Mock Test Paper - Series II: August, 2026

Date of Paper: 17th August, 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**

SUGGESTED ANSWERS / HINTS

Part I - Multiple Choice Questions

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.

1. (B)
2. (D)
3. (C)
4. (A)
5. (C)
6. (A)
7. (A)
8. (C)
9. (B)
10. (D)
11. (D)
12. (C)
13. (A)
14. (B)
15. (B)

Part II - Descriptive Answers

1. (a) Evaluating the Evidence Obtained

As per SA 505 "External Confirmations", the auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary.

When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

(i) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;

(ii) A response deemed unreliable;

(iii) A non-response; or

(iv) A response indicating an exception.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330.

From the given facts, it can be concluded that the audit assistant's view is not correct. The auditor is required to evaluate all results of the external confirmation procedures and not merely those received without exception. Responses that are unreliable, non-responses and responses indicating exceptions may require the performance of further audit procedures. Accordingly, the Engagement Partner's approach is in accordance with the requirements relating to the evaluation of evidence obtained through external confirmation procedures.

(b) Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in SA-200.

There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.

Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations.

Inherent risk factors are considered while designing tests of controls and substantive procedures. Category of auditor's assessment lower or higher, each category covers a range of degrees of inherent risk. Auditor may assess the inherent risk of two different assertions as lower while recognizing that one assertion has less inherent risk than the other, although both have been assessed as lower.

It is important to consider the reason for each identified inherent risk even if the risk is lower, when auditor designs tests of controls and substantive procedures.

External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete. Factors in the entity and its environment may also influence the inherent risk related to a specific assertion.

Few examples of inherent risks could include: -

i An accounting standard provides guidance on some complex issue which might not be understood by the management. Therefore, recording of this issue in financial statements carries inherent risk of being misstated.

ii There are large number of business failures in an industry. Therefore, assertions in financial statements of an entity operating in such an industry carry an inherent risk of being misstated.

From the facts of the case, it can be concluded that the audit assistant's views are not correct. Inherent risk exists before considering the related internal controls and may differ from one assertion to another depending upon its nature and complexity. Further, factors such as complex accounting issues and rapid technological changes in the industry increase the inherent risk of material misstatement.

(c) To establish the Existence of intangible fixed assets as at the period-end

Audit Procedure:

Since an intangible asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others or for administrative purposes.

Example: For verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.

Example: For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.

In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased beyond the date of deletion.

From the facts of the case, mere inclusion of intangible assets in the books of account is not sufficient to establish their existence. The auditor should verify whether such assets are in active use for the purposes for which they were acquired, along with the related activities of the entity. Accordingly, the unused software and designs relating to products that were no longer being manufactured should be appropriately dealt with in the books of account after obtaining the necessary management approval, and amortisation should cease from the date of deletion.

2. (a) Completeness of Inventories

Only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party.

The auditor should perform the following procedures:

(1) Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).

   (i) Compute inventory turnover ratio (COGS/ average inventory).

   (ii) Perform vertical analysis (inventory/ total assets).

   (iii) Compare budgetary expectations vis-à-vis actuals.

(2) Examine non-financial information related to inventory, such as weights and other measurements.

(3) Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records)

to accounting records immediately before and after year-end.

(4) With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.

(5) Verify the clerical and arithmetical accuracy of inventory listings.

(6) Reconcile physical inventory amounts with perpetual records.

(7) Reconcile physical counts with general ledger control totals.

(8) Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.

(9) Verify goods received on consignment basis have been properly segregated from other items of inventory.

From the above circumstances, physical counting of inventories at the year-end alone is not sufficient to establish their completeness. The auditor should perform analytical procedures, examine relevant non-financial information and carry out purchase and sales cut-off tests. Inventory records should be reconciled with perpetual records and general ledger control totals. The auditor should also verify inventories owned by the entity but held by third parties and ensure that goods received on consignment are properly segregated.

(b) The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. SA 320 deals with auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

From the facts of the case, it can be concluded that the Finance Director's views are not correct. Misstatements may be material individually or when considered in the aggregate if they could reasonably influence the economic decisions of users of the financial statements. Further, judgments about materiality are based on the common financial information needs of users as a group and not on the needs of any specific individual user. Therefore, the Engagement Partner's approach is in accordance with the requirements of SA 320.

(c) Nature and Extent of Audit Procedures

The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

3. (a) Verification of Bank Reconciliation Statement (BRS)

The auditor needs to obtain Bank Reconciliation Statements (BRS) for all bank accounts maintained by the entity as at the reporting period. In addition, the auditor needs to understand the client's process and periodicity of preparing the BRS.

