

PAPER – 5: AUDITING AND ETHICS

Part I – Multiple Choice Questions

Case Scenario 1

CA Rajesh and Co. are the statutory auditors of Ram Textiles Ltd. and are making arrangements to start the audit. CA Rajesh, planned to ensure that the work of engagement team members is properly directed, supervised and reviewed so as to conduct an effective audit by the team members. CA Rajesh understood that the nature, timing and extent of the direction and supervision of engagement team members and their review, depends on various factors relating to entity and firm. He ensured that planning of the audit is made so as to cover the scope of audit. Enough care has been taken to ensure that the scope does not include the matters which fall outside the domain of his competence and at the same time to obtain reasonable assurance whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion. The auditor understood the entity and its environment, internal controls, the IT environment and the related risks. Considering the large volume of transactions, the auditor preferred to go for audit sampling with proper checks and controls. The engagement team members were made aware that appropriate risk assessment procedures be designed to suit the circumstances and to strike a balance between the different components of audit risk, so as to reduce the overall audit risk to acceptable low-level and to adopt appropriate audit procedures as required. The auditors wish to determine the sample size by the application of statistical techniques or through the exercise of professional judgment, as would be appropriate in the particular circumstances and also decided in appropriate cases, to examine the entire population of items that make up a class of transactions or account balance. Accordingly, CA Rajesh decided to use statistical sampling for verification of sales, and at the same time, verify all the sales transactions to related parties. The auditor considered various factors that determine the sample size for tests of control and observed that when circumstances are similar, the effect on sample size of factors will be similar, regardless of whether a statistical or non-statistical approach is chosen. Further, he designed and performed audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate audit evidence and thereby enable to draw reasonable conclusions

on which to base the auditor's opinion. The engagement team members were given instructions, that apart from the appropriateness and relevance of audit evidence obtained, the need for sufficiency of audit evidence and the factors affecting auditor's judgment as to sufficiency of audit evidence, shall also be considered.

Based on the above facts, answer the following Q. Nos. 1 to 6.

1. CA Rajesh had considered all the factors affecting the supervision and review of engagement team members' work. One of the following is not a factor in deciding the nature, timing and extent of the direction and supervision of engagement team members and review of their work.

- (A) Size and complexity of the entity
 - (B) The availability of time and trained personnel to review the work
 - (C) The capability and competence of the individual team members performing the audit work
 - (D) The area of the audit
- (2 Marks)**

2. As per the understanding of CA Rajesh, which of the below options, falls within the scope of audit of financial statements?

- (A) Reliability and sufficiency of financial information.
 - (B) Responsibility of preparation and presentation of financial information.
 - (C) Expertise in authentication of documents.
 - (D) Duties outside scope of competence of auditor.
- (2 Marks)**

3. Suggest the audit team members of CA Rajesh and Co. to match the apt combination from the following information regarding risk and their description:

Type of Risk	Description
1. Sampling Risk	a. Sample was not representative of the population.
2. Audit Risk	b. Risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

3. Not an Audit Risk	c. Erroneous conclusion due to application of inappropriate audit procedure.
4. Non-sampling Risk	d. Risk that the auditor might express an opinion that the financial statements are materially misstated, when they are not.

(A) 1-a, 2-b, 3-c, 4-d

(B) 1-c, 2-a, 3-b, 4-d

(C) 1-b, 2-d, 3-a, 4-c

(D) 1-a, 2-b, 3-d, 4-c

(2 Marks)

4. CA Rajesh decided to go for sampling for verification of controls, transactions and for applying substantive procedures. In this regard, select a statement from the below options, which is not apt:

(A) It is possible to make 100% examination of test of controls.

(B) 100% examination may be made of a population constituting a small number of large value items.

(C) 100% examination is appropriate when there is a significant risk, and other means do not provide sufficient appropriate audit evidence.

(D) The repetitive nature of calculation or other process performed automatically by an information system, makes a 100% examination cost effective.

