PAPER – 5 : AUDITING AND ETHICS

PART – I Multiple Choice Questions

Case Scenario - I

Shree Foods Private Ltd., engaged in the production and distribution of packaged snacks. To increase sales, it introduced volume discounts and extended credit facilities to distributors.

The statutory audit of Shree Foods Private Ltd. was assigned to CA Vivek. While planning the audit programme, CA Vivek first obtained an understanding of the company's internal control system and evaluated whether such controls were actually operating effectively. He prepared a detailed audit plan specifying procedures such as:

- *Testing a sample of 100 invoices out of 1200 revenue transactions.*
- *Reviewing discount approvals and credit notes.*

During the audit, the following issues were noted:

(i) Some invoices with incorrect revenue amounts were not included in the selected sample and hence misstatements remained undetected.

(ii) One audit team member misunderstood the bulk discount policy and treated overstated revenue as valid.

(iii) While testing invoices and trade receivables, CA Vivek identified misstatement in some transactions. He needs to project these misstatements to the population to assess their overall impact.

(iv) Management refused to provide requested written representation required by CA Vivek relating to valuation of one of the major Trade Receivables.

(v) Additionally, while verifying trade receivables, CA Vivek performed several other audit procedures such as -

(a) Selecting few invoices from the accounts receivables ageing report and compare them with supporting documentation to see if they billed with the correct amounts, to the correct customer and on the correct dates.

(b) Matching sales invoices issued around the reporting date with the related shipping/dispatch records to ensure receivables are recorded in the correct accounting period.

(c) Reviewing the ageing analysis of receivables to identify long-outstanding balances and evaluate adequacy of provision of doubtful debts.

(d) Sending balance confirmation requests to selected distributors asking them to confirm the outstanding receivable balances as at the reporting date.

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

1. *CA Vivek formulates his audit programme after obtaining a satisfactory understanding of the internal control system. Which of the following statement is correct in this respect?*

   (A) A detailed evaluation of internal control by the auditor would unnecessarily expand the scope of the audit programme and his audit programme may become unwieldy and unnecessarily heavy.

   (B) If the auditor does not care to study the internal control system, his audit programme may become unwieldy and unnecessarily heavy, and the object of the audit may be altogether lost in the mass of entries and vouchers.

   (C) If the internal control is considered strong, the auditor should introduce additional audit procedures that otherwise might not be required to ensure absolute assurance.

   (D) A proper understanding of the internal control system, its content and functioning, does not significantly influence the auditor's selection of audit procedure to be applied in the various areas covered in the audit programme. ***(2 Marks)***

2. *During testing of 100 invoices out of 1200, some invoices with incorrect revenue amounts were not selected and the bulk discount policy was misinterpreted, and overstated revenue was treated as valid.*

   Which of the following combinations correctly identifies the type of risk represented in each of the respective situations?

   (A) Detection Risk - Sampling Risk & Detection Risk - Non-Sampling Risk

(B) Inherent Risk & Control risk

(C) Detection Risk - Non-Sampling Risk & Detection Risk - Sampling Risk

(D) Control Risk & Detection Risk - Non-Sampling Risk ***(2 Marks)***

3. *CA Vivek identified misstatements in some transactions. Some misstatements were anomalies. He needs to project these misstatements to the population to assess their overall impact.*

   Which of the following statement best describes the correct approach in this scenario?

   (A) The auditor is required to project misstatement for the population to obtain a broad view of the scale of misstatement, and this projection is sufficient to determine the amount to be recorded.

   (B) When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population, however, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

   (C) For test of details, the auditor shall project misstatement found in the sample to the population, whereas for test of controls, explicit projection of deviation is always required.

   (D) When a misstatement has been established as an anomaly, it must always be included when projecting misstatements to the population.

   (2 Marks)

4. *CA Vivek requested management to furnish a written representation relating to valuation of Trade receivable. Management failed to provide the same. In the given situation, which of the following actions should not be taken by the auditor referring SA 580?*

   (A) Re-evaluate the integrity of management and assess the impact of non-availability of written representation on the reliability of audit evidence as a whole.

   (B) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705 having regard to the requirement of disclaimer of opinion.

(C) Treat the absence of written representation as a disagreement with management and issue a qualified opinion.

(D) Discuss the matter with management. **(2 Marks)**

5. *Based on the other audit procedures performed by CA Vivek in relation to trade receivables in the above case study, match the audit procedures with the relevant audit assertions:*

Audit Procedures		***Assertions***
a	*i.*	*Existence*
b	*ii.*	*Completeness*
c	*iii.*	*Cut-off*
d	*iv.*	*Valuation*

Options:

(A) a-ii, b-iii, c-i, d-iv

(B) a-iv, b-iii, c-i, d-ii

(C) a-i, b-ii, c-iv, d-iii

(D) a-ii, b-iii, c-iv, d-i **(2 Marks)**

Case Scenario - II

Green Peak Ltd., a leading producer of sustainable packaging material manufactures a range of products including corrugated boxes and paper products.

