Mock Test Paper - Series II: April, 2026

Date of Paper: 10th April, 2026

Time of Paper: 10 A.M. to 1 P.M.

INTERMEDIATE GROUP – II

PAPER – 5: AUDITING AND ETHICS

Time Allowed – 3 Hours **Maximum Marks – 100**

PART I - Case Scenario based MCQs (30 Marks)

Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carry 2 Marks each.

Case Scenario 1 [MCQs 1–3]

RS & Co., Chartered Accountants, were appointed as auditors of X Ltd., a telecom company regulated by the Telecom Regulatory Authority of India and Y Bank Ltd., a banking company regulated by the Reserve Bank of India.

At the planning stage, the engagement partner emphasised that the audit team should obtain an understanding of the distinct legal and regulatory frameworks applicable to both entities. The team was also instructed to identify significant matters, determine materiality and consider the involvement of experts, particularly in areas involving complex estimates such as provisioning in Y Bank Ltd. Further, risk assessment procedures were initiated to identify and assess risks of material misstatement.

During discussions, the audit team noted that certain areas—such as revenue recognition in X Ltd. and loan loss provisioning in Y Bank Ltd.—were inherently complex and involved significant judgment. The engagement partner clarified that such areas are susceptible to material misstatement even before considering internal controls.

Subsequently, discrepancies were identified in both entities. However, the audit team was unable to immediately conclude whether these misstatements arose due to fraud or error. The engagement partner explained that the auditor's objective is to obtain reasonable assurance that the financial statements as a whole are free from material misstatements, whether caused by fraud or error and to evaluate their impact in totality while forming an opinion on compliance with the applicable financial reporting framework.

On the basis of above, answer the following MCQs (1–3):

1. In the planning stage described in the case scenario, the engagement partner emphasised understanding regulatory frameworks, identifying significant matters, determining materiality, and considering involvement of experts.

   In the context of the situation described above, the primary rationale for such an approach is to:

   (a) Restrict planning to scheduling audit procedures and allocation of audit staff

   (b) Consider regulatory framework and experts only after detection of misstatements

   (c) Ensure that planning includes understanding legal and regulatory requirements, identifying significant matters, determining materiality, considering use of experts and performing risk assessment procedures

   (d) Limit regulatory understanding only to compliance audits and not financial statement audits

2. In the case scenario, the audit team identified that revenue recognition in X Ltd. and loan loss provisioning in Y Bank Ltd. involve significant judgment and are susceptible to misstatement even before considering internal controls.

   Based on the facts described above, such risks are most appropriately classified as:

   (a) Risks that can be ignored until effectiveness of internal controls is tested

   (b) Inherent risks requiring greater auditor attention during planning and risk assessment

   (c) Risks arising only due to failure of internal controls

   (d) Detection risks arising from audit procedures

3. In the case scenario, the audit team identified misstatements but was unable to determine whether they arose due to fraud or error.

   In light of the engagement partner's explanation, which of the following best reflects the auditor's responsibility in such a situation?

   (a) Auditor must first conclusively establish fraud before evaluating materiality

   (b) Only misstatements arising from fraud affect the audit opinion

   (c) Misstatements arising from error can be ignored if individually immaterial

(d) Auditor should obtain reasonable assurance that financial statements as a whole are free from material misstatements, whether due to fraud or error, and evaluate their impact in aggregate

Case Scenario 2 [MCQs 4-7]

During the audit of MNO Hospitality Ltd., a large chain of luxury hotels, for the financial year 2024–25, the statutory auditor examined revenue streams from restaurants, rooms and banquet operations.

While reviewing restaurant operations, it was noted that the entity prepares weekly trading accounts, however, significant fluctuations in gross profit margins were observed in two outlets. Management attributed these variations to “seasonal factors,” but no supporting evidence was provided. Further, Kitchen Order Tickets (KOTs) were not consistently preserved and only selective bills could be traced to supporting records.

In respect of room revenue, the auditor observed that discounted room rates were frequently applied without documented approval. Additionally, housekeeping occupancy reports were not retained and reconciliation between guest register and bills could be performed only for limited dates.

Due to the absence of primary records such as Kitchen Order Tickets (KOTs), housekeeping occupancy reports and complete guest-wise billing trails, the audit team was unable to obtain sufficient appropriate audit evidence through direct verification. Consequently, the auditor was compelled to place significant reliance on management-generated reports, including system-based occupancy summaries, revenue analytics and consolidated outlet-wise performance statements.

However, it was observed that these reports were internally generated and not supported by effective underlying controls over their preparation and maintenance. Further, many of the explanations regarding fluctuations in revenue, occupancy levels, and discounting practices were obtained through oral representations from hotel staff and management personnel, without adequate documentary corroboration.