(2Marks)

5. CA Rajesh wants to choose a sample size which enables him to make a proper risk assessment of the population. In selecting the sample size, which of the below option is not correct?

(A) The lower the risk the auditor is willing to accept, the greater the sample size needs to be.

(B) If there is an increase in the tolerable rate of deviation, then the sample size will decrease.

(C) 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 thus the sample size will decrease.

(D) When there is an increase in the expected rate of deviation of the population to be tested, then sample size will increase. **(2 Marks)**

6. The auditor's judgment as to sufficiency of audit evidence is not dependent on one of the factors mentioned below. Choose one such factor from the below options:

- (A) Nature and source of audit evidence
- (B) Risk of Material Misstatement
- (C) Size and characteristics of population
- (D) Materiality

(2 Marks)

Case Scenario - II

Ravi Chopra and Associates are statutory auditors of a steel manufacturing company. The audit for the current financial year has been started. The engagement partner, as part of understanding and evaluating the internal controls of the company, chose to use Internal Control Questionnaire for collecting information about the existence, operation and efficiency of internal control in the organisation. Accordingly, the auditor handed over an Internal Control Questionnaire in respect of purchases, creditors, inventories and fixed assets, to the management.

In the process of verification of receivables of the company, the engagement partner performed certain Test of Controls and found them satisfactory. He then decided to use direct confirmation procedure and selected some of the parties for external confirmation, on the basis of his judgment. The partner decided to use both positive and negative confirmation request(s) depending on the circumstances, materiality and volume of transactions as would be appropriate for the class of transactions selected for verification. The responses received and the non-responses were carefully analysed for further audit procedures to be carried on, to corroborate evidence obtained from confirmation requests.

The engagement partner observed during the course of verification, that the company is facing tight working capital conditions and also availed additional cash credit limits on ad-hoc basis for six months, from its banker, to meet the stressed working capital requirements. The partner verified whether appropriate charges were registered within the statutory time period with the Registrar of Companies and whether necessary disclosures are made in the financial statements.

Further, during the course of audit verification, the partner identified certain events or conditions that cast doubt on the entity's ability to continue as a going concern. The engagement partner held appropriate discussions with the management and those charged with governance, to resolve the matter on appropriateness of going concern assumption. The management demonstrated their plans to the satisfaction of the auditor, to dispel the doubts raised on going concern assumption.

The audit manager during the course of audit verification came across certain subsequent events but had confusion in classifying them, so as to decide on their treatment in the financial statements. The subsequent events are to be dealt, based on whether the evidence of conditions that existed on the date of the financial statements, or events providing evidence of conditions, that arose after the date of financial statements.

In the Board meeting held during the month of April, the company discussed on the settlement of certain legal claims on the company, plans for reconstruction of business by issue of new share capital and merger proposals by interested parties. The engagement partner properly analysed all such events and ensured that they are appropriately dealt with in the financial statements.

Based on the above facts, answer the following Q. Nos. 7 to 12.

7. *The following are a part of Internal Control Questionnaire in respect of purchases, creditors, inventories and fixed assets. Match the apt combination from the following information regarding Related part of Internal Control Questionnaire and Description of item:*

Related part of Internal Control Questionnaire	Description of item
1. <i>Are materials inspected and counted, weighed or measured in the receiving department?</i>	a. <i>Creditors</i>
2. <i>In respect of raw material and supplies, are reconciliations made of quantities and / or values received as shown by purchase invoices, with receipt into stock records?</i>	b. <i>Purchases</i>
3. <i>Are there norms for re-order level?</i>	c. <i>Fixed assets</i>

4. <i>Is there a written procedure for periodic verification and discrepancies disclosed by such reports investigated and are the records and financial accounts corrected with appropriate authority?</i>	d. <i>Inventories</i>
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(A) 1-d, 2-a, 3-c, 4-b

(B) 1-b, 2-a, 3-d, 4-c

(C) 1-a, 2-c, 3-d, 4-b

(D) 1-c, 2-b, 3-d, 4-a

(2 Marks)