The auditor should ensure that the BRS is signed by the authorised personnel so that responsibility can be assigned in case of any errors.

Verification of BRS shall entail the following:

(1) **Tallying the Bank Balance:** Tally the balance as per the bank book with the bank confirmation/statement.

(2) Checking of Cheques Issued but not Presented for Payment

(i) Check all material reconciling items included under 'Cheques Issued but not Presented' with the underlying bank book forming part of the books of account.

(ii) Obtain bank statements for the subsequent period and verify whether the cheques have subsequently been cleared by the bank.

(iii) Where cheques have become stale (i.e., three months or more have elapsed since the date of issue), the same should not appear in the BRS and should instead be taken back to liabilities.

(3) Checking of Cheques Deposited but not Credited by Bank

(i) Check all material reconciling items included under 'Cheques Deposited but not Credited' by obtaining bank deposit slips duly acknowledged by the bank.

(ii) Verify from the subsequent period's bank statements whether such cheques have subsequently been credited by the bank.

(iii) Where cheques remain uncleared beyond a reasonable period, obtain explanations from the management.

(iv) If such explanations are found to be unsatisfactory, verify whether the related revenue has been recognised in accordance with the Company's revenue recognition policy.

(4) Checking of Amounts or Charges Debited/Credited by Bank but not Accounted for

(i) Check all material reconciling items relating to amounts or charges debited/credited by the bank but not recorded in the books by obtaining the relevant bank statements.

(ii) If the amounts are material, ensure that the management records the necessary adjustments in the books of account.

(iii) If the management does not make the required adjustments, the auditor shall consider qualifying the audit report.

The auditor should obtain BRS for all bank accounts and verify the material reconciling items with the underlying records and subsequent bank statements. Cheques issued but not presented, cheques deposited but not credited, and amounts or charges debited or credited by the bank but not recorded in the books should be appropriately examined. Stale cheques should be appropriately dealt with, and necessary adjustments should be considered for material items. Thus, verification of BRS involves detailed examination of reconciling items rather than merely agreeing the closing bank balances.

(b) SA 300, "Planning an Audit of Financial Statements", deals with the auditor's responsibility to plan an audit of financial statements. It states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Planning an audit is necessary to carry it out effectively in a timely manner. Besides ensuring compliance with professional standards, it helps in performing audit engagement effectively.

Adequate planning benefits the audit of financial statements in several ways, including the following: -

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
5. Facilitating the direction and supervision of engagement team members and the review of their work.
6. Assisting, where applicable, in coordination of work done by others such as experts.

Therefore, planning an audit ensures that audit risk is reduced to an acceptable low level. When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.

From the above facts, prior experience with the entity does not eliminate the need for adequate audit planning. Planning is essential for every audit engagement and assists the auditor in identifying important areas, addressing potential problems, allocating work appropriately and coordinating the work of experts, where required. Accordingly, the proposed planning activities are consistent with the requirements of SA 300 and contribute to the effective and efficient performance of the audit.

(c) **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 business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

The Assistant to keep an open mind: To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

The circumstances demonstrate that a single audit programme cannot be uniformly applied to all businesses, as the nature, size and composition of businesses, internal controls and the scope of audit work may differ. An audit programme should therefore be suitably framed and modified according to the specific circumstances of the engagement. Further, an audit assistant should keep an open mind while performing the prescribed procedures and should report significant matters noticed during the audit, even if they are not specifically covered by the programme. Thus, an audit programme provides necessary guidance but should remain sufficiently flexible to address matters relevant to the particular engagement.

4. **(a)** A cash credit account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power; or

- where the outstanding balance in the principal operating account is within the sanctioned limit/drawing power, there are no credits continuously for 90 days as on the date of the Balance Sheet; or
- credits are present but are not sufficient to cover the interest debited during the same period.

In the given case, PQR Ltd. has been sanctioned a cash credit limit of ₹30 crores by ABC Bank Ltd. The drawing power available to the company ranged between ₹26 crores and ₹29 crores during the financial year 2025-26. The outstanding balance remained below ₹24 crores throughout the year and, therefore, did not exceed the sanctioned limit/drawing power.

The amount outstanding in the cash credit account remained below ₹24 crores throughout the year. However, there were no credits continuously for 90 days as on 31st March 2026. Thus, although the outstanding balance was within the sanctioned limit/drawing power, there were no credits continuously for 90 days as at the Balance Sheet date.