For the financial year 2025-26, LMN & Co., Chartered Accountants, were appointed as the statutory auditors of the company. The audit was led by CA Aman Verma. The engagement partner CA Verma ensures that the audit team follows the firm's policies, supervises audit work, and ensures compliance with professional standards.

CA Verma obtained an understanding of the company's operations and documented audit plan activities including matters relevant to the overall audit strategy and audit programme.

During the audit, the audit team performed procedures relating to property, plant and equipment, including examination of accounting records, supporting *documents, fixed asset register, and depreciation calculations in the financial statements.*

Additionally the auditor carried out the following substantive analytical procedures to collect various other evidences-

(i) The auditor compares the current year's administrative expenses with the expenses of the previous four years and analysed the fluctuations.

(ii) He noticed, that the company pays sales commission at 4% of total sales. Based on total sales recorded during the year, the auditor estimates the expected commission and compares it with the commission expense recorded in the books.

(iii) He compared the inventory turnover ratio of the current year with that of previous years.

(iv) Using historical data of production volume and power consumption, the auditor develops a statistical model to estimate expected electricity expenses for the current year.

Based on the above facts, answer the following: ***(6 to 9)***

6. *Which of the following statements relating to the firm's system of quality control is/are correct in accordance with SQC 1?*

   (I) The firm's system of quality control consists of policies designed to be established separately for each audit engagement.

   (II) It is designed to provide reasonable assurance that the firm and its personnel comply with professional standards and legal requirements.

   (III) The responsibility for establishing the firm's system of quality control lies with the engagement partner of each audit engagement.

   (IV) The firm's system of quality control consists of policies designed to achieve its objectives.

   (A) (I) and (II) only

   (B) (I) and (III) only

   (C) (II) only

   (D) (II) and (IV) only ***(2 Marks)***

7. *Suggest the audit team members of LMN & Co. to match the apt combination from the following information as per SA 300.*

	Description		***Elements of Planning***
(a)	*Evaluating compliance with ethical requirement, including independence*	*(i)*	*Audit Programme*
(b)	*Detailed plan of applying audit procedures*	*(ii)*	*Preliminary engagement activity*
(c)	*Determination of materiality*	*(iii)*	*Audit Strategy*
(d)	*Consideration of number and location of branches for audit*	*(iv)*	*Audit Plan*

(A) (a)-(iv), (b)-(iii), (c)-(ii), (d)-(i)

(B) (a)-(ii), (b)-(i), (c)-(iv), (d)-(iii)

(C) (a)-(iii), (b)-(iv), (c)-(ii), (d)-(i)

(D) (a)-(ii), (b)-(iv), (c)-(i), (d)-(iii) ***(2 Marks)***

8. *As per the understanding of CA Verma, which of the following options, falls outside the scope of audit of financial statements?*

(I) Assessing the physical condition of industrial buildings and heavy & sophisticated machinery.

(II) Examining the reliability and sufficiency of financial information for audit purposes.

(III) Determining the suitability of buildings for continued use and estimating their remaining useful life.

(IV) Ensuring proper disclosure of property, plant and equipment in the financial statements.

(A) (I) and (III)

(B) (II) and (IV)

(C) (I), (II) and (III)

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

9. *CA Verma performed various substantive analytical procedures in the above case study. Which type of procedure is being performed in each of the given four circumstances?*

Procedures		**Type**
(i)	*(a)*	*Ratio Analysis*
(ii)	*(b)*	*Structural modelling*
(iii)	*(c)*	*Reasonableness Tests*
(iv)	*(d)*	*Trend Analysis*

(A) (i)-(c), (ii)-(d), (iii)-(a), (iv)-(b)

(B) (i)-(d), (ii)-(b), (iii)-(a), (iv)-(c)

(C) (i)-(a), (ii)-(c), (iii)-(b), (iv)-(d)

(D) (i)-(d), (ii)-(c), (iii)-(a), (iv)-(b) ***(2 Marks)***

Case Scenario - III

XYZ bank, a scheduled commercial bank, is preparing its financial statements for the financial year ended on 31st March, 2026.

During the financial year, the bank undertook various lending and investment transactions in the ordinary course of its banking operations. These transactions involved secured advances and bill discounting activities, giving rise to income recognition considerations at the year-end.