8. *In respect of the confirmations from the trade receivables, choose the statement which is not correct.*

(A) *Confirmation from trade receivables should necessarily be as on the date of balance sheet.*

(B) *The requested confirmation should preferably be without mentioning the balance outstanding, wherein the debtor is requested to respond with the balance outstanding as per his records.*

(C) *The method of selection of trade receivables to be circulated, should not be revealed to the client, until the trial balance of the trade receivables ledger is handed over to the auditor.*

(D) *The auditor employs direct confirmation procedure with the consent of the entity under audit.*

(2 Marks)

9. *Some of the parties to whom the confirmation requests were sent, have replied and some did not. CA Ravi Chopra analysed the responses received and discussed with his team members, the reasons for non-response and asked them to send the reminders. Choose the statement which is not correct from the following:*

(A) *The failure to receive a response to a negative confirmation request, does not explicitly indicate receipt by the intended confirming party, of the confirmation request or verification of the accuracy of the information contained in the request.*

- (B) Failure of a confirming party to respond to a negative confirmation request, provides significantly less persuasive audit evidence, than does a response to a positive confirmation request.*
- (C) Confirming parties may be less likely to respond in the case of disagreement with a confirmation request, when the information in the request is not in their favour and more likely to respond otherwise.*
- (D) Confirming parties may be more likely to respond indicating their disagreement with a confirmation request, when the information in the request is not in their favour, and less likely to respond otherwise.*

(2 Marks)

10. *In respect of registration or satisfaction of charges created on Borrowings of the company, following information is to be disclosed in the financial statements. Choose the correct option.*

- (A) Charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details thereof shall be disclosed.*
- (B) Charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details and reasons thereof shall be disclosed.*
- (C) Charges yet to be registered with Registrar of Companies beyond 12 months from the date of creation of charge, the details and reasons thereof shall be disclosed.*
- (D) Charges or satisfaction of charges made by the company during the year.*

(2 Marks)

11. *CA Ravi Chopra had considered all the events that cast a doubt on the going concern assumption. Consider the following examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern:*

- (1) Shortage of important supplies.*
- (2) Loss of major market share.*
- (3) Inability to pay creditor on due dates.*
- (4) Non-compliance with regulatory requirements.*
- (5) Arrears or discontinuance of dividends.*

- (6) *Emergence of highly successful competitor.*
- (7) *Pending legal proceedings which may result in claims which the entity is unlikely to be able to satisfy.*
- (8) *Inability to obtain financing for essential requirements.*

Choose the correct option which suits to events or conditions.

- (A) 1, 3, 4-Financing events: 2, 5, 6-operating events: 7, 8-other events
- (B) 1, 4-Financing events: 3, 2, 5-operating events: 6, 7, 8-other events
- (C) 1, 4-Financing events: 3, 7, 6-operating events: 2, 5, 8-other events
- (D) 3, 5, 8-Financing events: 1, 2, 6-operating events: 4, 7-other events

(2 Marks)

12. CA Ravi Chopra considered the subsequent events which require to be dealt with in the financial statements. Select from the below options, the one which is not an event, providing evidence of conditions that arose after the date of the financial statements:

- (A) *Settling a legal claim outside the court at a reduced amount, between the date of financial statements and the date of auditor's report, for which provision has already been made in financial statements.*
- (B) *Issue of new share capital.*
- (C) *Planned merger of the company.*
- (D) *Destruction of substantial inventories due to fire between the date of the financial statements and the date of auditor's report.*

(2 Marks)

13. CA Student Ajay learnt the concept of classification of advances as per RBI prudential norms for agricultural advances. As per the prudential norms, agricultural advances shall be treated as NPA:

- (A) *If instalment of principal or interest thereon remains overdue for one crop season in case of short duration crop and two crop seasons in case of long duration crops.*
- (B) *If instalment of principal or interest thereon remains overdue for two crop seasons in case of short duration crop and one crop season in case of long duration crops.*