In several instances, only photocopies or system extracts of records were made available in place of original documents and no alternative audit procedures could fully compensate for the lack of reliable primary evidence. This situation significantly impacted the reliability and sufficiency of audit evidence, thereby increasing audit risk and requiring the auditor to exercise heightened professional skepticism.

In the banquet segment, it was observed that several events were conducted before the year-end, but the related invoices were raised only after the year-end due to delays in finalising settlements. The auditor noted inconsistency in accounting treatment, as in some cases revenue for such events was recognised in the current year without raising invoices, raising concerns regarding the existence of trade receivables. In other cases, invoices raised after year-end were included in receivables as at the reporting date without adequate supporting documentation. Further, proper cut-off procedures were not followed, as there was no reconciliation between event records and invoicing data around year-end. This created ambiguity regarding completeness of revenue and existence of receivables, indicating a potential cut-off error and risk of material misstatement in the financial statements.

On the basis of above, answer the following MCQs (4–7):

4. Considering the absence of KOTs, unexplained GP fluctuations and weak internal controls in restaurant operations, what is the most appropriate audit implication?

   (a) Increase substantive procedures and consider modification if discrepancies remain unexplained

   (b) Rely on management explanations since periodic trading accounts are prepared

   (c) Ignore fluctuations as hotel industry margins are inherently volatile

   (d) Restrict audit scope to test checks due to practical limitations

5. Given that discounted room rates lacked approval and occupancy records were not retained, what is the most critical audit concern?

   (a) Risk of overstatement of room revenue due to duplicate billing

   (b) Risk of revenue leakage due to unauthorised discounts and inability to verify completeness and accuracy

   (c) Risk of minor timing differences in recording room revenue due to delayed reconciliation

   (d) Risk of misclassification between room revenue and other operating income

6. Where the auditor relied on internally generated reports and oral explanations due to missing primary records, how is the reliability of audit evidence best evaluated?

   (a) Oral explanations are sufficient when supported by internal summaries

   (b) Internally generated reports are always reliable

   (c) Evidence is less reliable due to weak controls and reliance on oral representations

   (d) Copies and summaries are equivalent to original records

7. Considering facts of the case and that banquet invoices for pre year-end events were raised after year-end but included in receivables, what is the most appropriate audit conclusion?

   (a) Receivables are understated due to delayed invoicing

   (b) There is a cut-off error affecting revenue recognition for the period

   (c) There is a cut-off error leading to potential misstatement of trade receivables

   (d) There is a cut-off error leading to potential misstatement of revenue and receivables

Case Scenario 3 [MCQs 8-12]

DEF InfraTech Ltd. is a capital-intensive infrastructure company engaged in construction and leasing of transport assets. The company has recently faced liquidity stress due to delayed government payments and cost overruns in ongoing projects.

CA R has been appointed as the statutory auditor for the financial year 2024–25, which is also the first year of audit engagement.

During the course of audit, the auditor observed that the company has incurred continuous losses for the last two years and has also breached major loan covenants. The management has prepared the financial statements on going concern basis supported by projected cash flows and expected restructuring of loans. However, these projections are based on assumptions of future government contracts which are yet to be finalised.

During discussions with management regarding the financial statements, the audit team raised concerns about the adequacy of disclosures relating to the company's ability to continue as a going concern, particularly in light of recurring losses, breach of loan covenants, and dependence on uncertain future cash inflows. However, the management strongly asserted that preparation of financial statements on a going concern basis was appropriate and that no additional disclosures were necessary. They argued that since the company had not initiated any formal insolvency proceedings, nor had any lender formally recalled loans or initiated recovery actions, there was no explicit requirement under the applicable financial reporting framework to disclose uncertainties relating to going concern.

Management further supported its position by referring to internally prepared cash flow projections and ongoing negotiations with lenders for restructuring of borrowings, expressing confidence that the company would be able to meet its obligations in the normal course of business. They also indicated that making such disclosures in the financial statements could adversely affect stakeholder confidence, lender relationships and future business prospects. Accordingly, management advised the audit team to rely on their assessment and avoid insisting on additional disclosures, emphasising that the absence of a specific rule mandating disclosure in such circumstances justified their position.

Being the first year of audit, the auditor noted that opening balances include capitalised project costs from prior years. No prior period auditor's working papers were available. Further, certain accounting policies relating to capitalisation of borrowing costs appeared to have been changed during the current year without adequate disclosure.

The engagement team assessed inherent risk as high considering financial stress and complexity of estimates. However, management representations appeared overly optimistic, leading to internal debate within the audit team regarding reliance on measurable indicators versus professional judgment.