In respect of its lending portfolio, the bank accounted for interest income amounting to ₹ 1.07 crores on advances secured by term deposits, National Savings Certificates (NSCs), and life insurance policies, even though the amounts had not been received as of the balance sheet date.

Further, on 01/01/2026, the bank purchased six-month bills and earned a total discount of ₹ 2.4 crores. Since half of the bill period extended beyond 31st March 2026, part of the discount is related to the subsequent accounting period. Additionally, rediscounting charges of ₹ 0.5 crores were netted off against the discount income in the books of account. These transactions require examination to determine whether income has been recognised in accordance with accrual principles and applicable banking guidelines.

XYZ bank is also a co-lender in a consortium arrangement where several banks jointly advanced a term loan of ₹ 150 crore to a corporate borrower. ABC Bank

Limited acts as the lead bank and is responsible for collecting and distributing borrower remittances among the consortium members.

At the year-end, it was observed that XYZ bank had not received its share of repayment from the lead bank, although the borrower had been remitting payments to the lead bank. The auditor must evaluate the correct asset classification and income recognition in respect of XYZ Bank's share of the consortium advance.

In addition, the bank monitors its loan portfolio in accordance with RBI prudential norms relating to asset classification. As of March 2026, certain borrowers had overdue instalments as follows:

Borrower A - 20 days, Borrower B - 30 days, Borrower C - 85 days. The bank follows Special Mention Account (SMA) framework to identify incipient stress before accounts become Non-Performing Assets (NPAs).

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

10. *Since, XYZ Bank recognised interest on advances secured by term deposits, NSCs, and life insurance policies and earned discount on Purchased bills where Rediscounting charges were netted off against the discount income.*

    Which of the following statements correctly reflects the appropriate accounting treatment?

    (A) *Interest on secured advances and the entire discount on bills purchased may both be recognised immediately, and rediscounting charges may be netted off under accrual principles.*

    (B) *Interest on secured advances may be recognised on an accrual basis where an adequate margin exists; however on bills purchased only the portion of discount earned up to 31st March should be recognised, and rediscounting charges should not be netted off from the discount earned.*

    (C) *Interest on secured advances may be recognised on an accrual basis where an adequate margin exists; however on bills purchased only the portion of discount earned up to 31st March should be recognised, and rediscounting charges should be netted off from the discount earned.*

    (D) *Both interest and discount income should be deferred until actual receipt, and rediscounting charges must be adjusted against discount income.* ***(2 Marks)***

11. *In the consortium lending arrangement where ABC Bank Ltd. is the lead bank, how should XYZ Bank classify its portion of the loan?*

    (A) *Classify as standard, since the borrower has remitted payment to the lead bank.*

    (B) *Classify as standard, provided the overall consortium exposure is being serviced.*

    (C) *Classify as NPA until XYZ Bank actually receives its share of repayment from the lead bank.*

    (D) *Recognize interest income on an accrual basis irrespective of receipt from the lead bank.* ***(2 Marks)***

12. *Based on RBI guidelines for Special Mention Accounts (SMA), how should the borrowers be classified?*

    (A) *Borrower A-SMA 0, Borrower B-SMA 0, Borrower C-SMA 2*

    (B) *Borrower A-SMA 0, Borrower B-SMA 1, Borrower C-SMA 2*

    (C) *Borrower A-Standard Regular, Borrower B-SMA 1, Borrower C-SMA 2*

    (D) *Borrower A-SMA 0, Borrower B-SMA 2, Borrower C-SMA 2* ***(2 Marks)***

13. *As part of a firm's system of quality control for audits of financial statements, a monitoring process is designed to provide reasonable assurance that the firm's policies and procedures are relevant, adequate, and operating effectively.*

    Which of the following matter, the engagement partner need not to document as part of the monitoring element of quality control?

    (A) *Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.*

    (B) *Conclusions on compliance with independence requirements that apply to the audit engagement.*

    (C) *Observations about the efficiency of audit procedures performed or suggestions for improving audit team productivity.*

    (D) *Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.* ***(2 Marks)***

14. *The engagement partner CA B, while evaluating and reporting on the designs and efficiency of internal financial controls at GHB Ltd., also highlighted to the directors, independent directors and the audit committee the manner in which the Companies Act, 2013 places greater emphasis on the effective implementation and reporting on the internal control of a company.*

With reference to reporting on the internal financial controls system under the Companies Act, 2013, which of the following statements does not fall within the nature of responsibility of GHB Ltd.?