(C) *If instalment of principal and interest thereon remains overdue for two crop seasons in case of short duration crop and one crop season in case of long duration crops.*

(D) *If instalment of principal and interest thereon remains overdue for one crop season in case of short duration crop and two crop seasons in case of long duration crops.* **(2 Marks)**

14. *During the course of audit of a company CA Nitin has verified various assertions relating to Income Statement and Balance Sheet items. Consider the following statements:*

Statement 1: *Occurrence and Valuation are assertions relating to Balance Sheet captions.*

Statement 2: *Measurement and Existence are assertions relating to Income Statement captions.*

Statement 3: *Measurement and Completeness are assertions relating to Income Statement captions.*

Statement 4: *Existence and Rights & Obligations are assertions relating to Balance Sheet captions.*

Choose the correct option from below:

(A) *Only 1 & 2 are correct.*

(B) *Only 1 & 3 are correct.*

(C) *Only 2 & 4 are correct.*

(D) *Only 3 & 4 are correct.* **(2 Marks)**

15. *A Limited company has certain borrowings from a consortium of banks. classified into Funded loan and Non-funded facilities. The description of the facilities is as under -*

i. *Letters of credit*

ii. *Cash credits*

iii. *Bank guarantees*

iv. *Overdrafts*

v. *Standby Letter of credit (SBLC)*

vi. Bills discounted and purchased

vii. Participation on Risk sharing basis

Choose the correct option with regard to Funded loans.

(A) i, ii, vi, vii

(B) ii, iv, vi, vii

(C) ii, iii, iv, vi

(D) i, v, vi, vii

(2 Marks)

Answer Key

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

Part II Descriptive Questions

Question No.1 is compulsory.

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

Question 1

(a) CA Student Kalyan was going through a topic on "Audit programme" and learnt that an audit programme is designed to provide most appropriate audit evidence by prescribing procedures and techniques to verify an assertion. Guide the student in answering the following:

(i) What type of audit evidence shall an auditor look into as the most appropriate evidence in verification of an assertion? **(3 Marks)**

(ii) Specify the most appropriate audit evidence in respect of:

- verification of Cash in hand
- verification of Investments pledged with bank **(2 Marks)**

(b) CA Ram Manohar and his team have just started the statutory audit of a listed company which is into manufacture of agro pesticides. The auditors wish to plan and perform the audit so as to reduce the risk of material misstatement to an acceptably low-level. Discuss, how the auditors can satisfy the objective of identifying and assessing the risk of material misstatement.

Your answer should be in line with relevant Standards on Auditing. **(5 Marks)**

(c) ABC Limited is a large drug manufacturing unit, having units at Hyderabad and Ahmedabad. The management has nominated an expert team from different functions of the organization, to conduct the year end verification of inventories and for finalization of accounts for the financial year 2024-25. The statutory auditors also, as a part of their audit verification, wish to attend the year end physical inventory verification planned by the management. The inventory at all the locations are considered material to the financial statements.

The auditor encountered following situations:

Hyderabad unit: Due to administrative reasons, the management had taken up the stock verification of inventory on 15th March 2025 itself.

Ahmedabad unit: *The Company had taken up the inventory verification as planned on 31st March 2025. However, there was news of local disturbances in the city of Ahmedabad during the last week of March 2025, whereby the auditor cancelled his planned visit for attending inventory verification.*

In the above circumstances, what additional audit procedures are to be undertaken by the statutory auditor for inventory verification?

Your answer should be in tune with relevant standards on auditing.