Further examination revealed that the company owns aircraft used for leasing, which are depreciated as a single unit instead of separating significant components such as engines and airframe. Residual values have not been deducted while computing depreciation. Additionally, the method of depreciation was changed during the year without proper disclosure.

On the basis of the above, answer the following MCQs (8–12):

8. Considering the auditor's responsibilities in relation to going concern as described in the facts, which of the following should be the auditor's primary focus?

   (a) To obtain sufficient appropriate audit evidence regarding appropriateness of going concern basis and assess material uncertainty based on assumptions used

   (b) To conclude only on the existence of losses and loan defaults

   (c) To verify only whether management has prepared projections supporting going concern

   (d) To report only if liquidation is certain

9. In the context of management's assertion that no disclosure is required unless insolvency is certain, which of the following approaches should the auditor adopt?

   (a) Follow rules strictly and avoid disclosure

   (b) Rely only on legal opinion

   (c) Accept management's view to maintain client relationship

   (d) Apply principles-based approach and exercise professional judgment considering substance over form

10. Considering that this is the first year of audit and prior period auditor's working papers are not available, along with change in accounting policy, what should the auditor primarily ensure?

    (a) Opening balances need not be verified

    (b) Only current year transactions should be verified

    (c) Obtain sufficient appropriate audit evidence regarding opening balances and consistency of accounting policies

    (d) Rely completely on management representations

11. Given the presence of optimistic management assumptions and high inherent risk, how should the auditor approach risk assessment?

    (a) Base risk assessment only on quantifiable metrics

    (b) Apply professional judgment based on audit evidence and auditor expertise

    (c) Treat risk assessment as a precise calculation ignoring subjective factors

    (d) Rely solely on management representations

12. Based on the depreciation issues identified in the case, which of the following is the most appropriate audit conclusion?

    (a) Multiple issues exist including non-component depreciation, ignoring residual value and lack of disclosure of change in method

    (b) Only change in method requires verification

    (c) Depreciation is acceptable if total expense appears reasonable

    (d) Depreciation errors are immaterial due to long-term nature of assets

13. GHI Ltd. is engaged in investment and manufacturing activities. During audit, the auditor performed inspection procedures in the following areas:

    - Examined share certificates held by the company as evidence of investments.
    - Inspected executed sales contracts to evaluate revenue recognition policies.
    - Physically verified plant and machinery at the factory.
    - Reviewed internally generated invoices to verify sales transactions.

Based on above, which of the following is the most appropriate audit conclusion regarding inspection as an audit procedure?

(a) Inspection of share certificates conclusively establishes existence, ownership, and valuation of investments.

(b) Inspection of executed contracts provides sufficient appropriate audit evidence regarding revenue recognition without need for further procedures.

(c) Physical inspection of plant and machinery provides evidence of existence, but additional procedures may be required for ownership and valuation.

(d) Inspection of internally generated invoices provides more reliable audit evidence than external confirmations.

14. PQR Ltd. is a manufacturing entity. During the audit, the auditor evaluated internal controls relating to safeguarding of assets and noted the following:

1. Password-protected access to systems handling cash disbursements.
2. CCTV surveillance in warehouses to prevent theft of inventory.
3. Controls to restrict excessive consumption of raw materials in production.
4. Maker-checker authorization for bank payments.

The auditor intends to rely only on those controls relevant to the financial statement audit.

Which of the following is the most appropriate set of controls relevant to the auditor's consideration?

(a) Controls 1, 2, 3, and 4, since all relate to safeguarding of assets

(b) Controls 1 and 4 only, since they directly impact financial reporting reliability

(c) Controls 1, 2, and 4, since all relate to safeguarding and hence are relevant

(d) Controls 2 and 3 only, since they prevent physical misuse of assets

15. STU Ltd., a listed company, issued Sweat Equity Shares to certain senior employees during the financial year. While verifying compliance with legal requirements, the auditor noted the following:

1. The issue was approved by an ordinary resolution passed at the AGM.
2. The resolution mentioned the number of shares and class of employees but did not specify the current market price.
3. The shares issued belonged to a new class of equity shares created specifically for employees.

4. The company complied with regulations issued by Securities and Exchange Board of India for such issuance.

Based on the above, which of the following is the most appropriate audit conclusion under Section 54 of the Companies Act, 2013?

(a) The issue is valid since SEBI regulations have been complied with for a listed company

(b) The issue is partially valid since only disclosure of market price is not mandatory

(c) The issue is valid as long as employees have received shares and consideration is properly recorded

(d) The issue is invalid as it is not approved by a special resolution and does not comply with specified disclosure requirements

PART II - Descriptive Questions (70 Marks)

Question No. 1 is compulsory.

Attempt any four questions from the Rest.

