

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
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.