



PAPER – 5:

AUDITING AND ETHICS



QUESTIONS

PART – I: Multiple Choice Questions based on Case Scenarios

Case Scenario

Arnav Engineering Limited is a listed company engaged in the manufacture of industrial equipments. The company has substantial inventories and trade receivables and operates through different business segments.

MNP & Associates have been appointed as its statutory auditors for the year ended 31st March, 2026. During the audit, the engagement team identified certain matters that required evaluation in determining the appropriate audit procedures and assessing their implications for the financial statements and auditor's independence.

The company processes a large number of sales transactions through its ERP system. The audit team has access to reliable monthly information, which can be analysed by product and geographical region. Trade receivables arising from these sales are also collected in a relatively consistent pattern, and reliable information on sales and subsequent collections is available for analysis by product and geographical region. Historical relationships between certain items have remained reasonably stable. However, some year-end balances arise from unusual transactions and involve significant management estimates. The engagement partner is considering the extent to which the available information can be used in performing substantive audit procedures.

Arnav Engineering Limited maintains inventory at its own premises as well as at warehouses operated by third parties. During the year, the company has also been involved in several legal proceedings with customers and suppliers

and reports financial information for different business segments. The engagement partner has instructed the audit team to consider the specific requirements applicable to these matters while obtaining sufficient appropriate audit evidence.

During the inventory count, differences were noted between physical quantities and the perpetual inventory records. Some goods belonging to the company were lying with third parties, while goods received on consignment were stored together with the company's own goods. Certain receiving reports and dispatch documents relating to the period around year-end had also not been reconciled with the accounting records. The engagement partner asked the audit team to perform further audit procedures before concluding on the inventory balance.

The company has incurred substantial operating losses and negative operating cash flows, and its current liabilities have exceeded its current assets during the year. Certain key financial ratios have also deteriorated significantly. Several fixed-term borrowings used to finance long-term assets are approaching maturity, with no firm arrangements yet in place for their renewal or repayment. A few lenders have indicated that continued financial support will depend upon specified financial targets, while the company has experienced delays in paying some creditors. During the year, the company also lost a major customer, while one of its principal suppliers changed its terms from credit to cash-on-delivery. The company has faced shortages of certain important supplies, and a major competitor has recently entered its principal market with aggressive pricing. Management expects to obtain additional finance, improve its market position and continue operations.

During the audit, the engagement partner noted certain instances involving members of the audit engagement team, namely Mr. S, Mr. R, Mr. A and Mr. M, which required evaluation in the context of the fundamental principles of professional ethics:

- (i) Mr. S became aware that certain information proposed to be included in the audit documentation was materially misleading but failed to raise the matter.
- (ii) Mr. R was influenced by pressure from senior management while exercising his professional judgement in evaluating a significant accounting treatment.

- (iii) Mr. A, who lacked the requisite knowledge and skill, was assigned an important audit procedure and failed to perform it with the necessary care and diligence.
- (iv) Mr. M proposed to disclose confidential information obtained during the audit to a third party, without any legal or professional requirement or authorisation from the client.

Based on above, answer the following questions (MCQs 1-5)

1. Which of the following would be most appropriate for determining the appropriate audit approach for revenue and receivable balances?
 - (A) Analytical procedures would be inappropriate for balance sheet accounts because such balances are inherently less predictable.
 - (B) Analytical procedures may be appropriate where data and relationships are reliable and predictable, subject to the assessed risks.
 - (C) Analytical procedures would be sufficient whenever reliable information exists, irrespective of estimates and unusual transactions.
 - (D) Analytical procedures would be sufficient where historical relationships remain stable, without requiring further detailed testing.
2. The engagement partner specifically asks the audit team to consider the requirements relating to inventory held at third-party locations, the company's legal proceedings, and its reporting of different business segments. Identify the objectives of the auditor, as specified in SA 501, in respect of these items?
 - (A) Valuation and completeness of inventory; presentation of litigation; recognition and measurement of segment information.
 - (B) Completeness and valuation of inventory; existence of litigation; classification and recognition of segment information.
 - (C) Rights and obligations over inventory; valuation of litigation; completeness and measurement of segment information.
 - (D) Existence and condition of inventory; completeness of litigation and claims; presentation and disclosure of segment information.