(4 Marks)

Answer

- (a) (i) While looking into the most appropriate evidence in verification of an assertion, the auditor shall consider that evidence is the very basis for the formulation of opinion, and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact. Audit procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

In most of the assertions much of the evidence be drawn, and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields, and it is generally of the following broad types:

- (a) Documentary examination
- (b) Physical examination
- (c) Statements and explanation of management, officials and employees
- (d) Statements and explanations of third parties
- (e) Arithmetical calculations by the auditor

- (f) State of internal controls and internal checks
 - (g) Inter-relationship of the various accounting data
 - (h) Subsidiary and memorandum records
 - (i) Minutes
 - (j) Subsequent action by the client and by others.
- (ii) Most appropriate evidence in respect of:
- verification of cash in hand is 'count'.
 - verification of investment pledged with bank is the banker's certificate.
- (b)** Auditors CA Ram Manohar and his team can satisfy the objective of identifying and assessing the risk of material misstatement to an acceptably low level while planning and performing the audit of Listed company in accordance with SA 315. As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.
- The objective of the auditor as stated in SA 315 is to identify and assess the risks of material misstatement.**
- (i) The auditor shall identify and assess the risks of material misstatement at:
- (I) the financial statement level
 - (II) the assertion level for classes of transactions, account balances, and disclosures
- to provide a basis for designing and performing further audit procedures.
- (ii) For the purpose of identifying and assessing the risks of material misstatement, the auditor shall: -

- (I) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements.
- (II) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.
- (III) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test and
- (IV) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

(c) Hyderabad Unit: Physical Inventory Counting Conducted other than at the Date of the Financial Statements: As per SA 501, "Audit Evidence-Specific Considerations for Selected Items", if physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the required procedures, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded/ whether the perpetual inventory records are properly adjusted.

Relevant matters for consideration when designing audit procedures to obtain evidence about whether change in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- i. Reliability of the entity's perpetual inventory records.
- ii. Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Ahmedabad Unit: If attendance at physical inventory counting is impracticable: As per SA 501, Audit Evidence-Specific Considerations for Selected Items", in some cases, if the auditor is unable to attend physical

inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

If attendance at physical inventory counting may be impracticable due to factors such as the nature and location of the inventory, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

Question 2

- (a) *What do you mean by 'Deficiency in internal control' and 'Significant deficiency in internal control'?* **(5 Marks)**
- (b) *CA Student Ravi is learning the concept of "Key Audit Matters". However, he is confused between modification of audit report and reporting of key audit matters.*

You are required to guide him in explaining the following:

- (i) *Purpose of communicating Key Audit Matters* **(2 Marks)**
- (ii) *Communicating Key Audit Matters is not a substitute for disclosure in financial statements.* **(3 Marks)**
- (c) *CA students Sriranga and Manga were discussing on the assurance, which the auditing services provide to the users, in the form of opinion on financial statements, by means of a written report. Such an assurance lends credibility to financial statements. You are required to state some of the aspects examined by the auditor, to ensure that the financial statements which are audited are not misleading.* **(4 Marks)**

Answer

- (a) SA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", defines the deficiency in internal control and significant deficiency in internal control.

Deficiency in internal control – This exists when: -

- (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or
- (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

- (b) (i) **Purpose of Communicating Key Audit Matters:** As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgement in the audited financial statements.
- (ii) **Communicating Key Audit Matters- not a substitute for disclosure in the Financial Statements:** Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:
- (1) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to

make, or that are otherwise necessary to achieve fair presentation.

- (2) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
 - (3) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
 - (4) A separate opinion on individual matters.
- (c) Aspects to be examined by the auditor to ensure that the financial statements which are audited are not misleading are as under:
- (i) the accounts have been drawn up with reference to entries in the books of account.
 - (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence.
 - (iii) none of the entries in the books of account has been omitted in the process of compilation.
 - (iv) the information conveyed by the statements is clear and unambiguous.
 - (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
 - (vi) the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

Question 3

- (a) CA Student Manoj is studying on the exemptions available to a private limited company in respect of certain reporting requirements. You are required to guide Manoj on the following:
- (i) *Applicability of Reporting requirements on adequacy of Internal Financial Controls (IFCs) with reference to financial statements to a private limited company.* **(2 Marks)**
 - (ii) *Applicability of Companies (Auditor's Report) Order, 2020 to a private limited company.* **(3 Marks)**

