

Mock Test Paper - Series II: August, 2025

Date of Paper: 8th August, 2025

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

INTERMEDIATE: GROUP – II

PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Part I - Multiple Choice Questions

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

Part II - Descriptive Answers

1. (a) In the given case, CA Sakshi, the statutory auditor identified various lapses in the company's internal control system, such as employees failing to act on important reports, duplicate payments, collusion to override system checks, management override of procedures and lack of segregation of duties due to limited staff. While discussing the same with management, she explained that such deficiencies,

despite the presence of internal controls, are not rare due to the inherent limitations of internal control, which include:

- (i) Internal control can provide only reasonable assurance: Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.
 - (ii) Human judgment in decision-making: Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
 - (iii) Lack of understanding the purpose: The operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
 - (iv) Collusion among People: Controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
 - (v) Judgements by Management: In designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.
- (b) There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions.

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed.

However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work.

Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

- (c) As per SA 510, "Initial Audit Engagements - Opening Balances", 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.

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 the other relevant documents relating to the prior period financial statements;
 - (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.

In the given case, CA Dheeraj relied solely on the prior year's audited financial statements and did not apply any audit procedures regarding opening balances. In view of above, CA Dheeraj's point of view is not correct, and he would therefore be required to consider this as an initial audit engagement and perform appropriate audit procedures regarding the opening balances.

2. (a) (i) The auditor will check **Rights & Obligations assertion** to ensure that the entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognised in the financial statements represent all the entity's obligations to repayment as at a given date.
- (ii) The auditor will check **Occurrence assertion** to ensure that the transactions recognized in the financial statements have occurred and relate to the entity.
- (iii) The auditor will check **Valuation assertion** to ensure assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement.
- (iv) The auditor will check **Cut-off assertion** to ensure that all income and expenses are reported in the-correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.
- (v) The auditor will verify **Completeness assertion** to ensure that all assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.
- (b) Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

- (i) Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- (ii) Advances represent amount due to the bank.
- (iii) Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.

- (iv) There are no unrecorded advances.
 - (v) The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
 - (vi) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
 - (vii) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
- (c) As per SA 300, "Planning an Audit of Financial Statements", Planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as: -
- (i) The analytical procedures to be applied as risk assessment procedures.
 - (ii) Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
 - (iii) The determination of materiality.
 - (iv) The involvement of experts.
 - (v) The performance of other risk assessment procedures.

The auditor is also required to consider determination of material or significant matters while planning. It also includes consideration that whether experts need to be involved taking into account complexity of business.

In the given case, since the company is engaged in technical and complex operations, the auditor is required to evaluate regarding the involvement of an expert at planning stage in accordance with SA 300. Such consideration helps in ensuring that the auditor has access to the required technical knowledge and skills for the audit. Thus, consideration for involvement of experts by auditors falls within domain of audit planning.

3. (a) As per SA 550, "Related Parties", during the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, for example:
- Entity income tax returns.

- Information supplied by the entity to regulatory authorities.
 - Shareholder registers to identify the entity's principal shareholders.
 - Statements of conflicts of interest from management and those charged with governance.
 - Records of the entity's investments and those of its pension plans.
 - Contracts and agreements with key management or those charged with governance.
 - Significant contracts and agreements not in the entity's ordinary course of business.
 - Specific invoices and correspondence from the entity's professional advisors.
 - Life insurance policies acquired by the entity.
 - Significant contracts re-negotiated by the entity during the period.
 - Internal auditors' reports.
 - Documents associated with the entity's filings with a securities regulator e.g, prospectuses)
- (b) As per SA 260, "Communication with Those Charged with Governance", significant findings from the audit that the auditor shall communicate with those charged with governance are as follows:
- (i) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity
 - (ii) Significant difficulties, if any, encountered during the audit;
 - (iii) Unless all of those charged with governance are involved in managing the entity: -
 - (I) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;
 - (II) Written representations the auditor is requesting

- (iv) Circumstances that affect the form and content of the auditor's report, if any and
 - (v) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.
- (c) An account should be treated as 'out of order' if:
- the outstanding balance remains continuously in excess of the 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'.