1. (a) DEF Ltd. is a profit-oriented company engaged in the FMCG sector. During the audit for the financial year ended 31st March 2025, the auditor observed that the company's profit before tax from continuing operations has been highly volatile over the past few years due to fluctuations in input costs and competitive pricing strategies. However, the company's total revenue and gross profit have remained relatively stable.

Further, the company is financed through a mix of equity and borrowings, and its financial statements are used by both investors and lenders for decision-making purposes.

The auditor is in the process of determining materiality for the financial statements as a whole in accordance with relevant Standard on Auditing.

With reference to above, explain the factors that may affect the identification of an appropriate benchmark while determining materiality for the financial statements as a whole. Also, state examples of benchmarks that may be appropriate in such circumstances. **(5 Marks)**

(b) OPQ Ltd. is a widely held company engaged in manufacturing activities. The management of the company is responsible for preparation of financial statements. The shareholders of the company are not involved in day-to-day operations.

Recently, during a board meeting, one of the directors questioned the necessity of conducting a statutory audit, stating that it only increases cost and does not add significant value. However, the CFO of the company argued that audit plays a crucial role in enhancing the reliability of financial information and safeguarding stakeholder interests.

In the given context, explain the benefits of audit to various stakeholders.

(5 Marks)

(c) CA A is the statutory auditor of AB Ltd., a company engaged in manufacturing high-precision industrial components used in the automobile sector. The company has experienced significant fluctuations in its gross profit ratio and raw material consumption during the current year as compared to previous years.

During the course of audit, CA A decides to apply substantive analytical procedures to evaluate the reasonableness of purchase prices, consumption levels and revenue trends. For this purpose, he plans to rely on various data sources such as internally prepared budgets, cost sheets, management reports and external industry statistics.

However, upon preliminary review, CA A observes that:

- Budgets appear to be prepared aggressively to achieve performance targets,
- Industry data relates to general manufacturing and not specifically to specialized components,
- Certain reports are generated from the entity's IT system, but adequacy of controls over such data is unclear.

Considering the above, CA A is concerned about whether such data can be relied upon for designing substantive analytical procedures.

In the given context, explain the relevant points that CA A should consider while determining the reliability of data for the purpose of designing substantive analytical procedures. **(4 Marks)**

2. (a) Zetta Manufacturing Ltd. is engaged in the production of textile machinery components. During the course of audit, the auditor observed fluctuations in the purchase quantity and prices of raw materials as compared to previous years. The management has provided data relating to consumption, stock composition, and turnover ratios.

The auditor intends to apply analytical procedures to evaluate the overall reasonableness of purchase quantity and price.

Discuss the audit procedures to be performed by the auditor in this regard.

(5 Marks)

(b) N Ltd., a manufacturing company, has availed a Cash Credit Facility of ₹ 1 crore from XY Bank Ltd. As per the latest stock statements submitted for the quarter ended 31st March 2025, the Drawing Power (DP) is ₹ 80 lakh. The outstanding balance in the cash credit account as on the balance sheet date is ₹ 75 lakh.

During the last two quarters, the bank has debited interest amounting to ₹ 7 lakh to the account. However, the total credits deposited by the company in the same period amount to only ₹ 5 lakh. The account has otherwise remained within the sanctioned limit and drawing power throughout the period.

The statutory auditor, while reviewing the loan account, is required to classify the asset as per prudential norms.

As an auditor, how will you report/classify this account? Give reasons with reference to applicable norms. **(5 Marks)**

(c) QRS & Associates, a firm of Chartered Accountants, is handling multiple audit engagements across diverse industries. One of its clients, Nova Manufacturing Ltd., is engaged in heavy engineering, whereas another client, Sparkle Retail Ltd., operates a chain of consumer retail outlets with a high volume of transactions and decentralized operations.

CA A, the engagement partner for Nova Manufacturing Ltd., has designed a detailed audit programme considering the nature of its operations. He proposes that the same audit programme be standardised and applied to the audit of Sparkle Retail Ltd. as well, to ensure uniformity and save time.

However, CA B, the engagement partner for Sparkle Retail Ltd., disagrees and believes that adopting the same audit programme may not be appropriate in the given circumstances.

In the context of the above, state the matters that should generally be considered while preparing an audit programme. Also, examine whether the view taken by CA B is justified. **(4 Marks)**

3. (a) Raghav Mehra & Co., Chartered Accountants, were appointed as the statutory auditors of Jeep Manufacturing Limited for the financial year 2024–25. The company is engaged in large-scale production of automobile components and

maintains significant opening balances relating to inventory, trade receivables, and fixed assets.

The financial statements for the previous year (2023–24) were audited by another firm, S.K. Verma & Associates, who had issued an unmodified audit opinion.

