Mock Test Paper - Series II: April 2025

Date of Paper: 5th April 2025

Time of Paper: 10 A.M. – 1 P.M.

INTERMEDIATE: GROUP – II

PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Part I - Multiple Choice Questions

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

Part II - Descriptive Answers

1. **(a)** (i) It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved in given situation is "inherent risk."

(ii) The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement involved in given situation is "control risk".

(iii) There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".

(b) Sample audit programme pertaining to purchases

Name of Concern : Arya Industries

Financial Year : 2023-24

Prepared by : Name of person with date

Reviewed by : Name of person with date

Approved by : Name of person with date

S.no.	Nature of Procedure	Extent of Check	Basis of Sample	Done by
(i)	Vouch few purchase invoices of paper from purchase records of concern.			
(ii)	Trace these invoices into account books of concern.			
(iii)	Verify few purchase invoices of paper on GST portal.			
(iv)	Trace few purchase invoices of paper in stock records to ensure that these have been added to stocks of raw material.			

(c) (i) The audit procedure used by auditor of ANT Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

(ii) Mr. M is using Observation as audit procedure as Observation consists of looking at a process or procedure being performed by others.

(iii) The audit procedure used by auditor is Recalculation. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

(iv) CA Isha is using Analytical Procedure to obtain audit evidence. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

2. **(a)** (i) The auditor will check the Existence Assertion to ensure Assets, liabilities and equity balances exist as at the period end.

(ii) The auditor will check the Cut-off assertion to ensure that all assets and liabilities are reported in the appropriate period.

(iii) The auditor will check Completeness Assertion to ensure all Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.

(iv) The auditor will check Rights & Obligations assertion to ensure that the entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements.

(v) The auditor will check Valuation assertion to ensure PPE have been valued appropriately and as per generally accepted accounting policies and practices

(b) **While planning the audit, the auditor may concentrate on the following:**

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.

(ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. The Foreign Contribution (Regulation) Act 1976, The Societies Registration Act, 1860, The Income-tax Act 1961 etc. and the Rules related to the statutes.

(iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(vii) Setting of materiality levels for audit purposes.

(viii) The nature and timing of reports or other communications.

(ix) The involvement of experts and their reports.

(x) Review the previous year's Audit Report.

(c) The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. The auditor plans what type of audit procedures are to be performed, their timing and how much work should be done taking into account sample size etc.

The overall audit strategy and the audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan. However, auditor may discuss elements of planning with entity's management without compromising effectiveness of audit.

In the given case, CA Tina, auditor of SKY Ltd. asks its finance and audit head to prepare audit strategy and to draw detailed audit procedures. On Auditor's request, finance head completes the audit strategy as well as audit procedures.

In view of above, CA Tina should prepare overall audit strategy and detailed audit procedures. Therefore, approach of CA Tina was wrong.

3. (a) While auditing a renowned four-star hotel in Pune, CA Shrey observes that a gift shop is operating within the hotel premises. Upon further enquiry, he finds that the stock in the gift shop belongs to gift shop owner and the hotel receives rental income for letting out the space. In this context, to verify the payment of common amenities used by the gift shop owner to hotel, the auditor may adopt the following audit procedures:

- The auditor should obtain and examine the rental/lease agreement entered into between the hotel and the gift shop owner.
- The auditor should verify rent receipts. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

- The auditor should satisfy himself that all taxes collected from gift shop have been paid over to the proper authorities.
- Evaluate internal controls related to monitoring of utility consumption and collection of recoveries from tenants or concessionaires (like gift shops).
- Verify the hotel's utility bills (electricity bill, water bill etc.) and assess whether cost sharing with the gift shop is proportionate and reasonable.
- The auditor should verify that amounts charged for such amenities have been appropriately recorded in the hotel's books and that collections are reconciled with receipts.
- The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

(b) As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", Indicators of significant deficiencies in internal control include, for example:

(i) Evidence of ineffective aspects of the control environment, such as: -

- Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
- Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
- Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.

(ii) Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.

(iii) Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.

(iv) Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).

(v) Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.

(vi) Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.

(vii) Evidence of management's inability to oversee the preparation of the financial statements.

(c) When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following: -

(i) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(ii) Perform inspection or other audit procedures appropriate in the circumstances.