3. Which of the following would be most appropriate to address the relevant audit concern before concluding on the inventory balance?
 - (A) Perform cut-off testing, reconcile inventory records, verify ownership of consignment goods, and verify inventory held by third parties.
 - (B) Inspect inventory condition, review valuation assumptions, calculate turnover, and compare margins with prior periods.
 - (C) Inspect damaged inventory, confirm external balances, review obsolescence, and examine subsequent inventory sales.
 - (D) Repperform valuation calculations, inspect physical condition, analyse ratios, and review provisioning methodology.
4. Considering the various circumstances affecting the company's future operations, which of the following would be the most appropriate assessment?
 - (A) Negative cash flows establish the uncertainty, while management's proposed financing plans need not be considered further.
 - (B) Approaching loan maturities represent the principal concern, while operating developments have comparatively little relevance.
 - (C) The combination of financial and operating conditions may, individually or collectively, cast significant doubt on going concern.
 - (D) Management's expectation of obtaining finance eliminates the uncertainty unless an actual borrowing default has occurred.
5. Identify the fundamental principles of professional ethics that have been compromised by Mr. S, Mr. R, Mr. A and Mr. M respectively.
 - (A) Integrity, Objectivity, Professional Competence and Due Care, Confidentiality
 - (B) Objectivity, Integrity, Professional Competence and Due Care, Professional Behaviour
 - (C) Integrity, Professional Behaviour, Objectivity, Confidentiality
 - (D) Professional Behaviour, Objectivity, Integrity, Professional Competence and Due Care

General MCQs

6. The trade receivables of ABC Ltd. range from ₹ 500 to ₹ 25 lakh. The auditor observes considerable variability in the monetary size of individual balances. Instead of selecting one sample from the entire population, the auditor divides the balances into separate groups based on their monetary size and selects samples from each group.

Which of the following sampling method best describes the auditor's approach?

- (A) Haphazard sampling
 - (B) Systematic sampling
 - (C) Stratified sampling
 - (D) Block sampling
7. During the audit of Bell Ltd., the auditor notices that several trade receivable balances have remained outstanding for a considerable period. Some customers have disputed the amounts payable, while the management continues to show the balances at their original amounts.

The auditor decides to examine whether the amounts represented by trade receivables are recoverable and whether appropriate adjustments have been made.

Which assertion is the auditor primarily seeking to verify?

- (A) Completeness
 - (B) Occurrence
 - (C) Cut-off
 - (D) Valuation
8. CA T is conducting the audit of PQR Ltd., a manufacturer of specialised electronic components. During the audit, he identifies the following situations:

- (i) The company's inventory valuation involves significant judgement due to rapid technological obsolescence, making the inventory balance susceptible to material misstatement.
- (ii) The company's internal controls are inadequately designed to prevent or detect and correct material misstatements on a timely basis.
- (iii) Despite designing and performing appropriate audit procedures, CA T considers the possibility that certain material misstatements may remain undetected.
- (iv) CA T evaluates the possibility of expressing an inappropriate audit opinion on financial statements that are materially misstated.

Based on the above situations, identify the risks involved and their respective associations with the entity or the auditor.

- (A) (i) Inherent risk – Entity; (ii) Control risk – Entity; (iii) Detection risk – Auditor; (iv) Audit risk – Auditor.
- (B) (i) Inherent risk – Auditor; (ii) Control risk – Entity; (iii) Detection risk – Entity; (iv) Audit risk – Auditor.
- (C) (i) Control risk – Entity; (ii) Inherent risk – Entity; (iii) Detection risk – Auditor; (iv) Audit risk – Auditor.
- (D) (i) Inherent risk – Entity; (ii) Control risk – Auditor; (iii) Detection risk – Auditor; (iv) Audit risk – Entity.

PART II – Descriptive Questions

Chapter 1 - Nature, Objective and Scope of Audit

9. ABC Ltd. is being audited for the year ended 31st March, 2026. During course of the audit, the auditor comes across several situations. The financial statements include certain balances and estimates based on judgements made by management. The auditor also relies on sampling instead of examining every transaction and balance.