During the audit, CA Raghav Mehra decided not to perform any audit procedures on opening balances. He was of the view that since the previous year's financial statements had already been audited by a qualified auditor, reliance could be placed on the same and no further verification was necessary.

The audit manager expressed concern that such an approach may not be in accordance with the Standards on Auditing.

In the light of the above facts:

(i) Examine whether the approach of CA Raghav Mehra is correct.

(ii) State the audit procedures that should be performed regarding opening balances in such cases. **(5 Marks)**

(b) Arvind & Associates, Chartered Accountants, were appointed as auditors of Stellar Appliances Ltd. for the financial year ended 31st March 2025. During the course of audit in June 2025, the auditor observed that the company operates in a rapidly changing market environment and there were frequent post year-end developments.

Further examination revealed the following:

- The company renegotiated a major long-term supply contract in April 2025, significantly reducing future purchase commitments.
- A legal case pending as at year-end was settled in May, 2025 with a substantial out-of-court settlement.
- Internal audit reports for April and May 2025 highlighted certain irregularities in revenue recognition practices.
- The company had circulated draft financial results for the first quarter to key lenders before finalisation.

The auditor is concerned about whether all relevant subsequent events have been properly identified and considered in the financial statements.

With reference to relevant Standard on Auditing, explain the audit procedures the auditor should perform as part of risk assessment to identify subsequent events. **(5 Marks)**

(c) Nature Charitable Trust runs a multi-specialty hospital in Noida. The hospital earns revenue from patients, donations, subscriptions, government grants and income from investments.

During the audit for the year ended 31st March 2025, the auditor, CA A, observed the following:

- The hospital maintains a patient register, billing system, and cash collection records.
- Donations and legacies are received, some of which are earmarked for specific purposes like construction of wards.
- The hospital owns investments and rental properties.
- There are inventory items such as medicines, surgical instruments, linen, etc.
- Budgetary controls exist but significant variations were noticed in certain expense heads.
- Internal controls over issue of medicines and stores appear weak.
- Capital expenditures were incurred during the year.

As an auditor, explain the important audit procedures you would perform while auditing such a hospital. **(4 Marks)**

4. (a) FGH & Co., Chartered Accountants, have been appointed as the statutory auditors of Alpha Ltd., a company engaged in manufacturing electrical equipment. The company follows a strict reporting schedule and requires continuous interaction with auditors during the audit process.

During audit planning, the engagement partner emphasised the need to properly determine reporting objectives of the engagement to ensure timely completion of audit procedures and effective communication with management and the audit team.

Based on the above, state the instances that the auditor should consider while ascertaining the reporting objectives of the engagement for establishing the overall audit strategy. **(5 Marks)**

(b) RS & Co., Chartered Accountants, were appointed as statutory auditors of Zifi Infra Ltd., a listed company engaged in infrastructure development. During the course of audit, it was observed that:

- The audit partner, CA R, had a close personal relationship with the CFO of the company.
- The firm had also provided consultancy services for designing internal financial controls of Zifi Infra Ltd. during the same financial year.
- Additionally, a substantial portion of the firm's total revenue was dependent on fees received from Zifi Infra Ltd.

A minority shareholder raised concerns that although the auditor may be acting objectively, the circumstances create doubt regarding the auditor's independence.

In the light of the above, explain whether the independence of the auditor is compromised. Also, discuss the concept of independence of mind and independence in appearance. **(5 Marks)**

(c) "Before the commencement of audit, the joint auditors should discuss and develop a joint audit plan". Discuss the points to be considered in developing the joint audit plan by the joint auditors. **(4 Marks)**

5. (a) Explain the objective of the auditor to express an appropriately modified opinion as per SA 705 – Modifications to the Opinion in the Independent Auditor's Report. Also, discuss the circumstances under which the auditor is required to issue a qualified opinion. **(5 Marks)**

(b) CD Manufacturing Ltd., engaged in the production and trading of consumer goods, has significant inventories comprising finished goods and goods held for resale. During the course of audit for the financial year ended 31st March 2025, the auditor observed that inventory includes certain slow-moving and obsolete items. Further, there were variations noted in cost allocation and selling prices in recent months.

The auditor is required to ensure that inventories are valued appropriately in accordance with applicable accounting standards.

Discuss the audit procedures to be performed by the auditor for verifying valuation of finished goods and goods for resale. **(5 Marks)**

(c) YZ Limited is engaged in the business of manufacturing electrical equipment. During the course of audit for the financial year 2024–25, CA R, the auditor, observed that while certain expenses like rent, power and fuel were subjected to monthly trend analysis, a large number of other expenses such as travelling, insurance, repairs, and miscellaneous expenses were not analysed trend-wise.