Therefore, the cash credit account of PQR Ltd. should be classified as an 'out of order' account in the books of ABC Bank Ltd. as on 31st March 2026. Hence, it would be considered NPA

(b) **Written representations about specific assertions:** When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

(i) The entity's past history in carrying out its stated intentions.

(ii) The entity's reasons for choosing a particular course of action.

(iii) The entity's ability to pursue a specific course of action.

(iv) The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements, in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion.

Example: If the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions.

Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

The Audit Assistant's view is not appropriate. The auditor should evaluate management's intentions using relevant audit evidence and may obtain written representations where necessary. However, such representations cannot by themselves constitute sufficient appropriate audit evidence for the relevant assertion.

(c) An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".

An incisive analysis of above meaning of auditing brings out following points clearly: -

(i) Audit is an independent examination of financial information.

Independence, here, implies that the judgement 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 entity whose financial statements are subject to audit so that he can form an opinion without being affected by any influence. Independence increases auditor's ability to act objectively without creeping in of any biases.

(ii) The entity whose financial information is examined need not necessarily be profit oriented like in case of a business. It can be a non-profit organization like an NGO or a charitable trust. Audit can be undertaken in respect of any organization be it a small, medium or large.

(iii) The purpose of audit is to express an opinion on the financial statements.

From the facts of the case, it can be concluded that the Managing Trustee's views are not correct. Audit is an independent examination of the financial information of any entity, whether profit-oriented or not and irrespective of its size or legal form. Therefore, Sunrise Foundation is equally subject to the fundamental principles of auditing, and the auditor's independence must be maintained to enable the expression of an independent opinion on its financial statements.

5. **(a)** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.

The important objectives of audit are:

(i) reporting on the fairness of the content and presentation of financial statements;

(ii) reporting upon the strengths and weaknesses of systems of financial control;

(iii) reporting on the adherence to legal and/or administrative requirements;

(iv) reporting upon whether value is being fully received on money spent; and

(v) detection and prevention of error, fraud and misuse of resources.

From the facts of the case, it can be concluded that the audit of Riverdale Municipal Corporation should address all the above objectives. The weaknesses in financial controls, non-adherence to prescribed requirements, inadequate value from expenditure and indications of error, fraud or misuse of resources are matters relevant to the objectives of municipal audit.

(b) **Significant findings from the audit:** The auditor shall communicate with those charged with governance:

(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:

(1) Significant matters arising during the audit that were discussed, or subject to correspondence, with management.

(2) Written representations the auditor is requesting.

(iv) Circumstances that affect the form and content of the auditor's report, if any.

(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) Which type of opinion is appropriate?

The decision regarding which type of modified opinion is appropriate depends upon:

(1) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(2) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor's judgement about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but not Pervasive	**Material and Pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

6. (a) **Principles of Financial Propriety:** Audit against propriety seeks to ensure that expenditure conforms to certain recognised standards of financial propriety. These principles may be stated as follows:

(i) Expenditure should not be prima facie more than the occasion demands: The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

Accordingly, the purchase of high-end furniture at substantially higher prices, when adequate furniture was available at considerably lower prices, would not satisfy this principle.

(ii) **Authority should not sanction expenditure to its own advantage:** No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

Accordingly, sanctioning expenditure that directly benefits a business entity in which a close relative of the sanctioning authority has a financial interest would be inconsistent with this principle.

(iii) **Public money should not ordinarily be used for the benefit of a particular person or section:** Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(1) the amount of expenditure involved is insignificant; or

(2) a claim for the amount could be enforced in a Court of law; or

(3) the expenditure is in pursuance of a recognised policy or custom.

Accordingly, the expenditure referred to in the case would not satisfy this principle since the amount is not insignificant, there is no enforceable legal claim and the expenditure is not pursuant to any recognised policy or custom.

(iv) **Allowances should not become a source of profit:** The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Accordingly, payment of travelling allowances substantially exceeding the expenditure ordinarily incurred, resulting in a profit to the officials, would not conform to this principle.

(b) **The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:**

(1) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgement and maintains professional skepticism throughout the audit; and

(2) Describe an audit by stating that the auditor's responsibilities are:

(i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.

(iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(3) When SA 600 applies, further describe the auditor's responsibilities in a group audit engagement by stating:

The division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions /branches/subsidiaries or other components audited by other auditors

(c) For audit of provisions and contingencies the auditor should:

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

OR

(c) With regard to the integrity of a client, matters that the firm considers include, for example:

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