(A) *In accordance with the terms of reference specified in writing by the Board, act of every audit committee to include evaluation of internal financial controls and risk management systems.*

(B) *Director's responsibility statement to state that the Director has laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.*

(C) *Board of Directors have to appoint an expert to state that the internal financial controls of the company are commensurate with the size and nature of its business.*

(D) *In terms of code for Independent Directors, independent directors to get themselves satisfied that financial controls and systems of risk management are robust and defensible.* ***(2 Marks)***

15. *While auditing the financial statements of Triveni Manufacturing Ltd. for the year ended 31/03/2026, the auditor observed that the company had certain transactions with MNO Trading Pvt. Ltd. During the audit, it was noted that MNO Trading Pvt. Ltd. had been struck off by the Registrar of Companies (ROC) under Sec 248 of the Companies Act, 2013. The transactions between Triveni Manufacturing Ltd. & MNO Trading Pvt. Ltd. included:*

- *Purchases of IT hardware during the year amounted to ₹ 18.50 lakh.*
- *As at 31 March 2026, ₹ 4.20 lakh remained outstanding and payable.*
- *One of the directors of Triveni Manufacturing Ltd. held 15% equity in MNO Trading Pvt. Ltd.*

Which of the following details are required to be disclosed in the financial statements of Triveni Manufacturing Ltd.?

I. Name of the struck-off company (MNO Trading Pvt. Ltd.)

II. Nature of transactions entered into with such company

III. Balance outstanding on reporting date (₹4.20 lakh)

IV. Total purchase amount from MNO Trading Pvt. Ltd. during the year (₹ 18.50 lakh)

V. Relationship with the Struck off company, if any

VI. Date on which MNO Trading Pvt. Ltd. was struck off by the ROC.

(A) I, II, III and IV

(B) I, II, IV and V

(C) I, II and IV

(D) I, II, III and V ***(2 Marks)***

Answer Key

MCQ No.	Correct Option
1.	(B)
2.	(A)
3.	(B)
4.	(C)
5.	(D)
6.	(D)
7.	(B)
8.	(A)
9.	(D)
10.	(B)
11.	(C)
12.	(A)
13.	(C)
14.	(C)
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 XYZ & Co., Chartered Accountants, is conducting the statutory audit of ABC Ltd. During the audit, the engagement partner notices certain unusual year-end sales transactions that have significantly increased the company's profits. Management explains that these are genuine transactions and provide supporting invoices.*

However, the engagement partner expresses concern that such unusual year-end transactions require deeper examination, notwithstanding the availability of documentation. He emphasizes that an auditor should remain alert to conditions that may indicate possible misstatements. He further remarks that although the firm generally follows a rule-based approach to ethics, auditors should not limit themselves to mere compliance with rules but also uphold the spirit of ethical principles while conducting an audit.

(i) *Determine the attitude that the engagement partner expects the audit team to maintain in the above situation. Which risks can be reduced while maintaining such an attitude throughout the audit?* ***(3 Marks)***

(ii) *Distinguish briefly between the principles-based approach and the rules-based approach to ethics.* ***(2 Marks)***

(b) *While auditing the trade receivables of Ocean Limited, CA R plans to select 100 customer balances from a population of 1000 receivables accounts appearing in the trade receivables ledger. For this purpose, he decides to select customer account number 5th as the starting point and thereafter select every 10th account from the ledger until the required sample size is obtained.*

Based on the above:

(i) *Identify and briefly explain the sampling method being used by CA R in the above situation.* ***(2 Marks)***

(ii) *State the important consideration that an auditor should keep in mind while using this method and how the risk arising from such sampling can be minimized?* ***(2 Marks)*** *(iii) Further, the audit partner suggests that instead of this approach, CA R should verify the first 150 customer accounts appearing in the receivables ledger for the last month. State the sampling method suggested by the partner.* ***(1 Mark)***

(c) During the statutory audit of Orion Manufacturing Ltd., the auditor, CA Raghav Mehta, observed that the company's management had changed during the financial year. The earlier management resigned midway through the year, and a new management team assumed charge thereafter.

While completing the audit, the auditor requested written representations from the management regarding their responsibilities for the preparation of financial statements and other audit-related matters. However, the new management stated that they could provide written representations only for the period from the date they assumed office and not for the earlier period when the previous management was in charge.

Examine the above situation and explain with reference to SA 580, the appropriate date of the written representation and the period that should be covered by such representation. ***(4 Marks)***

Answer

(a) (i) In the given case, the engagement partner expects the audit team to maintain an attitude of professional skepticism throughout the audit, especially while evaluating unusual year-end sales transactions. Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

(ii) Ethical guidance may follow principles-based approach or rules-based approach. The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.

However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

Therefore, it is necessary that spirit of code is followed.

(b) (i) Interval Sampling or Systematic Sampling: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example; 10 is the sampling interval in given situation (1000/100) and having determined starting point with customer number 5, each 10th sampling thereafter is selected until the required sample size is obtained. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

(ii) Important considerations an auditor should keep in mind while using this method and how the risk arising from such sampling can be minimised: When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population. Therefore, systematic sampling when chosen as a method should be carefully applied to bring together every type of transaction within its purview.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(iii) **The method selected by the partner is Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population.