The management contended that such expenses are irregular in nature and hence trend analysis may not be meaningful. The auditor decided to verify these expenses through vouching and examination of supporting documents to ensure their correctness and appropriateness.

In the light of the above, mention the attributes that the auditor should verify while vouching such expenses. **(4 Marks)**

6. (a) YZ & Co., Chartered Accountants, were appointed as auditors of Shree Ltd. for the financial year 2024–25. The auditor proposed to sign the audit report on 30th June 2025.

Management provided written representations dated 10th June 2025 and refused to update them closer to the date of the auditor's report, stating that no material changes had occurred.

Further, the present management took charge from 1st October 2024 and declined to give written representations for the period April to September 2024 on the ground that they were not in position during that period.

In the above context, explain the requirements relating to the date of written representations in relation to the auditor's report and the period(s) to be covered by such representations. Also, comment on the validity of management's stand.

(5 Marks)

(b) "Familiarity threats are a significant concern affecting the independence of auditors."

Explain the meaning of familiarity threats and discuss the circumstances in which such threats may arise. Also, briefly state how the provisions of the Companies Act, 2013 help in addressing such threats. **(5 Marks)**

(c) FRN Ltd. is a technology-driven company where most transactions such as sales, purchases, and inventory movements are processed through an automated ERP system. The auditor observed that the company relies heavily on system-based processing, with minimal manual intervention.

During the audit, it was noted that certain General IT Controls (GITCs), particularly relating to access controls and change management, are either not in place or are ineffective. The auditor is required to evaluate the effectiveness of controls and decide on appropriate audit procedures in such an automated environment.

Explain the testing methods to be used by the auditor in an automated environment and the course of action where GITCs are ineffective. **(4 Marks)**

OR

CA B, an auditor, after the completion of busy audit season, was occupied in assembling of final audit files of one of his client. First of all, he started preparing various documents of that client and then kept those documents in various folders. He was preparing documents as well as audit file in paper form because he believed that it is mandatory. He could complete documentation as well as assembling of final audit file of that client after three months from the date of audit report. Generally, he retains audit file of the clients for 4 years from the date of audit report. Check the validity of the action of CA B. **(4 Marks)**

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PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Part I - Multiple Choice Questions

1. (c)
2. (b)
3. (d)
4. (a)
5. (b)
6. (c)
7. (d)
8. (a)
9. (d)
10. (c)
11. (b)
12. (a)
13. (c)
14. (b)
15. (d)

Part II - Descriptive Answers

1. **(a)** As per SA 320 "Materiality in Planning and Performing an Audit", determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (Example - Assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (Example - For the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets)
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed and (Example - If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings;)
- The relative volatility of the benchmark

Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.

Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

(b) Benefits of Audit to various stakeholders are:

- Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
- In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- Audited financial statements are helpful to government authorities for determining tax liabilities.

- Audited financial statements can be relied upon by lenders, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
- An audit may also detect fraud or error or both.
- An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

Therefore, audit is not merely a statutory requirement but an essential mechanism that enhances credibility of financial statements, protects stakeholder interests, and supports informed decision-making.

(c) The auditor needs to ensure that the data used for substantive analytical procedures is reliable, in accordance with SA 520 – Analytical Procedures.

The following are the relevant points while determining whether data is reliable for purposes of designing substantive analytical procedures:

i. Source of the information available.

For example, information may be more reliable when it is obtained from independent sources outside the entity.

ii. Comparability of the information available.

For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.

iii. Nature and relevance of the information available.

For example, whether budgets have been established as results to be expected rather than as goals to be achieved.

iv. Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity.

For example, controls over the preparation, review and maintenance of budgets.

In view of the above, CA A should critically evaluate the reliability of data by examining its source, comparability, relevance and the effectiveness of controls over its preparation before relying on it for substantive analytical procedures, so as to obtain sufficient and appropriate audit evidence.

2. **(a)** The auditor needs to perform analytical procedures to obtain audit evidence as to the overall reasonableness of purchase quantity and price. Such procedures may include:

(i) **Consumption Analysis:** Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years along with closing stock levels. In case of any significant variations, the auditor should seek explanations from management and corroborate the same with supporting evidence.

(ii) **Stock Composition Analysis:** Auditor should obtain reports from management showing composition of stock, i.e., raw materials as a percentage of total inventory, and compare the same with previous years. Significant deviations should be investigated and appropriate explanations obtained.

(iii) **Ratio Analysis:** Auditor should compare relevant ratios such as creditors turnover ratio and stock turnover ratio of the current year with those of previous years. Any abnormal fluctuations may indicate issues relating to purchase quantity, pricing, or recording of transactions.

(iv) **Quantitative Reconciliation:** Auditor should review quantitative reconciliation of closing stock with opening stock, purchases, and consumption. This helps in verifying the completeness and accuracy of purchase quantities.