Further, the auditor notices that certain purchase invoices have been supported by authorisations from the Goods Receiving Section. However, the audit team becomes aware that the accountant and an authorised employee may have colluded in approving certain fictitious

purchase invoices. In addition, management provides supporting documents for certain transactions which appear genuine, but their authenticity cannot be independently established in every case.

During the audit, the auditor also identifies certain transactions with parties whose relationship with the company was not initially disclosed to the audit team.

The Audit Assistant, after considering the above circumstances, states:

"If the auditor performs the required audit procedures and examines the documents and internal controls maintained by ABC Ltd., the auditor should be able to obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error."

With reference to above circumstances, explain the inherent limitations of an audit arising from (i) the nature of financial reporting and (ii) the nature of audit procedures and examine whether the statement made by the Audit Assistant is correct.

Chapter 2 - Audit Strategy, Audit Planning and Audit Programme

10. XYZ Ltd. is being audited for the year ended 31st March, 2026. During the initial planning of the engagement, the Engagement Partner determines the overall scope, timing and direction of the audit and considers the allocation of audit resources. Based on the matters identified at this stage, the Audit Manager develops a detailed audit plan specifying the nature, timing and extent of audit procedures to be performed by members of the engagement team.

As the audit progresses, certain risks initially assessed as significant are found to be lower than expected, while an unexpected issue relating to revenue recognition comes to the auditor's attention. The Audit Manager proposes changes to the audit procedures in response to these developments. A team member, however, believes that once the overall audit strategy has been established, it should remain unchanged and that the audit plan is merely a separate document prepared after completion of the strategy.

Explain the relationship between the overall audit strategy and the audit plan. With reference to above facts, discuss whether the overall audit

strategy and the audit plan are necessarily separate and sequential processes.

Chapter 3 - Risk Assessment and Internal Control

11. During the course of audit of PQR Ltd. for the year ended 31st March, 2026, the auditor identifies the following matters:
- The company has entered into a number of complex transactions involving multiple contractual arrangements and unusual financing terms.
 - The auditor identifies circumstances indicating a possibility of management manipulation of revenue to achieve performance targets.
 - The auditor becomes aware of a significant transaction with an entity controlled by a close relative of one of the directors.
 - During the audit, a recent change in the regulatory environment comes to the auditor's attention, which has a significant impact on the company's accounting and reporting.
 - The valuation of certain financial instruments involves significant management judgement and a wide range of measurement uncertainty.
 - The auditor identifies a large transaction that is outside the normal course of the company's business.

With reference to above, explain the factors that the auditor is required to consider in determining whether an identified risk is a significant risk.

Chapter 4 - Audit Evidence

12. MNO Ltd. is engaged in the manufacture and sale of consumer products. During the audit for the year ended 31st March, 2026, the auditor considers the controls surrounding sales. Under the company's system, sales invoices can be generated only after approval by the sales manager, and dispatch documentation can be generated only against an approved sales order. The auditor selects a sample of transactions to

determine whether these prescribed controls operated consistently throughout the year.

While auditing trade receivables, the auditor notices that the balance has increased significantly compared with the previous year. Selected customer balances are verified with supporting documents, and the auditor also compares the current year's receivables ageing pattern with that of the previous year to identify and investigate significant or unusual movements.

Explain the components of further audit procedures and, in the above circumstances, analyse the audit procedures performed by the auditor and identify whether each procedure represents a test of controls, test of details or substantive analytical procedure.

13. Excel Industries Ltd. conducts its physical inventory count on 18th March 2026, whereas its financial statements are prepared as at 31st March 2026. During the audit, CA Nandini observes significant differences between the quantities recorded during the physical count and the perpetual inventory records as on 31st March 2026. The auditor also needs to assess whether movements in inventory between 18th March and 31st March 2026 have been properly recorded.

While auditing trade receivables, CA Nandini decides to obtain external confirmations from selected customers. However, the management refuses to allow her to send confirmation requests to certain customers. What additional audit procedures are to be undertaken by the statutory auditor for inventory verification? Also, what should the auditor do if she concludes that management's refusal to allow the auditor to send the confirmation request is unreasonable?