Applying the above to the given case of Fair Ltd, its Drawing power is ` 1.45 crores, although outstanding balance in the account is ` 1.40 crores , but still the account would be reported as out of order because credits in the account are not sufficient to cover the interest debited during the same period

Therefore, classification of account made by the bank for the account as 'out of order' is in order.

4. (a) In the given case, CA Mohit noticed that the last year's financial statements contain an adverse opinion for the financial statement whole due to a misstatement in the evaluation and disclosure of the debtors. If the auditor's report on the prior period, as previously issued, included an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
- (i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
 - (ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

Further, when comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

- (i) That the financial statements of the prior period were audited by a predecessor auditor;
 - (ii) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
 - (iii) The date of that report.
- (b) In the given case, while reviewing the purchase records, CA Sulsa noticed a large purchase transaction that was supported by only one internal document. The management explained that this was the usual practice and assured her of the document's authenticity. Such a response could affect CA Sulsa's exercise of professional skepticism.

Thus, the auditor CA Sulsa shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example:

- ◆ Audit evidence that contradicts other audit evidence obtained.
- ◆ Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- ◆ Conditions that may indicate possible fraud.
- ◆ Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

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

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

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

- (c) There are three components of audit risk viz. inherent risk, control risk and detection risk.

The auditor can only influence detection risk. Inherent risk and control risk belong to the entity and are influenced by the entity. Examples of detection risk are as under: -

- Sizeable work-in-progress inventories are expected in financial statements of a company. However, auditor of the company does not devote time to attending inventory count. Instead, he chooses to rely upon alternative audit procedures.
- The auditor of a company has audited revenue of a company by taking a sample. However, there is a risk that sample of revenue is not representative of overall revenue.

Therefore, the auditor must reduce detection risk in order to keep audit risk at low level. Detection risk may be reduced by increasing area of checking, testing larger samples and by including competent and experienced person in the engagement team.

5. (a) Procedures to be performed by the auditor to verify student fee collections are as follows:
- (i) Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
 - (ii) Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
 - (iii) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

- (iv) Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
 - (v) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
 - (vi) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
 - (vii) Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.
- (b) Difference between "Historical financial information" and "Prospective financial information": The "Historical financial information" relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The "Prospective financial information" relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.

In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed.

Prospective financial information relates to future events. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future-oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.

Hence, such type of assurance engagement provides only a "moderate" level of assurance.

- (c) CA Saurabh should perform following analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price:
- (i) Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management if any significant variations are found.
 - (ii) Stock Composition Analysis: Auditor should collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.
 - (iii) Ratios: Auditor should compare the creditors' turnover ratios and stock turnover ratios of the current year with previous years.
Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.
6. (a) Clause (iii) of Para 3 of CARO, 2020, requires the auditor to report whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so,-
- (a) whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-
 - (A) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;
 - (B) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates;
 - (b) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;

- (c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (d) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
 - (e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];
 - (f) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013;
- (b) Audit procedures to be performed by auditor to verify rent expenses:
- Obtain a month wise expense schedule along with the rent agreements.
 - Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement.
 - Specific consideration should be given to escalation clause in the agreement to verify if the rent was required to be recorded on a straight-line basis during the period under audit.
 - Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity.
- (c) In the given case, all except two misstatements have been corrected by management.

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of

uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

The documentation requirements regarding misstatements identified during the course of audit in accordance with SA 450 are as under: -

- (a) The amount below which misstatements would be regarded as clearly trivial
- (b) All misstatements accumulated during the audit and whether they have been corrected and
- (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

OR

- (c) If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.

A letter of specific inquiry includes:

- (i) A list of litigation and claims;
- (ii) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (iii) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.