(c) As per SA 580 "Written Representations", the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

In the given case, CA Raghav Mehta should obtain written representations from the current management as near as practicable to, but not after, the date of the auditor's report. Further, such written representations must cover the entire financial year referred to in the auditor's report, including the period during which the previous management was in charge. The inability of the current management to have been present during the earlier period does not reduce its responsibility for the financial statements as a whole. Therefore, the auditor is still required to request written representations covering the whole relevant period in accordance with SA 580.

Question 2

(a) *During the audit of Urban Build Constructions Ltd., the auditor reviewed the accounting information system used for recording and processing financial transactions in the company. Transactions relating to purchases, payroll and expenses are recorded through this system by different departments.*

During discussion with employees, the auditor realized that there is limited documentation how financial information flows through the system.

What are the areas relating to the entity's information system and related business processes relevant to financial reporting that the auditor should obtain an understanding as a part of risk assessment procedures? ***(5 Marks)***

(b) *PQR & Associates, a large firm of Chartered Accountants, have been appointed as the auditors of a listed company. CA P, an engagement partner, gathered his audit team to explain them the importance of audit programme. The audit team was impressed by the advantages of audit programme and decided to strictly follow the same. CA P, however, explained that an audit programme can have disadvantages also, if not used diligently.*

(i) What are the Disadvantages of an Audit programme (Any 3)? ***(3 Marks)***

(ii) How can these Disadvantages be minimized? ***(2 Marks)***

(c) *You are appointed as the auditor of JK Apparels Ltd., a public limited company. The company entered into an arrangement during the financial year 2025-26 with one of its promoters Mr. K whose son is a director in JK Apparels Ltd. Under this arrangement, the company acquired an immovable property owned by the promoter. As consideration for the purchase, the company allotted 2% of its equity share capital to the promoter instead of making payment in cash. The title deed of the property has been duly transferred and held in the name of the company.*

(i) Discuss the reporting requirements of the auditor under CARO, 2020.

(2 Marks)

(ii) Discuss the disclosure requirements of Shareholding of Promoters under Schedule III (Part I) of the Companies Act, 2013. ***(2 Marks)***

Answer

(a) The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: -

(i) The classes of transactions in the entity's operations that are significant to the financial statements.

(ii) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.

(iii) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions.

(iv) How the information system captures events and conditions that are significant to the financial statements. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT). Information system should provide qualitative financial information.

(v) The financial reporting process used to prepare the entity's financial statements.

(vi) Controls surrounding journal entries.

Alternate Answer

The Entity's Risk Assessment Process

The auditor shall obtain an understanding of whether the entity has a process for:

(i) Identifying business risks relevant to financial reporting objectives

(ii) Estimating the significance of the risks

(iii) Assessing the likelihood of their occurrence

(iv) Deciding about actions to address those risks

(v) The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is amatter of judgment.

(b) (i) Some disadvantages are also there in the use of audit programmes but most of these can be removed by following some concrete steps. The disadvantages of audit program are:

(1) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(2) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

(3) Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(4) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

(ii) All these disadvantages may be minimised/eliminated by the auditor in the following manner by:

(1) imaginative supervision of the work carried on by the assistants;

(2) having a receptive attitude as regards the assistants;

(3) encouraging the assistants to observe matters objectively and

(4) encouraging assistants to bring significant matters to the notice of supervisor/principal.

(c) (i) Disclosure requirements of shareholding of promoters under Schedule III (Part I) of the Companies Act, 2013: As per clause (xv) of Paragraph 3 of CARO, 2020, the auditor is required to report - whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of the Companies Act, 2013 have been complied with.

(ii) A company shall disclose Shareholding of Promoters* as below:

Shares held by promoters at the end of the year				**% Change during the year*** **
S. No.	**Promoter Name**	**No. of shares**	**% of total shares****	
Total				

* Promoter here means promoter as defined in the Companies Act, 2013.