By performing the above analytical procedures and investigating significant variations, the auditor can obtain reasonable assurance regarding the correctness and overall reasonableness of purchase quantity and price, thereby supporting the audit opinion.

(b) As per prudential norms for classification of advances, a cash credit account is treated as **"Out of Order"** if:

- The outstanding balance remains continuously in excess of sanctioned limit/drawing power; or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

In the given case:

- Sanctioned limit = ₹ 1 crore

- Drawing power = ₹ 80 lakh
- Outstanding balance = ₹ 75 lakh (within DP)
- Interest debited = ₹ 7 lakh
- Credits during two quarters = ₹ 5 lakh

  Although the outstanding balance is within the drawing power, the credits in the account are not sufficient to cover the interest debited during the same period.

  Therefore, applying prudential norms, the cash credit account of N Ltd. shall be classified and reported as "Out of Order", since the servicing of interest is inadequate, indicating potential stress in the account.

  As per the definition of Non-Performing Asset (NPA):

- In respect of OD/CC accounts, an account is treated as NPA when it remains "out of order".

Since the cash credit account of N Ltd. is out of order, the same shall be classified as a Non-Performing Asset (NPA) as at the balance sheet date.

(c) Following matters should be considered generally while preparing an Audit Programme:

(1) Stay within the scope and limitation of the assignment.

(2) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

(3) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

(4) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

(5) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.

(6) Consider all possibilities of error.

(7) Co-ordinate the procedures to be applied to related items.

Evolving one audit programme – Not Practicable for All Businesses: Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all businesses under all circumstances is not practicable.

In view of the above mentioned provisions, CA B is correct in emphasizing the need for a different audit programme for Sparkle Retail Ltd., as the nature and circumstances of the engagement differ significantly from those of Nova Manufacturing Ltd.

3. (a) Initial audit engagement is an engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

In the given case, since the previous year's financial statements were audited by another auditor, the present engagement is an initial audit engagement.

Therefore, the approach of CA Raghav Mehra is not correct, as reliance cannot be placed solely on the predecessor auditor's report. The current auditor is required to obtain sufficient appropriate audit evidence regarding opening balances.

Audit Procedures regarding Opening Balances: The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

    (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including other relevant documents relating to the prior period;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

Thus, CA Raghav Mehra's approach is inappropriate. As per Standards on Auditing, even in cases of audited prior period financial statements, the incoming auditor must perform adequate procedures on opening balances to ensure that they are free from material misstatement and properly brought forward.

(b) As per SA 560 "Subsequent Events", the auditor shall perform audit procedures to obtain sufficient appropriate audit evidence that all events occurring between the date of financial statements and the date of auditor's report requiring adjustment or disclosure have been identified.

The auditor shall take into account the risk assessment and perform the following procedures:

(i) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(ii) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(iii) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(iv) Reading the entity's latest subsequent interim financial statements, if any.

Considering the dynamic environment and significant post year-end developments, the auditor must carefully perform the above procedures to ensure proper identification and treatment of subsequent events. Failure to do so may result in material misstatements in the financial statements.

(c) In the audit of a hospital run by a charitable trust, the auditor should consider the following important audit procedures:

1. Register of Patients: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2. **Collection of Cash**: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

3. **Income from Investments, Rent etc**: See with reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.

4. **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

5. **Reconciliation of Subscriptions**: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

6. **Authorisation and Sanctions**: Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

7. **Grants and TDS**: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

8. **Budgets**: Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

9. **Internal Check**: Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

10. **Depreciation**: See that depreciation has been written off against all the assets at the appropriate rates.

11. **Registers**: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

12. **Inventories**: Obtain inventories, especially stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

13. **Management Representation and Certificate**: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

By performing the above procedures, the auditor can obtain sufficient and appropriate audit evidence regarding completeness of income, proper utilisation of funds, existence of assets, and effectiveness of internal controls, thereby forming a reliable opinion on the financial statements of the hospital.

4. (a) The ascertaining of reporting objectives of the engagement helps the auditor to plan the timing of audit procedures and the nature of communications. Some of the relevant instances are:

- The entity's timetable for reporting.
- Organization of meetings to discuss the nature, timing, and extent of audit work with management.
- Discussion with management regarding the expected type and timing of reports to be issued, including the auditor's report.
- Discussion with management regarding expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including team meetings and review of work performed.

Accordingly, by considering the above instances, the auditor can effectively plan audit timing and communication, thereby ensuring a well-structured audit strategy.

(b) "Independence" implies that the judgment of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of the entity subject to the audit.

There are two interlinked perspectives of independence of auditors, one, independence of mind and two, independence in appearance.