- (b) *Enumerate the factors that may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms. (5 Marks)*
- (c) *XYZ Developers, a property development firm, has secured a short-term construction loan from ABC Bank to finance a residential project. Upon completion of the project, XYZ Developers plan to refinance this loan with a long-term takeout loan from DEF Financial Institution. However, due to delays in the project's completion, XYZ Developers face difficulties in repaying the loan, and the bank classifies the loan as a Non-Performing Asset (NPA).*

What is the meaning and primary objective of takeout finance in property development, and how does the classification of a loan as a Non-Performing Asset (NPA) impact income recognition by the lending bank? (4 Marks)

Answer

- (a) (i) **Applicability of Reporting requirements on adequacy of IFC w.r.t to financial statements to a Private Limited Company:** The auditor's report shall state whether the company has adequate Internal financial controls with reference to financial statements in place and also on the operating effectiveness of such controls. This requirement shall not apply to a private company which –
- (I) is a One Person Company or a small company; or
 - (II) has turnover less than ₹ 50 crore as per the latest audited Financial Statements, and which has aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial Year less than ₹ 25 crore.
- (ii) **Applicability of CARO to a Private Limited Company:** Companies (Auditor's Report) Order, 2020 shall not apply to a private limited company, not being a subsidiary or holding company of a public company:
- (I) having a paid-up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and
 - (II) does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and

(III) does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

(b) As per SA 210 "Agreeing the Terms of Audit Engagements", the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- (i) Any indication that the entity misunderstands the objective and scope of the audit.
- (ii) Any revised or special terms of the audit engagement.
- (iii) A recent change of senior management.
- (iv) A significant change in ownership.
- (v) A significant change in nature or size of the entity's business.
- (vi) A change in legal or regulatory requirements.
- (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
- (viii) A change in other reporting requirements.

(c) Meaning of Take-out finance in property development: A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan. More specifically, a takeout loan, or takeout financing, is long-term financing that the lender promises to provide at a particular date or when particular criteria for completion of a project are met. Takeout loans are commonly used in property development.

Objective of Take-out finance in property development:

- (I) To expand sources of Finance for infrastructure projects by facilitating participation of new entities.
- (II) To address sectoral/group/entity exposure issues and asset liability in mis-match concerns of tenders.
- (III) To boost the availability of longer tenor debt finance for projects.

Impact of classification of loan as NPA on income recognition by lending bank: In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).

Question 4

- (a) *Takur and Co; Chartered Accountants were conducting an audit of an LLP. They have verified the Receivables and concluded that all the Receivables are genuine and recoverable. However, before the final completion of the audit, the auditors came to know of severe financial crisis of one of the Receivables, M/s. Raj Enterprises, whose outstanding account balance was material to the overall Receivables figure as on the date of financial statements. CA Takur had discussions with the appropriate level of management to address the issue, and the management finally agreed to make provision for the same, as suggested by the auditor.*

You are required to -

- (i) *Ensure how the auditor can fulfil the "Documentation" part of this matter. (3 Marks)*
- (ii) *Mention any four different examples of "Audit Documentation". (2 Marks)*
- (b) *RK Associates, a leading Chartered Accountant firm were approached by SK Group, for appointment as statutory auditors for their new start-up company. It was learnt that some companies of the group faced raids by the Enforcement Directorate, in the recent past. The firm follows the SQC 1 and the firm's Quality control policy requires it to obtain vital information about the client before accepting an engagement. Specify the matters which the firm would consider for verifying the integrity of the client, to decide on acceptance of the engagement. Your answer should be in line with SQC 1. (5 Marks)*
- (c) *An auditor while verifying the sales during the year observed that the sales transactions in that year are more than 1 lakh in number. He wants to determine the sample size and its composition on the basis of his personal experience and knowledge and do the testing on his own judgment. Kindly advise him about the scientific approach to sampling and the method of sampling to be chosen in such a situation. (4 Marks)*

Answer

- (a) (i) The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.