** Details shall be given separately for each class of shares

***percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.

Question 3

(a) *Alpha Manufacturing Ltd. and Beta Engineering Ltd. are audited for the year ended 31 March 2026. CA Y plans to perform tests of controls over purchase transactions in both companies.*

The following information is available:

Particulars	***Alpha Manufacturing Ltd.***	***Beta Engineering Ltd.***
Population of purchase invoices	*12,000*	*12,000*
Tolerable deviation rate	*5%*	*5%*
Reliance the auditor places on the operating effectiveness of control	*Same*	*Same*
Expected deviation rate	*2%*	*6%*

(i) *Briefly explain factors to be considered by CA Y in determining the sample size for tests of controls.* ***(4 Marks)***

(ii) *Based on the above information, which company will require a larger sample size and why?* ***(1 Mark)***

(b) *During the statutory audit of Moon Ltd., the auditor finalized the auditor's report. While reviewing the draft, the audit team was unsure about where the "Basis for Opinion" section should be placed in the auditor's report and what it should contain as per auditing standards. As a senior auditor, explain:*

(i) *Where should the "Basis for Opinion" section be included in the auditor's report?* ***(1 Mark)***

(ii) *What are the key elements included in this section?* ***(4 Marks)***

(c) *During the audit of a manufacturing company, the engagement team encountered several complex areas requiring careful evaluation. The audit senior reminded the team that matters involving higher judgement must be documented more thoroughly.*

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results. Explain, stating clearly the examples of significant matters (referring SA 230). ***(4 Marks)***

Answer

(a) (i) The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

(I) When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

(II) If there is an increase in the tolerable rate of deviation, then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be. Tolerable error is the maximum error in the population that auditor is ready to accept in a given sample size. Smaller the tolerable error, larger will be the sample size.

(III) When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

(IV) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

(V) In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

(ii) Alpha Manufacturing Ltd and Beta Engineering Ltd both have the same population of purchase invoices of 12,000, the same tolerable deviation rate of 5%, and the same level of reliance placed by the auditor on the operating effectiveness of controls. The only difference between the two companies is the expected deviation rate, which is 2% for Alpha Manufacturing Ltd and 6% for Beta Engineering Ltd.

As discussed above, sample size increases when the expected rate of deviation increases. A higher expected deviation rate indicates that the auditor expects more control failures in the population and, therefore, needs to examine a larger number of items to make a reliable estimate of the actual deviation rate.

Accordingly, Beta Engineering Ltd will require a larger sample size because its expected deviation rate of 6% is higher than the 2% expected deviation rate of Alpha Manufacturing Ltd.

(b) **(i)** **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion"

(ii) **Key elements included in this section are:**

(I) States that the audit was conducted in accordance with Standards on Auditing;

(II) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(III) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(IV) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

(c) Examples of significant matters include: Matters that give rise to significant risks.

(i) Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.

(ii) Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.

(iii) Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

Question 4

(a) *Bright Star Foods Limited processes a large volume of daily sales and purchases using automated accounting software. Most transactions are recorded automatically, and management claims that the system controls reduce the need for manual intervention.*

During the audit of the company's financial statements, the auditor needs to ensure that transactions are recorded accurately and completely. The auditor also needs to decide which audit test to use, when, and in what combination.

Discuss the different ways in which testing is performed in an automated environment and explain which combinations of audit tests are generally considered most effective and efficient. ***(5 Marks)***

(b) *While auditing the financial statements of Moon Ltd. for the year ended 31 March 2026, the auditor was verifying the disclosures relating to trade payables and other liabilities. During the course of the audit, it was noticed that the company has certain outstanding balance payable to Micro and Small Enterprises.*

The auditor decided to ensure that the disclosures required under Schedule III of the Companies Act 2013, in respect of such enterprises have been appropriately made in the notes to accounts.

State the disclosures that the auditor should verify in respect of Micro and Small Enterprises while auditing trade payables and other liabilities.

(5 Marks)

(c) *Apex Infra Ltd. is a mid-sized infrastructure company engaged in construction of highways and bridges.*

During the statutory audit, the auditor notices frequent disputes with contractors, pressure on site managers to meet targets, heavy reliance on automated data processing, and aggressive working capital management by the finance department. The auditor realises that mere verification of accounting records is insufficient to form an opinion. With reference to the *above case, explain why an auditor is expected to have working knowledge of disciplines other than auditing, specifically in relation to:*

(a) Statistics & Mathematics

(b) Financial Management

(c) Data Processing

(d) Behavioural Science **(4 Marks)**

Answer

(a) i. There are basically four types of audit tests that should be used. These are inquiry, observation, inspection and reperformance. For example, when testing in an automated environment, some of the more common methods are: (i) Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection. (ii) Observe how a user processes transactions under different scenarios. (iii) Inspect the configuration defined in an application.

ii. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

iii. Re-performance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

iv. Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence.

v. However, which audit test to use, when and in what combination, is a matter of professional judgment and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file.

(b) **The auditor should ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:** Whether the Company has disclosed the following details relating to micro and small enterprises in the notes to accounts:

(i) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year.

(ii) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year.

(iii) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006.

(iv) the amount of interest accrued and remaining unpaid at the end of each accounting year.