Chapter 5 - Audit of Items of Financial Statements

14. While auditing the financial statements of Timnic Engineering Ltd. for the year ended 31st March, 2026, CA Nisha is verifying the depreciation and amortisation expenses. She notices certain changes in accounting policies, incorrect consideration of residual values, differences in useful lives of significant components, and possible errors in the calculation and period of recognition of depreciation.

Explain the key attributes that CA Nisha should consider while verifying depreciation and amortisation expenses.

Chapter 6 - Audit Documentation

15. The auditor of VWX Ltd. signed the auditor's report on 30th June, 2026. During July and August 2026, the engagement team undertakes the process of assembling the final audit file. During this process, superseded working papers are removed, documents are sorted and cross-referenced, and completion checklists are signed.

The engagement partner also asks a team member to place in the audit file certain audit evidence that had been obtained, discussed and agreed with the relevant members of the engagement team before 30th June, 2026, but had not been included in the file at that time.

On 25th August, 2026, after completion of the final audit file, the team discovers that one of the working papers contains an error in the auditor's earlier assessment. The team proposes to delete the original working paper and replace it with a revised working paper reflecting a new conclusion.

The firm's policy provides for retention of audit documentation for seven years from the date of the auditor's report.

Analyse the actions proposed and undertaken by the audit team after the date of the auditor's report and explain the requirements relating to completion and retention of the final audit file.

Chapter 7 - Completion and Review

16. During the audit of TUV Ltd. for the year ended 31st March, 2026, the auditor evaluates the company's internal control system and identifies certain deficiencies in the control environment, risk assessment process, response to identified risks, and controls over financial reporting. Some of these deficiencies relate to the manner in which significant transactions involving management are scrutinised, the prevention and detection of fraud, the identification and response to risks of material misstatement, and the implementation of remedial measures for deficiencies communicated earlier. The auditor also considers the effect of deficiencies that may result in misstatements and the circumstances

in which significant deficiencies may exist even though no misstatement has been identified during the audit.

The management of TUV Ltd. believes that a deficiency in internal control can be regarded as significant only when the auditor has identified an actual material misstatement in the financial statements.

With reference to SA 265, explain the meaning of significant deficiency in internal control, the basis for determining its significance, and the examples of indicators of significant deficiencies in internal control. Apply the relevant principles to the circumstances of TUV Ltd.

Chapter 8 - Audit Report

17. Explain the circumstances in which an Emphasis of Matter paragraph is included in the auditor's report as per SA 706 (Revised), including the conditions to be satisfied. Where the auditor includes an Emphasis of Matter paragraph in the auditor's report, explain:
- (a) the manner in which the paragraph is presented in the auditor's report and the heading used;
 - (b) the reference to the matter being emphasized and the relevant disclosures in the financial statements; and
 - (c) the indication given by the auditor regarding the auditor's opinion in respect of the matter emphasized.

Chapter 9 - Special Features of Audit of Different Type of Entities

18. Vidya Vikas Society is registered under the applicable State Societies Law and is engaged in educational and charitable activities. During the audit of its financial statements for the year ended 31st March, 2026, the auditor notes that the Society receives donations and grants from various sources, including contributions received from outside India. Certain grants are subject to specific conditions regarding their utilisation, while some expenditure incurred by the Society is reimbursed by donors.

The auditor also notices that the Society has recently amended some of its activities and therefore needs to consider whether they continue to fall within the objects stated in its memorandum and bye-laws. The Society has claimed exemption under the Income-tax Act. During the

year, an inquiry was also conducted by the Registrar into certain aspects of the Society's working and financial affairs.

While reviewing the expenditure records, the auditor comes across certain payments which appear irregular and certain amounts due to the Society that have not been recovered. There are also indications that some expenditure may have resulted from improper use of the Society's funds by members of its governing body.

In the light of the above circumstances, explain the important considerations that should be kept in view by the auditor while conducting the audit of a society.

Chapter 10 - Audit of Banks

19. During the audit of Suryodaya Bank Ltd. for the year ended 31st March, 2026, the auditor examines the following advances and their outstanding balances as at that date.

Advance A: ₹ 80 lakh, against which the borrower has provided eligible security valued at ₹ 50 lakh. The advance has remained non-performing for 9 months.