Considering the above, the auditor shall document the minutes of the discussions with the management, regarding the financial crisis of M/s Raj enterprises, the matters discussed, the persons representing the management and the auditor, the amount recommended for provision by the auditor and the amount of provision finally accepted and provided by the management and any other relevant data in support of the same.

(ii) Examples of Audit Documentation:

- Audit programmes.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

- (b) As per SQC 1, matters RK Associates would consider for verifying the integrity of SK Group to decide on acceptance of the engagement are as under:**

- (i) The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- (ii) The nature of the client's operations, including its business practices.

- (iii) Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- (iv) Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- (v) Indications of an inappropriate limitation in the scope of work.
- (vi) Indications that the client might be involved in money laundering or other criminal activities.
- (vii) The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

(c) Statistical Sampling – More Scientific:

1. Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves the use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.
2. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items, and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers. In larger organizations, with huge transactions, statistical sampling is always recommended as the samples selected are not prejudged.
3. There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

In the instant case, an auditor while verifying the sales during the year observed that the sales transactions in that year are more than one lakh in number. In such case, statistical sampling will be highly recommended in the audit program. Random Sampling is the method he can decide to choose sample in such a situation.

Question 5

(a) CA Taman is the auditor of a company dealing in trading of mobile accessories. This year the company has also started assembling of mobile phones. The audit manager instructed the team to develop the audit programme based on the previous year's audit plan and proceed with the audit. However, CA Taman disagreed, explaining to the audit manager that before commencing the audit and throughout its course, she would plan the nature, timing and extent of direction and supervision for the engagement team members and the review of their work. Explain:

(i) What factors will CA Taman consider when planning the nature, timing, and extent of direction and supervision of the engagement team members and review of their work? **(3 Marks)**

(ii) If, during the course of the audit, CA Taman discovers information that significantly differs from what was available when the audit procedures were initially planned, then what must she do? **(2 Marks)**

(b) Following is the extract from the Balance Sheet of Rain Pvt. Ltd.:

(i) Borrowings as on 31/03/2025	₹ 10 Cr.
(ii) Fresh borrowings from bank during the year	₹ 3 Cr.
(iii) Borrowings repaid during the year	₹ 5Cr.

Parri passu charge has been created on the assets of the company. Further, borrowing limits have not been exceeded.

From the above information, what audit procedures would you perform, to ensure that all borrowings reflected in the balance sheet, are valid claims owed to banks or other third parties? **(5 Marks)**

(c) State the auditor's duty regarding audit of LLP. **(4 Marks)**

Answer

(a) (i) SA 300 "Planning an Audit of Financial Statements", the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors.

Factors CA Taman will consider while planning the nature, timing, and extent of direction and supervision of the engagement team members and review of their work are as follows:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement
- The capabilities and competence of the individual team members performing the audit work.

(ii) In case, during the course of the audit, CA Taman discovers information that significantly differs from what was available when the audit procedures were initially planned, she would update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, CA Taman may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through on detailed checking may contradict the audit evidence obtained through testing internal controls.

(b) Audit procedures performed to ensure that all borrowings reflected in the balance sheet are valid claims owed to bank or third parties are as under:

- (i) Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments were approved by the board of directors.
- (ii) Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by agreements are not exceeded.

- (iii) Roll out and obtain independent balance confirmations (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).
- (iv) Agree details of leases and hire purchase creditors recorded to underlying contracts/agreements.
- (v) In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- (vi) When debt is retired, ensure that a discharge is received on assets securing the debt.
- (vii) Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders.
- (viii) Auditor will ensure parri passu charge has been created on the assets of the company.
- (ix) Trace the fresh borrowings of ₹ 3 crores and repayment of ₹ 5 crores to the Company's Bank statement and Account books to confirm the movement of funds.