(v) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

(vi) The following ageing schedule shall be given for Trade payables due for payment:

Trade Payables ageing schedule

					(Amount in ₹)
Particulars	***Outstanding for following periods from due date of payment#***				
	Less than 1 year	***1-2 years***	***2-3 years***	***More than 3 years***	***Total***
(i) ***MSME***					
(ii) Others					

*(iii) Disputed Dues- **MSME***					
(iv) Disputed Dues Others					

Similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction. Unbilled dues shall be disclosed separately.

(c) In the given case of Apex Infra Ltd., the auditor observed disputes with contractors, pressure on site managers, dependence on automated systems and aggressive working capital practices. These factors indicate that mere checking of books of account is not sufficient and that the auditor is required to possess working knowledge of disciplines other than auditing.

(a) Auditing and Statistics & Mathematics: Auditor is expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories. In the case of Apex Infra Ltd., where large-scale construction activities and inventories of construction materials are involved, statistical techniques help the auditor in selecting representative samples and drawing reliable conclusions from voluminous transactions and records.

(b) Auditing and Financial Management: Auditor is also expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. Since the finance department of the company is following aggressive working capital management practices, the auditor requires understanding of financial management concepts to assess liquidity position, evaluate financial risks and analyse whether such practices may lead to possible misstatements in the financial statements.

(c) Auditing and Data Processing: EDP auditing in itself is developing as a discipline in itself. As the company heavily relies on automated data processing systems, the auditor should understand the functioning of computerised accounting systems, internal controls in EDP environment and risks relating to processing of electronic data to ensure reliability and accuracy of financial information.

(d) **Auditing and Behavioural Science:** Knowledge of human behaviour is essential for an auditor to effectively discharge his duties. In the given case, pressure on site managers to achieve targets and frequent disputes with contractors may create conditions conducive to manipulation, bias or fraud. Understanding behavioural aspects helps the auditor in assessing management attitude, identifying unusual conduct and evaluating the possibility of intentional misstatements.

Question 5

(a) ZX Technologies Ltd., a listed company engaged in software development, decided to reward certain key employees and directors for their contribution towards development of proprietary technology and process improvements. Accordingly, the company decided to issue shares to selected employees at a concessional price in consideration of their technical know-how.

(i) Identify and briefly explain the type of shares the company is planning to issue. ***(1 Mark)***

(ii) State the conditions that the auditor should verify which must be complied with for valid issue of such shares under the Companies Act, 2013. ***(4 Marks)***

(b) STP Ltd. has entered into lease arrangements for two different categories of equipment from the same lessor. The key terms of the arrangements are summarised below:

Particulars	***Manufacturing equipment***	***Specialised Manufacturing Equipment***
Lease period	*5 years*	*8 years*
Estimated economic life	*10 years*	*8 years*
Transfer of ownership	*NO*	*NO*
Insurance and major maintenance	*Borne by lessor*	*Borne by STP Ltd.*
Alternative use after lease period	*Available*	*Not Available*

(i) Analyse the above arrangements and determine the appropriate classification of lease in case of Manufacturing Equipment and Specialised Manufacturing Equipment. ***(1 Mark)***

(ii) As a senior auditor of STP Ltd., suggest the accounting treatment and Tax benefits for: ***(4 Marks)***

- *Manufacturing Equipment*
- *Specialised Manufacturing Equipment*

(c) ABC Ltd. is a listed company with an annual turnover of ₹ 1,000 crores. The company has appointed three joint auditors, ST and Associates, TR and Associates and PQ and Associates, to conduct the statutory audit for the financial year 2025-26.

Since ABC Ltd. is a listed entity, the joint auditors are required to comply with ethical requirements relating to independence. Before commencing the audit, the audit firms held a meeting with the Audit Committee and submitted written communications regarding their independence. During the meeting, the Audit Committee asked the auditors to clarify the specific matters that must be included in such communication to ensure compliance with professional requirements.

With reference to SA 260, explain the matters that should be included in the communication regarding auditor's independence to those charged with governance in case of listed entities. ***(4 Marks)***

Answer

(a) (i) As per the facts given in the case, the company ZX Technology Ltd. is planning to issue Sweat equity shares.

"Sweat Equity Shares" mean equity shares issued by the company to employees or directors at a

(I) discount or

(II) for consideration other than cash

for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

(ii) As per Section 54 of the Companies Act, 2013 the auditor needs to verify that the following conditions have been complied with:

(I) the issue is authorized by a special resolution passed by the company;

(II) the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(III) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

(IV) the Sweat Equity Shares issued by the company are of a class of shares already issued by them.