Advance B: ₹ 1.20 crore, against which the eligible security is valued at ₹ 80 lakh. The advance has remained in the doubtful category for 20 months.

Advance C: ₹ 2 crore, against which the eligible security is valued at ₹ 1.20 crore. The advance has remained in the doubtful category for 3 Years 8 months.

Advance D: ₹ 60 lakh is an advance in respect of which loss has been identified by the RBI during its inspection. The bank has not yet written off the amount.

The management has made a total provision of ₹ 1.40 crore against the above four advances.

With reference to above facts, determine the classification of each advance and calculate the total provision required. Also comment on whether the provision made by the management is adequate.

Chapter 11 - Ethics and Terms of Audit Engagements

20. M/s. VPN & Co. is the statutory auditor of PLB Ltd. During the audit for the financial year 2025–26, the following situations arose:

- (i) CA Sumit, a partner of VPN & Co., holds a significant financial interest in PLB Ltd.
- (ii) The Managing Director of PLB Ltd., Mr. Sanjeev, threatens to replace VPN & Co. if the auditors do not agree with its proposed accounting treatment.
- (iii) The audit team is required to verify certain financial information that was prepared by VPN & Co. while providing an earlier non-audit service to PLB Ltd.
- (iv) The spouse of a member of the audit team holds a senior management position in PLB Ltd.
- (v) VPN & Co. is representing PLB Ltd. in a legal dispute against a third party.

Identify and explain the type of threat to independence arising in each of the above situations.

**SUGGESTED ANSWERS****PART – I: Answers to Multiple Choice Questions**

MCQ No.	Answer
1.	(B)
2.	(D)
3.	(A)
4.	(C)
5.	(A)
6.	(C)
7.	(D)
8.	(C)

PART – II: Answers to Descriptive Questions

9. The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations may arise due to various factors, including the nature of financial reporting and the nature of audit procedures.

(1) Nature of financial reporting: Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

Consider, for example, that management of a company has devised a control that all purchase bills should reflect stamp and signatures of an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises. It is an example of internal control devised by the company to ensure that only those purchase bills are produced for payment for which goods have been actually received. Now, what happens if concerned accountant and authorised person in "Goods Receiving Section" collude. It is a case of overriding of internal controls devised by the company due to collusion between two persons. Such a probable collusion is one of limitations of internal controls itself.

(2) Nature of Audit procedures: The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion

only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.

An auditor is not an expert in authentication of documents. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.

It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

In case of ABC Ltd., the financial statements involve management judgements, the auditor uses sampling rather than examining every transaction, internal controls may be overridden through collusion, documents provided by management may not always be genuine, and undisclosed related party relationships or transactions may not be detected through audit procedures.

The statement made by the Audit Assistant is incorrect. Even after performing appropriate audit procedures and obtaining sufficient appropriate audit evidence, the auditor cannot obtain absolute assurance that the financial statements are free from material

misstatement due to fraud or error. The objective of an audit is therefore to obtain reasonable assurance, and not absolute assurance.

- 10. Relationship between Audit Strategy and Audit Plan:** Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy. Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

In XYZ Ltd., the Engagement Partner first determines the broad scope, timing and direction of the audit, while the Audit Manager develops the detailed audit plan covering the nature, timing and extent of audit procedures. However, the subsequent changes in the assessed risks and the identification of an unexpected revenue recognition issue may require corresponding changes in the audit plan and, where necessary, the overall audit strategy.

The overall audit strategy and the detailed audit plan are closely inter-related and are not necessarily separate or sequential processes. Changes arising during the audit may result in consequential changes to either the audit strategy or the audit plan. Therefore, the view that the strategy, once established, must remain unchanged and that the two processes are completely separate is not correct.

- 11.** As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In

exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud
- (b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention
- (c) The complexity of transactions
- (d) Whether the risk involves significant transactions with related parties
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty and
- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

In PQR Ltd., the circumstances identified by the auditor correspond to several factors relevant for determining significant risks.

The above factors indicate that the identified risks require careful evaluation by the auditor to determine whether they constitute significant risks. The determination is based on the auditor's professional judgment after considering the nature and circumstances of each identified risk.