Other audit procedure may include –

For example,

- Inspecting documentation regarding inventory held by third parties, example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.

4. When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or 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:

   (a) 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

(b) 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.

2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

3. Prior Period Financial Statements Not Audited - If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

(b) Professional skepticism includes being alert to, for example:

(i) Audit evidence that contradicts other audit evidence obtained.

(ii) Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.

(iii) Conditions that may indicate possible fraud.

(iv) Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

(v) 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.

(c) The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment which shall include the following:

(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.

5. **(a)** As per sub-section (3) & (4) of section 73 of the Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State Co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

(i) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and

(ii) In the case of the profit and loss account, of the profit or loss for its financial year.

The auditor's report shall also state:

(i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.

(ii) Whether, in his opinion, proper books of account have been kept by the Multi - State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.

(iii) Whether the report on the accounts of any branch office audited by a person other than the Multi - State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

(iv) Whether the Multi - State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

(b) Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses: -

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- The accounting policy has been applied consistently year on year. Any change in the accounting policy has been adequately disclosed.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Whether each part of an item of PPE with a cost that is significant in relation to the total cost of the item have been depreciated separately.

  Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

- Whether the most appropriate depreciation method for each separately depreciable component has been used.

(c) The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors: -

(i) **The Nature of Financial Reporting**: The preparation of financial statements involves judgment by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(ii) **The Nature of Audit Procedures**: There are practical and legal limitations on the auditor's ability to obtain audit evidence such as:

- Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.
- Fraud may involve sophisticated and carefully organised schemes.

(iii) **Not in the nature of Investigation**: An audit is not an official investigation into alleged wrongdoing. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(iv) **Timeliness of financial reporting and decrease in relevance of information over time**: Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

(v) **Future events**: Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business.

6. **(a)** 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:

1. Entity income tax returns.
2. Information supplied by the entity to regulatory authorities.

3. Shareholder registers to identify the entity's principal shareholders.

4. Statements of conflicts of interest from management and those charged with governance.

5. Records of the entity's investments and those of its pension plans.

6. Contracts and agreements with key management or those charged with governance.

7. Significant contracts and agreements not in the entity's ordinary course of business.

8. Specific invoices and correspondence from the entity's professional advisors.

9. Life insurance policies acquired by the entity.

10. Significant contracts re-negotiated by the entity during the period.

11. Internal auditors' reports.

12. Documents associated with the entity's filings with a securities regulator e.g, prospectuses).

(b) In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results.

The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- Check completeness of data and population that is used in either test of controls or substantive audit tests.
- Selection of audit samples – random sampling, systematic sampling.
- Re-computation of balances – reconstruction of trial balance from transaction data.

- Reperformance of mathematical calculations – depreciation, bank interest calculation.
- Analysis of journal entries
- Fraud investigation.
- Evaluating impact of control deficiencies.

(c) As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

(i) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report";

(iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(iv) A separate opinion on individual matters.

OR

(c) CA Amit is verifying Occurrence Assertion while verifying the existence of vendors and the actual receipt of goods or raw materials by the company.

The audit procedures generally required to be undertaken while verifying Occurrence Assertion:

Ensure purchases are not understated/ overstated by performing following audit procedures:

- Whether any fictitious vendors have been booked or purchases have been recorded by reviewing the vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors.
- Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register.
- Whether quality inspection of goods was done.

- Whether a goods receipt note was prepared and signed by an appropriate client personnel.
- Whether the purchase invoice was approved as per delegation of authority and whether a 3 or 2-way match was done.
- Whether stock record has been updated by the stores personnel.

Special considerations during audit of purchases:

- The purchase invoice received should be the “Original” copy (and not photocopy/ carbon copy) against which the entity has recorded the purchase in its books of account.
- Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B., C.I.F. etc.
- Purchase invoice should be in the name of entity. However, in case of different branches, it should be addressed to the appropriate branch.
- Input tax component should have been booked in the input tax ledger. The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns.
- In case of purchases made from related parties or allied and associated concerns, the auditor needs to verify if requisite approval from Board of Directors (appropriate authority) has been obtained and should verify the selected samples and perform analytical procedures in relation to price of goods to confirm that the price charged is at arm’s length.
- The auditor should review whether purchases should be capitalized or expensed off in Statement of Profit and loss according to his professional judgement.
- Review journal entries for unusual transactions.