(b) (i) In case of Manufacturing Equipment, Lease is classified as Operating Lease due to following reasons:

- Lease term extends to less than 75% of the projected useful life of the leased asset. In the given case, estimated economic life is 10 years and lease period is 5 years which is significantly less than 75%.
- Lessee pays only the monthly lease payments. Insurance and major maintenance are borne by lessor.

In case of Specialised Manufacturing Equipment, Lease is classified as Finance Lease, due to following reasons:

- Lease term is equal to estimated economic life of the asset under the lease arrangement.
- Lessee bears insurance and major maintenance.

(ii) In case of Manufacturing Equipment: Accounting treatment: Operating lease is generally treated like a renting arrangement. That means, the lease payments are treated as operating expenses and the asset does not appear as an asset on lessee’s balance sheet.

Tax Benefit: Since operating lease is as good as renting, lease payment is considered as expense. No depreciation can be claimed by the lessee.

In case of Specialised Manufacturing Equipment: Accounting treatment: Finance lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.

Tax Benefit: Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.

(c) As per SA 260 "Communication with Those Charged with Governance", in case of listed entities, the auditor shall include following matters in the communication regarding auditor's independence to those charged with governance:

(I) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and

(II) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and

(ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

Question 6

(a) M/s PJ Shrimali & Co., Chartered Accountants, were appointed as the statutory auditors of Pristine Limited. Before commencing the audit, the auditors issued an engagement letter to the Board of Directors confirming the terms of the audit engagement.

The letter described the objective of the audit, the scope of work to be performed, and certain matters relating to the conduct of the audit. It also contained a specific section explaining the responsibilities of the auditor while performing the audit of financial statements.

With reference to the above situation, illustrate the responsibilities of the auditor (Any 5) that are generally included in an engagement letter in accordance with SA 210. ***(5 Marks)***

(b) *The financial statements of SUN Ltd. for the year ended 31st March, 2026 include corresponding figures for the year ended 31st March, 2025. The prior period financial statements were audited by a predecessor auditor. The current auditor is permitted by law and regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so.*

(i) *State and briefly explain the type of paragraph that the auditor should include in the auditor's report in the above circumstances.* ***(2 Marks)***

(ii) *With reference to SA 710, list the information that should be included in this paragraph regarding the prior period financial statements.*

(3 Marks)

(c) *SP Co-operative Ltd. is a large co-operative organisation engaged in multiple activities. During audit, the auditor observed that although the entity maintained few primary books of accounts such as the cash book and general ledger, several subsidiary books and registers maintained were either incomplete or not maintained.*

The management contended that for co-operative organisation, maintenance of the subsidiary books and registers is not necessary.

As an auditor, you are required to guide the management about the important subsidiary books and registers that should normally be maintained by a large co-operative organisation. ***(4 Marks)***

OR

(c) *Discuss examples of the factors that the auditor may consider significant in directing the engagement team's efforts while establishing the overall audit strategy.* ***(4 Marks)***

Answer

(a) The responsibilities of the auditors that are generally included in an engagement letter in accordance with SA 210 "Agreeing the Terms of Audit Engagements" are as follows:

(i) Conducting audit in accordance with Standards on Auditing (SAs) issued by the Institute of Chartered Accountants of India (ICAI). These Standards require compliance with ethical requirements. As part of an audit in accordance with SAs, exercise professional judgment and maintain professional skepticism throughout the audit.

(ii) Identifying and assessing the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(iii) Obtaining an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. Communicating in writing any significant deficiencies in internal control relevant to the audit of the financial statements that have been identified during the audit.

(iv) Evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(v) Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists related to going concern, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the auditor's opinion. Such conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause the company to cease to continue as a going concern.

(vi) Evaluating the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(vii) Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

(b) (i) As per SA 710 "Comparative Information - Corresponding Figures and Comparative Financial Statements", If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall include "Other Matter paragraph" in the auditor's report.

Other Matter Paragraphs in the Auditor's Report: Other Matter paragraph is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

(ii) List of information that should be included in Other Matter paragraph regarding the prior periods financial statements are as follows:

(I) That the financial statements of the prior period were audited by the predecessor auditor;

(II) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and

(III) The date of that report.

(c) In case of large scale co-operative organisation, different subsidiary books and registers shall be maintained and the daily summary totals will be transferred to main Cash Book. For example:

(i) Daily cash sales summary register.

(ii) A register of collection from debtors if credit sales are allowed by bye-laws of society.

(iii) A register of recovery of loans from salaries and directly by receipts from members in case of credit society.

(iv) Loan disbursement register in case of credit society.

(v) Any other columnar subsidiaries depending upon the nature and functions of society.

OR

(c) Examples of the factors that the auditor may consider significant in directing the engagement team's efforts while establishing the overall audit strategy are listed as under:

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.