12. Further Audit Procedures comprise of:

- (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
 - (ii) Substantive procedures, including tests of details and substantive analytical procedures.
- (i) Tests of controls:** Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

In MNO Ltd., the auditor selects a sample of sales transactions to determine whether the prescribed approval and dispatch controls operated consistently throughout the year. Since the purpose of this procedure is to evaluate the operating effectiveness of controls, it represents a test of controls.

- (ii) **Substantive Procedures – Tests of details and Substantive analytical procedures:** Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

In other words, Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level.

Substantive procedures comprise:

- (i) Tests of details (of classes of transactions, account balances, and disclosures), and
- (ii) Substantive analytical procedures.

In relation to trade receivables, the auditor verifies selected customer balances with supporting documents. Since this procedure is directed towards detecting possible misstatements in the account balance, it represents a test of details. Further, the comparison of the current year's receivables ageing pattern with that of the previous year and investigation of significant or unusual movements represents a substantive analytical procedure, as it is designed to identify possible material misstatements through analysis of relationships and trends.

13. 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 perform additional audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

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

- (i) Whether the perpetual inventory records are properly adjusted.
- (ii) Reliability of the entity's perpetual inventory records.
- (iii) Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

SA 505, "External Confirmations", if management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

14. CA Nisha needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- (i) Obtain the understanding of entity's accounting policy related to depreciation and amortisation.

- (ii) Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of the Companies Act, 2013/ applicable accounting standards.
 - (iii) The accounting policy has been applied consistently year on year. Any change in the accounting policy has been adequately disclosed.
 - (iv) Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
 - (v) Whether depreciation and amortisation charges are valid.
 - (vi) Whether depreciation and amortisation charges are accurately calculated and recorded.
 - (vii) Whether all depreciation and amortisation charges are recorded in the appropriate period.
 - (viii) Whether each part of an item of PPE with a cost that is significant in relation to the total cost of the item have been depreciated separately. Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.
 - (ix) Whether the most appropriate depreciation method for each separately depreciable component has been used.
- 15.** The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that

does not involve the performance of new audit procedures or the drawing of new conclusions.

Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

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

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

The activities undertaken during July and August, such as removing superseded documents, sorting and cross-referencing working papers and completing checklists, are administrative activities that may be undertaken during the assembly of the final audit file. Similarly, placing in the file audit evidence that had already been obtained and agreed before the auditor's report is permissible.

However, replacing the original working paper after completion of the final audit file in order to reflect a new conclusion is not an administrative change permitted during final file assembly. Further, the original documentation cannot be deleted or discarded after completion of the final audit file.

- 16.** 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.

Examples of indicators of significant deficiencies in internal control

- Evidence of ineffective aspects of the control environment, such as:
 - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
 - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
 - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.

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

In TUV Ltd., the deficiencies identified by the auditor relate to several areas that are relevant when considering whether deficiencies in internal control constitute significant deficiencies. The matters concerning inadequate scrutiny of significant transactions involving management, ineffective prevention and detection of fraud, failure to address previously communicated deficiencies, weaknesses in the risk assessment process, inadequate response to identified risks and deficiencies in controls over financial reporting are relevant indicators in assessing the significance of the deficiencies.

The auditor should not determine the significance merely by considering whether an actual material misstatement has been identified. The auditor should also consider the likelihood that a misstatement could occur and the potential magnitude of such misstatement. Therefore, the absence of an identified material misstatement does not, by itself, prevent a deficiency from being regarded as significant. Thus, the management's view is not correct.

17. Emphasis of Matter Paragraphs in the Auditor's Report: If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

- (i) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and
- (ii) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

- (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

18. Considerations that should be kept in view by the auditor while conducting the audit of a society are:

- (a) The auditor should ascertain governing legislation of society i.e. the Societies Registration Act, 1860 or any applicable state law under which it has been registered.
- (b) Object of society needs to be ascertained from its memorandum of association/bye laws. Its activities may include charitable, social, cultural or educational activities.
- (c) Ascertain whether society has obtained registration under the Foreign Contribution (Regulation) Act, 2010 in case foreign contributions are received.
- (d) Ascertain whether it is also registered under relevant provisions of the Income Tax Act which may make it eligible for tax exemption on its income.
- (e) Obtain an understanding of internal control to design audit procedures with special reference to donations and various expenditures incurred in relation to achievements of objects of society.
- (f) Evaluate appropriateness of accounting policies with special reference to donations and grants. Also evaluate accounting policies in relation to specific grants.
- (g) In case some expenses incurred by society are reimbursed by donors, ascertain how these are recognized in financial statements.
- (h) Ascertain, if any inquiry has been held by Registrar under applicable law in the working or financial condition of society and its implications for auditor's opinion.

- (i) Ascertain all cases of irregular, illegal or improper expenditure or failure or omission to recover monies or other property belonging to society or of loss or waste of money or other property thereof.
- (j) Ascertain whether such expenditure or waste was caused in consequence of breach of trust or misapplication or any other misconduct on the part of governing body.

In the case of Vidya Vikas Society, the auditor should first ascertain the applicable State societies law and examine the objects stated in its memorandum and bye-laws, particularly since the Society has recently amended some of its activities. As the Society receives contributions from outside India, the auditor should ascertain whether it has obtained the required registration under the Foreign Contribution (Regulation) Act, 2010. The auditor should also verify its registration under the relevant provisions of the Income-tax Act in view of the tax exemption claimed by the Society.

The auditor should obtain an understanding of internal controls relating to donations and expenditure and evaluate the accounting policies relating to donations, grants and specific grants. Since certain expenditure is reimbursed by donors, the auditor should ascertain its appropriate recognition in the financial statements.

The inquiry conducted by the Registrar should also be considered and its implications for the auditor's opinion should be evaluated. Further, the auditor should ascertain the nature of the irregular payments, amounts not recovered and any loss or waste of the Society's money or property. Where such expenditure or waste is identified, the auditor should further ascertain whether it resulted from breach of trust, misapplication or any other misconduct by the governing body.

19. Classification of advances

Categories of NPAs	Provision required
Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
Doubtful Assets:	

Would be one, which has remained in the substandard category for a period of 12 months. Sub-categories: Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	(Secured + Unsecured) 25%+100% 40%+100% 100%+100%
Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Advance A : The advance has remained NPA for 9 months. Therefore, it is a Substandard Asset.

Provision = ₹ 80 lakh × 15% = ₹ 12 lakh

Advance B: The advance has remained in the doubtful category for 20 months. Therefore, it falls under Doubtful Assets – D2, i.e., doubtful for more than 1 year but up to 3 years.

Secured portion = ₹ 80 lakh

Unsecured portion = ₹ 120 lakh – ₹ 80 lakh = ₹ 40 lakh

Provision on secured portion = ₹ 80 lakh × 40% = ₹ 32 lakh

Provision on unsecured portion = ₹ 40 lakh × 100% = ₹ 40 lakh

Total provision = ₹ 72 lakh

Advance C: The advance has remained in the doubtful category for 3 years and 8 months. Therefore, it falls under Doubtful Asset – D3, i.e., doubtful for more than 3 years.

Secured portion = ₹ 1.20 crore

Unsecured portion = ₹ 2 crore – ₹ 1.20 crore = ₹ 80 lakh

Provision on secured portion = ₹ 1.20 crore × 100% = ₹ 1.20 crore

Provision on unsecured portion = ₹ 80 lakh × 100% = ₹ 80 lakh

Total provision = ₹ 2 crore

Advance D: Loss has been identified by the RBI, but the amount has not been completely written off. Therefore, it is a Loss Asset.

Provision = ₹ 60 lakh × 100% = ₹ 60 lakh

Adequacy of total provision required

Advance	Amount
A	₹ 12 lakh
B	₹ 72 lakh
C	₹ 200 lakh
D	₹ 60 lakh
Total	₹ 344 lakh i.e. ₹ 3.44 crore

Provision already made by management = ₹ 1.40 crore

Therefore, additional provision required:

₹ 3.44 crore – ₹ 1.40 crore = ₹ 2.04 crore

20. (i) **Self-interest threat:** Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.
- (ii) **Intimidation threat:** Intimidation threats occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism.
- (iii) **Self-review threat:** 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.

- (iv) **Familiarity threat:** 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) **Advocacy threat:** 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