or a disclaimer of opinion in the auditor's report that may be appropriate, in accordance with SA 705.

(D) Auditor shall disclose the matter in EOM paragraph of the auditor's report. ***(2 Marks)***

12. *Mr. Sanjay considers the following as examples of indicators of significant deficiencies in internal control. Which of the following items would actually indicate a significant deficiency?*

I. Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.

II. Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.

III. Evidence of management's inability to oversee the preparation of the financial statements.

IV. Presence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.

V. Evidence of an effective response to identified significant risks.

(A) I, II, III, IV, V

(B) I, II, III, IV

(C) I, II, II

(D) I, II **(2 Marks)**

13. *Mr. Saurabh, a Chartered Accountant, has been appointed as the Statutory Auditor of GM Bank, a nationalized bank, for the financial year 2024-25. Before commencing the audit, Mr. Saurabh conducted an orientation session for his audit team, to familiarize them with the Long Form Audit Report (LFAR) - its applicability, contents, and submission requirements.*

Which of the following statements are correct in respect of the Long Form Audit Report (LFAR)?

I. Besides the audit report, as per the statutory requirements, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks including their branches, require the auditors to also furnish a long form audit report.

II. The matters which the banks require their auditors to deal with in the long form audit report have been specified by RBI.

III. The Statutory Central Auditors are required to submit the LFAR to the banks at the latest by 31^{st} July every year.

IV. The format of LFAR mandatorily requires an executive summary to be given, where members must provide the same to bring out the key observations from the whole document.

(A) I, II, III, IV

(B) I, IV

(C) I, II

(D) III, IV **(2 Marks)**

14. *During the audit of EF Limited for the financial year 2024-25, Mr. Uday, an articled clerk was assigned the task of preparing additional information to be disclosed relating to Crypto Currency or Virtual Currency transactions in the financial statements, in accordance with the Companies Act, 2013.*

    As a senior auditor, help Mr. Uday to identify which of the points, out of the options given, should be included in the additional information to be disclosed relating to Crypto Currency or Virtual Currency.

    I. *Profit or loss on transactions involving Crypto currency or Virtual Currency.*

    II. *Maximum amount of currency held during the financial year.*

    III. *Market value of crypto currency at the end of the financial year.*

    IV. *Amount of currency held as at the reporting date.*

    V. *Deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.*

    (A) *I, II, III, V*

    (B) *I, III, V*

    (C) *I, II, IV*

    (D) *I, IV, V* ***(2 Marks)***

15. *During the audit of ABC Ltd. CA P found that some of the inventories of the company are lying with third parties. Which of the following are not considered audit risks in this situation?*

    I. *There is a risk that company will lose competitive advantage if third party delays production.*

    II. *There is a risk that inventory will not be insured properly by the third party.*

III. *There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties.*

IV. *There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with the third parties.*

(A) *III*

(B) *I, II & III*

(C) *II & IV*

(D) *I, II & IV* ***(2 Marks)***

Answer Key

MCQ. No.	Correct Option
1.	**(B)**
2.	**(B)**
3.	**(C)**
4.	**(C)**
5.	**(A)**
6.	**(B)**
7.	**(B)**
8.	**(C)**
9.	**(B)**
10.	**(C)**
11.	**(B)**
12.	**(C)**
13.	**(C)**
14.	**(D)**
15.	**(D)**

Part II Descriptive Questions

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

*Attempt any **four** questions from the remaining **five** questions.*

Question 1

(a) M/s RS & Co. has been appointed as the statutory auditor of Blue Sky Ltd., a listed company, for the financial year 2024-25. CA R is the engagement partner for this assignment. During the audit, the firm decided that an Engagement Quality Control Review (EQCR) is required for Blue Sky Ltd.

CA T appointed as the engagement quality control reviewer raised concerns regarding the adequacy of documentation for related party transactions and inventory valuation.

However, the management is pressuring CA R to issue the auditor's report before the board meeting, even though the EQCR process is not yet complete. There is also a disagreement between CA R and CA T regarding the extent of further audit procedures.

As per SA 220, "Quality Control for an Audit of Financial Statements," discuss the responsibilities of CA R as the engagement partner in relation to overall direction and review of the audit and the specific responsibilities relating the EQCR. ***(5 Marks)***

(b) Mr. Praveen, an articled clerk, wants to know the applicable Engagement Standards in the following situations:

(i) An assignment to assist the management of Healthy Foods Ltd. with the preparation and presentation of historical financial information, without obtaining assurance on that information. ***(1 Mark)***

(ii) An assignment to examine the prospective financial information of Digital Future Ltd. ***(1 Mark)***

Further, explain to Mr. Praveen the difference between reasonable assurance engagements and limited assurance engagements. ***(3 Marks)***

(c) CA Z, the auditor of Prime Tech Industries Ltd., is conducting the audit for the financial year 2024-25. While reviewing contingent liabilities, he identifies significant litigations and legal claims that may materially affect the financial statements. The management's explanation regarding the progress and possible outcomes of these cases are inadequate and

unconvincing. Anticipating that the company's external legal counsel may not respond to a general letter of enquiry. CA Z decides to seek direct communication through a letter of specific inquiry requesting the legal counsel to provide information to the auditor.

You are required to state the matters to be included in such a letter of specific enquiry as per SA 501. ***(3 Marks)***

Further, explain the auditor's responsibility if the management refuses to permit communication or meeting with the entity's external legal counsel.

(1 Mark)

Answer

(a) Responsibilities of CA R as the engagement partner in relation to overall direction and review of the audit: As per SA 220 - "Quality Control for an audit of financial statements",

(i) Engagement partner has the responsibility for direction, supervision and performance of audit engagement in accordance with professional standards and regulatory and legal requirements.

(ii) He is responsible for auditor's report being appropriate in circumstances.

(iii) Review of audit documentation before issue of audit report is his responsibility.

(iv) It has to be ensured that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for issuance of auditor's report.

(v) Engagement partner is also responsible for ensuring undertaking appropriate consultation on difficult or contentious matters by engagement team not only within the team but also with others at appropriate level within or outside the firm.

Specific responsibilities relating to EQCR: For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

(i) Determine that an engagement quality control reviewer has been appointed.

(ii) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.

(iii) Not date the auditor's report until the completion of the engagement quality control review.

(iv) If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Accordingly, CA R must ensure that the audit is properly directed, reviewed and completed, and that the auditor's report is not issued until the EQCR is completed and all significant matters and differences of opinion are resolved in accordance with SA 220, notwithstanding management pressure.

(b) (i) **An Assignment to assist the management of Healthy Foods Ltd. With the preparation and presentation of historical financial information without obtaining assurance on that information:** Standards on Related Services / The applicable standard is SRS 4410 (Revised)

(ii) **An Assignment to examine prospective financial information of Digital Future Ltd.:** Standards on Assurance Engagements / The applicable standard is SAE 3400

(iii) Difference between Reasonable assurance engagement and Limited assurance engagement.

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.

It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

(c) As SA 501 - "Audit Evidence-Specific Considerations for Selected Items", a letter of specific inquiry includes:

(1) list of litigation and claims;

(2) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(3) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

Auditor's responsibility where management refuses permission: If management refuses to permit the auditor to communicate or meet with the entity's external legal counsel, and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

Question 2

(a) You are the Chief Financial Officer (CFO) of Fortune Hotels Ltd., a company operating in the hospitality sector with multiple hotels across India. The company has recently completed its accounting and financial reporting for the financial year 2024-25, which includes preparation of the balance sheet, profit and loss account, and notes to accounts. As a Key Managerial Personnel (KMP), you are required to provide a written representation letter to the statutory auditors.

Illustrate the matters you would include in the Written Representation letter (in accordance with SA 580 "Written Representations") relating to the Financial Statements. ***(5 Marks)***

(b) *MNO & Co, Chartered Accountants, have been auditing Spark Industries Ltd. for the past five years. Recently, there has been a change in the company's ownership and the new management has shown reluctance in providing complete accounting records and other relevant information for verification. The audit team has faced difficulty in obtaining audit evidence and is unsure whether to continue the audit engagement for the next financial year.*

As an engagement partner, explain the procedures that MNO & Co. should perform before deciding on the continuance of the client relationship and the audit engagement as part of preliminary engagement activities. ***(5 Marks)***

(c) *During the audit of Alpha Components Ltd., the management informs the auditor that the company has implemented a sophisticated ERP system that tracks all movements of raw materials and finished goods in real time. Based on this system, they have stopped conducting any physical verification of inventories, claiming that the system itself ensures accuracy and control over stock levels.*

As the auditor, explain reporting requirement under CARO, 2020. ***(4 Marks)***

Answer

(a) Matters to be included in Written Representation Letter– Relating to Financial Statements: As management and Key Managerial Personnel, we acknowledge and represent to you that:

1. We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated ______, for the preparation of the financial statements in accordance with financial reporting Standards in particular, the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

2. Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.

3. Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)

4. All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)

5. The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (SA 450)

(b) Performing procedures regarding the Continuance of Client Relationships and Audit Engagements: It should be ensured that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and that conclusions reached in this regard are appropriate.

1. The firm should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

2. Evaluate matters such as integrity of principal owners and key management.

3. Assess the competence of engagement team to perform the audit engagement.

4. Implications of matters that have arisen during current and previous audit engagement may need to be considered.

5. Besides, in case of initial engagements, communication with predecessor auditor should be made, where there has been a change of auditors.

(c) Reporting requirement under CARO 2020: As per Clause 3(ii)(a) of CARO, 2020, the auditor is required to report whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedures of such verification by the management is appropriate. The auditor is also required to report whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and, if so, whether the same have been properly dealt with in the books of account.

Auditor must Report on the non-conduct of physical verification

In the present case, the management of Alpha Components Ltd. has stated that it has discontinued physical verification of inventories on the ground that a sophisticated ERP system tracks inventory movement in real time. However, the existence of an ERP system does not replace the requirement of physical verification, as CARO, 2020 specifically requires reporting on physical verification conducted by management.

Therefore, in compliance with Clause 3(ii)(a) of CARO, 2020, the auditor must report the non-conduct of physical verification of inventory, notwithstanding the use of an ERP system, and suitably reflect this matter in the CARO report.

Question 3

(a) During the audit of STU Ltd., the auditor concludes that the financial statement is true and fair, requiring no modification. However, the notes to accounts disclose that a major fire occurred shortly after year end causing significant effect on entity's financial position. The disclosure is complete and no adjustment is needed, but the auditor believes that user should be specifically alerted to this important matter in his audit report.

Identify the type of paragraph the auditor should include in audit report in this situation. ***(1 Mark)***

Explain its meaning and state other circumstances in which such a paragraph may be necessary. ***(4 Marks)***

(b) Mr. Uttam, an articled clerk at RQP & Associates, is auditing AB Pharma Ltd. and has collected various papers and documents during the course of the audit. However, he is unsure about which of these papers and documents should be maintained as part of audit documentation and which should not be included. Later, AB Pharma Ltd. has also requested certain audit documentation from RQP & Associates. Advise him –

Which items need not to be included in the audit documentation? ***(3 Marks)***

Whether RQP & Associates is obliged to provide their audit documentation to the client? ***(2 Marks)***

(c) You are the statutory auditor of Tec Fab Industries Ltd., a company that has recently shifted from manual accounting system to a fully automated ERP

system. The management informs you that all accounting records, vouchers and reports are now generated electronically, and manual books are no longer maintained.

As the auditor, explain how you would understand and evaluate the company's automated environment for planning and performing the audit effectively? ***(4 Marks)***

Answer

(a) In the present case there is a need to add "Emphasis of Matter Paragraph (EOM)" in the Auditor's Report as per SA 706 (Revised).

Meaning of EOM- It is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to the users' understanding of the financial statements.

Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

1 An uncertainty relating to the future outcome of exceptional litigation or regulatory action.

2 A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.

3 Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.

4 A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

(b) Items which need not be included in audit documentation: As per SA 230, "Audit Documentation", the auditor need not include in audit documentation -

1. superseded drafts of working papers and financial statements
2. Notes that reflect incomplete or preliminary thinking.
3. Previous copies of documents corrected for typographical or other errors
4. Duplicates of documents.

Whether RQP & Associates is obliged to provide audit documentation to the client: As per Standard on Quality Control (SQC) 1, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. The auditor is not obliged to provide audit documentation to the client. However, he may, at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Thus, RQP & Associates is not obliged to provide audit documentation to AB Pharma Ltd., since such documentation is the property of the auditor; however, at its discretion, limited extracts may be shared provided such disclosure does not impair audit validity or auditor independence.

(c) **Understanding and evaluating automated environment:** In an audit of financial statements, an auditor is required to understand the entity and its business, including IT. Understanding the entity and its automated environment involves understanding how the IT department is organised, IT activities, IT dependencies, relevant risks, and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

1. Information systems being used, including one or more application systems
2. Purpose of the systems, whether financial or non-financial
3. Location of IT systems, whether local or global
4. Architecture, such as desktop-based, client-server, web application or cloud-based
5. Version of the applications, as functions and risks could vary in different versions of the same application
6. Interfaces within systems, particularly where multiple systems exist
7. In-house or packaged systems
8. Outsourced activities, such as IT maintenance and support
9. Key persons, such as CIO, CISO and system administrators

10. Documenting business processes using flowcharts or narratives.
11. Preparing Risk and Control Matrices (RCM) to identify risks and controls.
12. Evaluating design of controls through walkthroughs of end-to-end processes.
13. Assessing process-wide considerations, including entity-level controls, segregation of duties, and IT general and application controls.

In view of above, the understanding of a company's IT environment that is obtained should be appropriately documented.

Question 4

(a) *During the audit of Zenith Appliances Ltd. for the year ended 31st March 2025, you observe that expenditure on purchase of machinery parts that enhance the useful life of the machine has been charged to repairs and maintenance in the Profit and Loss Account.*

As the statutory auditor, explain whether the above situation constitute misstatements in the financial statements. ***(1 Mark)***

Explain the meaning of Misstatement along with other examples (Any 3) that may arise in financial statements. ***(4 Marks)***

(b) *The accounts team of Infant Garments Private Ltd., while ascertaining the cost of Property, Plant and Equipment (PPE), included various expenses such as:*

- *Cost of testing a machine: ₹ 1,80,000*
- *Cost of inauguration of the new machine: ₹ 1,00,000*

As a Senior auditor, guide the team regarding the recognition criteria of PPE and the elements of costs to be included at the time of recognition.

(5 Marks)

(c) *Ms. Shalini, an articled clerk in Namrata & Co. LLP, has the following questions while going through SQC-1. Guide her on the following:*

(i) Can the firm have a mechanism to ensure compliance with independence requirements? ***(2 Marks)***

(ii) Is engagement quality review mandatory for all engagements?

(1 Mark)

(iii) Can the firm obtain from Ms. Shalini a written confirmation of compliance with the firm's policies and procedures on independence?

(1 Mark)

Answer

(a) Charging of an item of capital expenditure to revenue: In the given situation, expenditure on purchase of machinery parts that enhance the useful life of the machine has been charged to repairs and maintenance in the Profit and Loss Account. This situation constitutes misstatement as expenditure on purchase of machinery parts that enhance the useful life of the machine is a capital expenditure, but it is treated as revenue expenditure. Charging of an item of capital expenditure to revenue is one of the examples of misstatement.

Meaning of Misstatement: Misstatement refers to a difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Examples of misstatements that may arise in financial statements: Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework -

1. Selection or application of inappropriate accounting policies
2. Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework
3. Intentional booking of fake expenses in statement of profit and loss
4. Overstating receivables in financial statements by not writing off irrecoverable debts
5. Overstating or understating inventories

(b) Recognition Criteria for PPE: The cost of an item of PPE should be recognised as an asset if, and only if:

(1) It is probable that future economic benefits associated with the item will flow to the enterprise, and

(2) The cost of the item can be measured reliably.

Elements of Cost to be included at the time of recognition: The cost of an item of property, plant and equipment comprises:

(1) its purchase price, including import duties and non–refundable purchase taxes, after deducting trade discounts and rebates.

(2) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(3) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located (decommissioning, restoration and similar liabilities), the obligation for which is incurred on acquisition of the asset or as a consequence of its use.

Treatment of expenses given in the question

- **Cost of testing the machine (₹ 1,80,000):** Testing costs incurred to check whether the asset is functioning properly before it is put to use are directly attributable costs and are therefore capitalised as part of the cost of PPE.
- **Cost of inauguration of the new machine (₹ 1,00,000):** Inauguration expenses are not directly attributable to bringing the asset to the condition necessary for its intended use and do not generate future economic benefits. Hence, such costs are not capitalised and should be charged to the Statement of Profit and Loss.

(c) (i) There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence. All breaches of independence should be promptly notified to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied.

(ii) Engagement quality control review is mandatory for all audits of financial statements of listed entities. In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.

(iii) At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

Question 5

(a) You are the auditor of LMN Ltd. The company's financial statements for the year ended 31st March, 2025, along with your audit report, were issued on 30th June, 2025. Two months after the issue of auditor's report, you become aware of a fact that existed as on the date of your audit report but was not known to you at that time. Had this fact been known earlier, it would have required a modification of your audit opinion.

Give the Overview of the Auditor's responsibilities in the given facts and situation in line with SA 560 "Subsequent Events". ***(5 Marks)***

(b) XYZ Sewa Foundation a registered NGO receives income from various sources such as foreign grants, membership fees, subscription etc. As the audit assistant you are assigned to verify the receipt of income of the NGO for the year.

You are required to describe the audit procedures you would perform to verify the receipt of income of an NGO. ***(5 Marks)***

(c) Mr. Nikhil is the engagement partner for Amazing Ltd., an e-commerce company, for the financial year 2024-25.

(i) Mr. Nikhil plans to hold a discussion with the senior members of the audit team regarding the current assignment. However, Mr. Hardik, a newly joined article clerk, is surprised at the need for the engagement partner to discuss the audit plan with other team members. He questions why such discussions are necessary? ***(2 Marks)***

(ii) Later, Mr. Hardik learns that Ms. Poornima, the audit manager, intends to discuss certain elements of the audit planning with the management of Amazing Ltd. He believes this is unnecessary, as sharing the audit plan

with the client would remove the "surprise element" of audit procedures. Guide Mr. Hardik in relation to the above scenarios. ***(2 Marks)***

Answer

(a) SA 560 "Subsequent Events" - The auditor has no obligation to perform any audit procedures regarding such financial statements after the financial statements have been issued.

However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: -

(i) Discuss the matter with management and, where appropriate, those charged with governance.

(ii) Determine whether the financial statements need amendment and, if so,

(iii) Inquire how management intends to address the matter in the financial statements.

(iv) If the management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment.

(v) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.

(vi) Extend the audit procedures, already referred, to the date of the new auditor's report and provide a new auditor's report on the amended financial statements.

(vii) Include in the new auditor's report Modified opinion as applicable/ an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

(viii) If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management that the auditor will seek to prevent future reliance on the auditor's report.

(ix) If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

(b) The receipt of income of NGO may be checked on the following lines:

(i) Contributions and Grants for projects and programmes: Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 2010

(ii) Receipts from fund raising programmes: Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) Membership Fees: Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) Subscriptions: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.

(v) Interest and Dividends: Check the interest and dividends received and receivable with investments held during the year.

(c) (i) As per SA 300 "Planning an audit of financial statements", the engagement partner and other key members of the engagement team shall be involved in planning the audit including planning and participating in the discussion among engagement team members. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.

Therefore, Mr. Hardik's doubt is not justified, as SA 300 requires discussion of the audit plan with senior engagement team members to utilise their experience and professional judgment, thereby enhancing the effectiveness of audit planning.

(ii) As per SA 300, the auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

Thus, Mr. Hardik's belief is incorrect, since SA 300 permits discussion of relevant elements of audit planning with management to facilitate coordination, provided care is taken not to compromise the effectiveness of audit procedures or the element of unpredictability.

Question 6

(a) CA Mini was appointed as the statutory branch auditor of DFC Bank Ltd., for the financial year 2024-25. While verifying advances, she observed the following cases:

(i) A term loan to JT Mills Ltd. with an outstanding balance of ₹ 140 lakh and security valued at ₹ 80 lakh was classified by the branch as Doubtful-Category D1 (doubtful upto 1 year) with a provision of ₹ 70 lakh created. ***(3 Marks)***

(ii) A Loan to Z Pvt. Ltd. with an outstanding balance of ₹ 65 lakh and realizable security value of ₹ 6 lakh (as per approved valuer) was classified by the branch as a Doubtful Asset and provision for doubtful debts was made accordingly. ***(2 Marks)***

You are required to examine whether the asset classification and provisioning made by the branch in both cases are in accordance with the RBI Prudential Norms on Income Recognition, Asset Classification and Provisioning.

(b) Yamika, an articled clerk, is conducting the audit of Durable Bags Ltd. During the course of the audit, she intends to use the work of the company's internal auditor as per SA 610 "using the work of internal auditor". State the

circumstances under which Yamika shall plan to use less of the work of the internal audit function and instead perform more of the audit work directly.