(c) Auditor's Duty Regarding Audit of LLP

- 1. Engagement Letter:** The auditor should get definite instructions in writing as to the work to be performed by him.
- 2. Minutes Book:** If partners maintain minute book he shall refer it for any resolution passed regarding the accounts
- 3. LLP Agreement:** The auditor should read the LLP agreement & note the following provisions:
 - (i) Nature of the business of the LLP.
 - (ii) Amount of capital contributed by each partner.
 - (iii) Interest – in respect of additional capital contributed.
 - (iv) Duration of partnership.
 - (v) Drawings allowed to the partners.
 - (vi) Salaries, commission etc. payable to partners.
 - (vii) Borrowing powers of the LLP.

- (viii) Rights & duties of partners.
- (ix) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
- (x) Any loans advanced by the partners.
- (xi) Profit sharing ratio

4. Reporting: The auditor should mention:

- (i) Whether the records of the firm appear to be correct & reliable.
- (ii) Whether he was able to obtain all information & explanation necessary for his work.
- (iii) Whether any restriction was imposed upon him.

Question 6

(a) *State the required disclosures for inventories as required under Schedule III (Part I) to the Companies Act, 2013.* **(5 Marks)**

(b) *A government department conducted an inventory audit and discovered that several items in inventory were found to be either damaged or obsolete, but they had not been removed from the records. There were no periodic physical verification reports of inventory, and the valuation of the materials in stock was outdated.*

Explain, how the audit of stores and inventories, as part of the expenditure audit, under the duties and responsibilities entrusted to the Comptroller and Auditor General (C&AG), can help address these issues. **(5 Marks)**

(c) *CA Raj has just concluded the audit of a company and noted certain findings/exceptions in the IT environment and controls, which need to be assessed and reported accordingly. Specify, what points shall the auditor consider in assessing and reporting of audit findings in IT Environment and IT Controls.* **(4 Marks)**

OR

(c) *Mentioned below are the threats to independence of auditors. Classify them, with reasons, into the appropriate type of threats viz. Advocacy threat, Intimidation threat, Familiarity threat, Self-review threat, Self-interest threat.* **(ANY FOUR)**

- (i) *Close business relationship with an audit client;*

- (ii) *Auditors perform services that are themselves subject-matter of audit;*
 - (iii) *Auditor deals with shares or securities of the audited company;*
 - (iv) *Long association between specific auditors and their specific client counterparts;*
 - (v) *Auditor deterred from acting objectively with an adequate degree of professional skepticism.*
- (4 Marks)**

Answer

(a) Disclosures for inventories as required under Schedule III (Part I) to companies Act, 2013: Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made:

- (i) Whether inventory has been classified as:
 - Raw materials
 - Work-in-progress
 - Finished goods
 - Stock-in-trade (goods acquired for trading)
 - Stores and spares
 - Loose tools
 - Others (specify nature).
- (ii) Whether goods-in-transit have been disclosed separately under each sub-head of inventories.
- (iii) Mode of valuation shall be stated.

(b) Audit of Stores and Inventories: The issues faced by government department given in the question would be addressed in C&AG audit. The audit of Stores and Inventories is conducted:

- (i) to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
- (ii) to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

- (iii) to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.
 - (iv) to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.
 - (v) to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.
- (c) Points the auditor shall consider in assessing and reporting of audit findings in IT Environment and IT Controls are as follows:
- (i) Are there any weaknesses in IT controls?
 - (ii) (What is the impact of these weaknesses on overall audit?
 - (iii) Report deficiencies to management – Internal controls memo or Management letter.
 - (iv) Communicate in writing any significant deficiencies to those Charged with governance.

OR

- (c) (i) Close business relationship with an audit client would be classified as Self-interest threat.

Reason: Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

- (ii) Auditors perform services that are themselves subject-matter of audit would be classified as Self-review threat.

Reason: Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

- (iii) Auditor deals with shares or securities of the audited company would be classified as Advocacy threat.

Reason: Advocacy threats occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised.

- (iv) Long association between specific auditors and their specific client counterparts would be classified as Familiarity threat.

Reason: Familiarity threats are self-evident and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.

- (v) Auditor deterred from acting objectively with an adequate degree of professional skepticism would be classified as Intimidation threat.

Reason: Intimidation threats could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation.