

MODEL TEST PAPER 5
INTERMEDIATE GROUP – II
PAPER – 5: AUDITING AND ETHICS

Time Allowed – 3 Hours

Maximum Marks – 100

PART I - Case Scenario based MCQs (30 Marks)

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

Case Scenario 1

DLP & Associates, a firm of Chartered Accountants, are in midst of conducting audit of Twist and Spin Limited. The company is in business since last 15 years and have appointed DLP & Associates as their auditor for the first time for a term of 5 years beginning from financial year 2023-24. While identifying and assessing the risk of material misstatement at assertion level, the engagement team had assessed risk of material misstatement for revenues and trade receivables to be high.

The team is considering to send negative confirmation requests as sole substantive procedure to some business entities representing trade receivables appearing in the financial statements of the company. The company had made sales to these business entities in January, 2024. Such business entities are few and have quite large balances as on 31st March, 2024. However, team members are not on the same page regarding sending negative confirmation requests.

Besides considering sending of confirmation requests, engagement team has planned certain audit procedures pertaining to trade receivables. These procedures include: -

1. Verification of invoices issued during last 7 days of financial year 2023-24 to verify that goods have been despatched by the company.
2. Selection of a few invoices from ageing report of the month March 2024 for verification of correctness of the billed amounts, to correct customers and on correct dates.
3. Preparation of schedule of movement of bad debts.
4. Review of the process of providing discounts to ensure that it is in accordance with company policy.

Another junior team member, S, observed that “Share Options Outstanding Account” reflected in the financial statements of the company. He started searching classification requirements of Schedule III of Companies Act, 2013 in this regard.

The engagement team wants to ensure that only the inventories held by company have been recorded in the financial statements and do not include any inventories belonging to third parties. They are keen to verify completeness assertion for inventories. The team has planned following audit procedures in this respect: -

1. Comparison of inventory turnover ratio of current period with previous years;
2. Vertical analysis of current period with previous years;
3. Comparison of budgetary expectations vis-à-vis actuals;
4. Performing purchase and sales cut-off tests

During the course of audit, R, a team member concluded that company has followed a particular accounting policy for revenue recognition during year 2023-24 which is in accordance with Accounting Standards and applicable financial reporting framework, but it was not consistently applied in preceding period having an impact upon opening balances of trade receivables of current year 2023-24. R is confused regarding the possible implications on auditor's report on this issue.

Based upon above, answer the following questions: -

1. The engagement team members are not able to take decision on sending negative confirmation requests to some entities described in case scenario. Which of the following statements is in accordance with Standards on Auditing?
 - (a) It would be appropriate for engagement team to send negative confirmation requests to these business entities.
 - (b) It would be inappropriate for engagement team to send negative confirmation requests to these business entities.
 - (c) Sending negative confirmation requests depends upon auditor's professional judgment and Standards on Auditing do not spell out any confirmation requirements in this respect.
 - (d) Business entities are more likely to respond in case of disagreement. Therefore, sending negative confirmation requests always provides better qualitative audit evidence as compared to other confirmation modes.
2. Which of the planned audit procedure(s) pertaining to trade receivables described in case scenario is/are not related to verification of "Completeness assertion"?
 - (a) 2 only
 - (b) 2 and 3
 - (c) 3 only
 - (d) 1 and 3
3. Guide team member S by selecting the correct option with respect to "Share Options Outstanding Account":
 - (a) It is required to be classified under head "Current liabilities".

- (b) It is required to be classified under Shareholder funds under "Share Capital". Further, it is to be classified separately under "Paid up Share Capital".
 - (c) It is required to be classified under Shareholder funds under "Reserves & Surplus". Further, it is to be classified separately as such under "Reserves & Surplus".
 - (d) It is required to be classified under Shareholder funds under "Reserves & Surplus". However, it is shown as part of Capital Reserve. No Separate disclosure is mandated under Schedule III of Companies Act, 2013.
4. Which of the planned audit procedures in relation to the inventories described in the case scenario is/are not in nature of analytical procedure(s)?
- (a) 2 and 3
 - (b) 3 only
 - (c) 2 and 4
 - (d) 4 only

Case Scenario 2

CA J is nearing completion of audit of Cheap Cost Private Limited, a manufacturing company for the year 2023-24. The draft financial statements of the company show a profit before tax of ₹ 5 crores. Materiality for financial statements as a whole has been determined @ 5% of Profit before Tax. At the end of June 2024, he is considering following issues flagged during the course of audit which remain uncorrected: -

- A fire took place in one of the premises of the company on 1st May, 2024 resulting in damages to all the inventories lying there amounting to ₹ 1 crores. The inventories of affected premises are insured with Quick Bima Limited for ₹ 50 lakhs and company has also lodged a claim with it which is still to be settled.
- The company has debited ₹ 10 lakhs under "Machinery Account" whereas expenditure relates to normal wear and tear of high-speed automated machinery. The amount has been wrongly capitalised under "Machinery account". (Ignore depreciation effect)
- The company has not properly accounted for necessary elements of cost in arriving at work in progress. Further, estimates regarding various stages of production have not been made properly. All such factors have resulted in overstatement of work in progress inventories by ₹ 20 lakhs.

No other issues except as stated above merit attention. Besides, written representation letter has also been obtained on matters concerning management's responsibilities regarding fulfilment of responsibilities for preparation of financial statements and providing access to all information to CA J. However, written representation provided to CA J begins in the below stated manner:

"This representation letter is provided in connection with your audit of the financial statements of Cheap Cost Private Limited for the year ended March 31, 2024, for

the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves)

Based upon above, answer the following questions: -

5. Which of following statements is most appropriate as regards to fire incident?
 - (a) The auditor should ask management to adjust financial statements for period under audit and book a loss of ₹ 50 lakhs in its Statement of Profit and Loss.
 - (b) The auditor should ask management to adjust financial statements for period under audit and book a loss of ₹ 1 crores in its Statement of Profit and Loss.
 - (c) The auditor should ask management to disclose it in notes to accounts.
 - (d) The auditor has no responsibility regarding described fire incident.
6. Identify the correct option regarding materiality of uncorrected misstatements relating to wrong capitalisation under "Machinery Account" and overstatement of inventories of work in progress.
 - (a) The uncorrected misstatements are not material in context of audit of financial statements as a whole as these are below materiality level determined by auditor.
 - (b) The uncorrected misstatements are material in context of audit of financial statements as a whole and their effect on opinion should be considered by auditor.
 - (c) The uncorrected misstatements are not material in context of audit of financial statements as a whole as these are in nature of management's judgment.
 - (d) The uncorrected misstatements are material in context of audit of financial statements as a whole and auditor should correct these.
7. The auditor has performed certain audit procedures described in case scenario relating to inventories of work in progress. Such procedures are related to verification of _____ assertion.
 - (a) Completeness
 - (b) Valuation
 - (c) Existence
 - (d) Rights and obligations
8. Which of the following statements is correct in respect to manner of providing written representations by management?
 - (a) The extract of written representations provided in case scenario is proper.

- (b) The use of words “having made such enquiries” is not permitted.
- (c) The use of words “to the best of our knowledge and belief” is not permitted.
- (d) The use of both kind of words “having made such enquiries” and “to the best of our knowledge and belief” is not permitted.

Case Scenario 3

MPM & Associates, a firm of Chartered Accountants, have received offer letter from PST Bank for carrying out statutory audit of their Chandigarh branch for the financial year 2023-24. The offer letter, inter alia, requests audit firm to give an undertaking in writing that firm is not disqualified under Section 141(3)(d)(ii) of Companies Act, 2013. Such provision relates to disqualification of a person as auditor of a company if he, his relative or partner is indebted to the company subject to certain prescribed conditions. Before accepting the said audit, the firm checks out whether it complies with law requirements. However, there is a difference of opinion among firm personnel whether such an undertaking can be given in case of banks.

The offer letter also contains following declaration to be signed by the auditors in case they choose to accept the appointment: -

“We declare that we will not communicate or allow to be communicated to any person, not legally entitled thereto, any information relating to the affairs of PST Bank or to the affairs of the person having any dealing with the Bank, nor will we allow any such person to inspect or have access to any books or documents belonging to or in possession of the Bank relating to the business of any person having any dealing with the Bank.”

The audit firm has also received a document kit provided by Statutory Central Auditors of Bank. It relates to scope of audit, areas of special consideration while performing audit and requires audit firm to confirm certain matters like adherence to RBI Master Circulars for income recognition, asset classification & provisioning and adequacy of checking of books of accounts based on sample etc. to them by way of a letter.

The document kit received also requires MPM & Associates to consider adverse comments made by stock auditors of borrowers enjoying cash credit facilities in their reports for purpose of reporting. It also contains specific instructions to check foreign letter of credits (FLCs) issued during the year in compliance with sanction terms of the respective borrowers and to verify income recognized in respect of FLCs.

9. Which of the following statements is likely to be most appropriate regarding required undertaking in accordance with the Companies Act, 2013?
 - (a) The referred provision mainly addresses self-interest threats to independence of auditors. The audit firm can give such an undertaking after verifying if it complies with such requirements.
 - (b) The referred provision mainly addresses self-review threats to independence of auditors. The audit firm can give such an undertaking after verifying if it complies with such requirements.

- (c) The referred provision mainly addresses self-interest threats to independence of auditors. However, the audit firm can't give such an undertaking as such provisions are applicable to companies and not to banks.
 - (d) The referred provision mainly addresses self-review threats to independence of auditors. However, the audit firm can't give such an undertaking as such provisions are applicable to companies and not to banks.
10. The declaration relating to non-communication of information related to affairs of Bank is related to adherence to which fundamental principle governing professional ethics?
- (a) Objectivity
 - (b) Confidentiality
 - (c) Independence
 - (d) Professional Competence and due care
11. MPM & Associates are required to report on adverse comments made by stock auditors of borrowers of branch enjoying cash credit facilities. Which of the following statements is most appropriate in this regard?
- (a) Stock auditors make comments in their reports on valuation of security and calculation of drawing power.
 - (b) Stock auditors make comments in their reports on valuation of security only. However, no comments are made on calculation of drawing power.
 - (c) Stock auditors make comments in their reports on valuation of security, documentation made by bank in respect of sanctioned credit facilities, leakage of revenue and calculation of drawing power only.
 - (d) Stock auditors make comments in their reports on calculation of drawing power only.
12. Keeping in view matter of foreign letters of credits (FLCs) described in case scenario, consider following statements: -
- 1. Foreign letter of credit issued by branch is a non-funded loan.
 - 2. Branch earns interest on issuance of foreign letter of credit which is credited in interest earned account of profit and loss account of branch.
 - 3. The bank which receives foreign letter of credit is known as beneficiary bank.

Which of following statement(s) is/are true?

- (a) Only statement 1 is correct.
- (b) Only statements 1 and 3 are correct.
- (c) Only statements 1 and 2 are correct.
- (d) Only statements 2 and 3 are correct.

MCQs

13. CA Y has started planning for audit of a listed company. In this respect, he is considering all the matters relating to acceptance of client, assessment of compliance with ethical requirements including independence, consideration regarding the use of analytical procedures to be performed as risk assessment procedures and to have common understanding regarding terms of engagement with management. Which of the following does not fall under the preliminary engagement activities of planning process?
- (a) Considering all matters relating to acceptance of client.
 - (b) Assessing ethical requirements including independence.
 - (c) Using analytical procedures to be performed as risk assessment procedures.
 - (d) Establishing common understanding regarding terms of engagement.
14. A practicing Chartered Accountant is appointed by a company to perform certain agreed-upon procedures relating to its trade payables. Such agreed upon procedures include verifying listing with books of accounts, sending confirmation letters and reporting factual discrepancies to company management. Which of statements is correct in this context?
- (a) The practicing CA shall perform work in accordance with Standards on Related Services and SA 220.
 - (b) The practicing CA shall perform work in accordance with Standards on Related Services and SQC 1.
 - (c) The practicing CA shall perform work in accordance with Standards on Auditing including SA 220.
 - (d) The practicing CA shall perform work in accordance with Standards on Assurance Engagements and SQC 1.
15. The audit of government expenditure is one of the major components of government audit. In this regard, what is meant by "Audit against rules and orders"?
- (a) That the expenditure is incurred with due regard to broad and general principles of financial propriety.
 - (b) That there is sanction, either special or general, accorded by competent authority authorising the expenditure.
 - (c) That there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority.
 - (d) That the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the financial rules and regulations framed by the competent authority.

PART II - Descriptive Questions

Question No. 1 is compulsory.

Attempt any **four** questions from the Rest.

1. (a) CDE Private Limited, a manufacturing company, had made investment in shares of some blue-chip companies. Additionally, it had temporarily deposited some of its extra funds in fixed deposits with a scheduled bank. Dividend from shares amounting to ₹ 1.80 lakhs (net of TDS, TDS = ₹ 0.20 lakhs) and bank interest of ₹ 2.70 lakhs (net of TDS, TDS = ₹ 0.30 lakhs) were credited in bank account of the company. During the year 2023-24, it has also sold some shares resulting in net gain of ₹ 5 lakhs. The company has shown above incomes under head "Other income" for consolidated amount of ₹ 9.50 lakhs in the statement of Profit and Loss. No other information is furnished in the financial statements put up for audit. As the auditor of the company, discuss whether the above situation constitutes "misstatement" in the financial statements of the company. Also state, few examples of misstatements. **(5 Marks)**
- (b) During the audit of a company, CA Z is using a software to select samples pertaining to sales records of the company. While performing this process, a window opens in software prompting the user to enter certain information. CA Z is in the process of entering information in this regard as given under: -

Selection Interval	?
Number of records to select	100
Starting record number to select	1
Ending record number to select	1000
File name	Sales

Going through the above fields, which method of sampling is likely being used in the software? Discuss. Which foremost consideration should be kept in mind by auditor for selecting samples in such a manner?

Additionally, partner of CA Z suggested him to select the first 200 sales invoices from the sales book of the last month. Which method of sampling is being suggested by partner of CA Z? **(5 Marks)**

- (c) Truthful Products Private Limited is engaged in trading stationery items. During the year 2023-24, there was a huge fire in one storage location of the company resulting in loss of inventories of ₹ 5 crores. As a result, the operations of the company were badly affected for about two months. Unfortunately, the insurance claim of the company was rejected due to certain defects in the policy issued and loss was booked by company in the year 2023-24 itself. There was no change in nature of business of company in relation to the last year. The draft financial statements of the company reflect following information:

(Figures in ₹ crores)

Particulars	FY 2022-23	FY 2023-24
Revenue from Operations	80	100
Net profit before tax	6	10

CA D who has been the statutory auditor for past three years, has decided to rely upon the same tests of details as performed in previous years. In the given situation what is lacking on part of the auditor? Discuss. **(4 Marks)**

2. (a) “Assurance engagement” means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. In this context, give three examples of assurance engagements highlighting difference in nature of assurance provided by such engagements. **(5 Marks)**
- (b) Pure Services Limited is into the litigation relating to some legal action initiated by the industry regulator. The matter has reached jurisdictional High Court. Keeping in view uncertainty related to future outcome of matter, statutory auditor of the company has decided to include Emphasis of Matter (EOM) Paragraph in auditor’s report.
- (i) Briefly discuss the considerations to be taken care of by the statutory auditor when EOM paragraph is included in auditor’s report.
- (ii) State any two examples of circumstances where the auditor may consider it necessary to include an EOM paragraph. **(5 Marks)**
- (c) CA Y, statutory auditor of a company, is in process of determining materiality for financial statements while planning audit. Since materiality is a matter of professional judgment and is affected by auditor’s perception of financial information needs of users of financial statements, he is reasonably making certain assumptions about users of financial statements. Which reasonable matters are likely to be assumed by him in respect of users? **(4 Marks)**
3. (a) During the course of statutory branch audit of a nationalized bank, CA Amrish is performing audit procedures in relation to the advances. He has verified the selected sample of borrower accounts representing advances and found nothing unusual. In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. List out few such documentary evidence which can be made use of by CA Amrish. **(5 Marks)**