Independence is:

(i) **Independence of mind –** the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(ii) **Independence in appearance** – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors' independence.

In the given case, although the auditor may be maintaining objectivity (independence of mind), the following factors raise serious concerns regarding independence in appearance:

- Close personal relationship with the CFO
- Provision of consultancy services (self-review threat)
- Economic dependence on a single client

These circumstances may lead a reasonable third party to conclude that the auditor's independence is compromised.

(c) Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

(i) Identify division of audit areas and common audit areas;

(ii) Ascertain the reporting objectives of the engagement;

(iii) Consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;

(iv) Consider the results of preliminary engagement activities, or similar engagements performed earlier.

(v) Ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

5. (a) Objective of the Auditor - To Express Clearly an Appropriately Modified Opinion: As per Standard on Auditing (SA) 705 "Modifications To The Opinion In The Independent Auditor's Report", the objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

(i) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Qualified Opinion

The auditor shall express a qualified opinion when:

(i) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(b) The auditor should perform the following audit procedures for valuation of finished goods and goods for resale:

1. Enquire as to what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the financial statements.

2. Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/partly processed inventories (work in progress) and raw materials have also been written down.

3. Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory. For this purpose, request the client to provide inventory ageing analysis and follow up for any inventories which were noted as damaged or obsolete during physical verification.

4. Compare recorded costs with replacement costs to identify any significant variations.

5. Examine vendor price lists to determine if recorded cost is less than current prices.

6. Calculate inventory turnover ratio. Obsolete inventory may be indicated if the ratio is significantly lower.

7. In manufacturing environments, test overhead allocation rates and ensure that only direct labour, direct material and appropriate overheads have been included.

8. Verify the correct application of the principle of lower of cost or net realizable value.

Thus, the auditor should ensure that inventory is properly valued at lower of cost or net realizable value and that adequate provisions are made for obsolete, damaged and slow-moving items to present a true and fair view of the financial statements.

(c) While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify the following attributes:

(i) Whether the expenditure pertained to current period under audit.

(ii) Whether the expenditure qualified as a revenue and not capital expenditure.

(iii) Whether the expenditure had valid supporting documents

(iv) Whether the expenditure has been classified under the correct expense head.

(v) Whether the expenditure was authorised as per delegation of authority.

(vi) Whether the expenditure was incurred for business purposes.

Thus, in cases where analytical procedures are not effective, the auditor should rely on detailed vouching to verify the genuineness, accuracy, classification, and business relevance of expenses to ensure that financial statements present a true and fair view.

6. (a) **Date of and Period(s) covered by Written Representations:** The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

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

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

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

The management is required to provide written representations dated as near as practicable to the date of the auditor's report and covering the entire period under audit. In case of refusal, the auditor should consider appropriate modification in the audit report.

(b) 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. This can occur in many ways including:

(i) close relative of the audit team working in a senior position in the client company

(ii) former partner of the audit firm being a director or senior employee of the client

(iii) long association between specific auditors and their specific client counterparts and

(iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

Provisions in the Companies Act, 2013 regarding rotation of auditors mainly address these very familiarity threats. Such provisions prescribe that auditor is rotated after a certain number of years so that auditors do not become too familiar with their clients.

Familiarity threats may arise in situations involving close relationships, long tenure of auditors, or undue benefits received from the client, all of which may impair professional judgment and objectivity.

Therefore, familiarity threats can impair the independence of the auditor and appropriate safeguards such as auditor rotation and avoiding close relationships or undue benefits must be implemented to ensure compliance with ethical requirements.

(c) There are basically four types of audit tests that should be used, namely inquiry, observation, inspection and reperformance.

Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

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

In the context of FRN Ltd., while testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application.

Where the general IT controls are not existing or existing but ineffective, the auditor should assess the impact of IT risks and complexity of the automated environment in which the business operations take place and plan alternative audit procedures in order to rely on the system-based information. This may include performing additional substantive procedures and reducing reliance on automated controls.

Thus, the auditor should apply an appropriate combination of audit testing methods based on professional judgement and, in case of ineffective GITCs, design alternative procedures to obtain sufficient and appropriate audit evidence.

OR

(c) **Assembly of the Final Audit File:** Audit documentation may be recorded on paper or on electronic or other media. Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. Hence the views of CA B that audit documentation should be maintained mandatorily in paper form is not correct.

The auditor shall prepare audit documentation on timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed. Completing the audit Documentation by CA B not on timely basis is not proper.

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. In the given situation, CA. B, after completion of audit season, is completing the audit file as well as assembling of final audit files of his client after three months of the date of audit report which is not valid as per SQC 1.

SQC 1 "Quality Control for Firms that perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements", 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. He retains audit file of the client for 4 years from the date of audit report is also non-compliance of SQC 1.