(5 Marks)

(c) *In Audit against Rules & Orders of government expenditure audit, the executive government frames various rules, regulations and orders that are to be observed by sub-ordinate authorities. It is the function of audit to see that these rules, regulations and orders are applied properly by the sub-ordinate authorities.*

State the important points that an auditor must ensure while carrying out the examination of various rules, regulation and orders issued by the executive authorities. ***(4 Marks)***

OR

(c) *Sapphire Stones Ltd. has trade payables and other current liabilities of ₹ 210 crores and ₹ 58 crores respectively at the end of the financial year 2024-25. Mr. Amit, the auditor of the company, wants to ensure that trade payables and other current liabilities reported in the balance sheet have been valued appropriately. State the audit procedures that Mr. Amit should perform to ensure that trade payables and other current liabilities are valued properly.* ***(4 Marks)***

Answer

(a) Case (i) – Term Loan to JT Mills Ltd.: The outstanding balance of the term loan to JT Mills Ltd. is ₹140 lakh and the realizable value of security is ₹ 80 lakh. The branch has classified the advance as Doubtful – D1 (up to one year) and created a provision of ₹ 70 lakh.

As per RBI Prudential Norms, in case of a doubtful asset up to one year, provisioning is required at 25% of the secured portion and 100% of the unsecured portion.

In the present case, the secured portion is ₹ 80 lakh and the unsecured portion is ₹ 60 lakh. Accordingly, the required provision is ₹ 20 lakh i.e., (25% of ₹ 80 lakh) plus ₹ 60 lakh (100% of ₹ 60 lakh), aggregating to ₹ 80 lakh.

The classification of the advance as Doubtful – D1 is appropriate, however, the provision of ₹ 70 lakh is inadequate. As per RBI norms, a provision of ₹ 80 lakh should be made.

Case (ii) – Loan to Z Pvt. Ltd.: If the realisable value of the security, as assessed by the bank/approved valuers/ RBI is less than 10 per cent of the outstanding in the borrower accounts, the existence of security should be ignored, and the asset should be straight-away classified as loss asset. It may be either written off or fully provided for by the bank.

The loan to Z Pvt. Ltd. has an outstanding balance of ₹ 65 lakh and realisable security value of ₹ 6 lakh. The realisable value of security is less than 10% of the outstanding amount.

As per RBI guidelines on erosion in the value of security, where the realizable value of security is less than 10% of the outstanding balance, the existence of security should be ignored, and the asset should be straight-away classified as a Loss Asset. Such an asset should be either written off or fully provided for by the bank. Therefore, classification of this advance merely as a doubtful asset is not in accordance with RBI norms.

The asset should be straight-away classified as a Loss Asset and 100% provision should be made. The classification and provisioning made by the branch are not in accordance with RBI Prudential Norms.

(b) Circumstances under which Yamika shall plan to use less of the work of the Internal audit function and perform more of the work directly: The external auditor shall make all significant judgments in the audit engagement, and to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly if:

(i) The more judgment is involved in:

(a) Planning and performing relevant audit procedures; and

(b) Evaluating the audit evidence gathered.

(ii) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant.

(iii) The less the internal audit function's organisational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and

(iv) The lower the level of competence of the internal audit function.

(c) While carrying out the examination of the various rules, regulations and orders issued by the executive authorities, the auditor must ensure that:

(i) they are not inconsistent with any provisions of the Constitution, or any laws made thereunder;

(ii) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;

(iii) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(iv) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

OR

(c) Mr. Amit should perform following audit procedures to ensure that trade payables and other current liabilities are valued properly:

1. Review the process followed by the Company to identify, if any, old creditor balance/ liability needs to be written back. This will include a consistency comparison with the method used in the last year and determination of whether the method is appropriate for the underlying business environment.

2. Obtain the ageing of payable balances and the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.

3. Check that write backs in the liability balances assessed as no longer payable have been approved by an appropriate and authorized member of senior management, for example – CEO/MD.
4. Check that the restatement of foreign currency trade payables has been done properly in accordance with AS 11.
5. Understand management's process to identify the principal amount and the interest due thereon (if any) remaining unpaid to any Micro, Small and Medium Sized Enterprises suppliers at the end of accounting year. Test check the management process to assess if the auditor could rely on the management process.