- (b) While auditing the financial statements of Bro Traders LLP, CA L is carefully going through LLP agreement. Briefly discuss the key points CA L should pay attention in the LLP agreement and the reporting responsibilities of CA L concerning the financial statements of Bro Traders LLP? **(5 Marks)**
- (c) CA N, statutory auditor of Rock Limited, is in the process of final assembly of audit file. Under what circumstances, a statutory auditor can make changes to audit documentation during final assembly process of audit file? Give a few examples of such changes. **(4 Marks)**
4. (a) CA J is appointed as statutory auditor of Sigma and Beta Limited for the year 2023-24. During the audit he observed trade receivables amounting to ₹ 50 crores are reflected in the financial statements of the company. He wants to obtain sufficient appropriate evidence to conclude that trade receivables have been valued appropriately. Suggest few audit procedures in this regard. **(5 Marks)**
- (b) While planning the audit of Me Limited, CA M has planned nature, timing and extent of risk assessment procedures to identify and assess risks of material misstatements. How risk should be assessed by the auditor CA M? It is also well known that assessment of risks is a matter of professional judgment.
- Which specific matters are not included in audit risk? Additionally, CA K, one of the team members of CA M, is of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment. **(5 Marks)**
- (c) CA D is planning an audit of a listed company. List specific documentation requirements in accordance with SA 300 in relation to planning such an audit. How such planning documentation is useful? **(4 Marks)**
5. (a) Section 143(1) of Companies Act, 2013 states that every auditor of a company shall have access to books of accounts and vouchers of company and shall be entitled to require from officers of company such information and explanation as considered necessary and shall inquire into certain matters. State those matters to be inquired. **(5 Marks)**
- (b) M/s Veer and Associates is appointed as auditor of KMP limited. During the audit, auditor wants to verify that trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. Which assertion auditor wants to ensure and what audit procedures should be followed by him in this regard? **(5 Marks)**
- (c) CA M, auditor of a company, has planned to use substantive analytical procedures during course of audit. In this regard, he has decided to use such procedures in following areas: -

- (i) For testing relationship between sales and cost of sales
- (ii) For testing rights over certain assets forming part of account balances

Comment upon his approach along with reasons. **(4 Marks)**

6. (a) Mr. Vaayu is appointed as the auditor of PRISM Limited for the year 2023-24. He wants to ensure that the PPE has been valued appropriately and as per generally accepted accounting policies and practices and also that PRISM Limited has valid legal ownership rights over the PPE claimed to be held by the company and recorded in the financial statements. Explain how the auditor will verify the same. **(5 Marks)**
- (b) M/s TP & Co., a firm of Chartered Accountants, has been conducting audit of KSR Ltd. since last 4 years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified? Guide them. **(5 Marks)**
- (c) As per SA 560, when after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that had it been known to the auditor at the date of the auditor's report, it may have caused the auditor to amend the auditor's report. In this context, what is meant by "Date the financial statements are issued"? Can it be later than the date of providing auditor's report to the entity? **(4 Marks)**

OR

CA N, statutory auditor of QST Limited, appointed for a term of 5 years has completed audit for the first financial year ending on 31st March 2024. In compliance with requirements of professional standards, an audit file has been assembled. After about a period of six months from date of issue of audit report, he gets a call from CFO of the company to share complete audit file so that financial reporting of company can be improved upon in coming periods. Is it mandatory for statutory auditors to share audit files with client? What are the requirements for making audit documentation available to clients? **(4 Marks)**