

Case Scenario

ABC Limited is a mid-sized manufacturing company engaged in the production of electrical components and spare parts. The company maintains significant inventory across multiple warehouses.

During the audit of the financial statements for the year ended 31st March 2025, the auditor noted that inventory prices were highly volatile during the year and that discrepancies in inventory records had been reported in earlier audits. Certain inventory items were also identified as slow-moving and required significant management judgement for valuation. Based on these factors, the auditor assessed the risk of material misstatement in inventory valuation as high.

In the course of the audit, the auditor performed inquiries with the stores manager, production head, and finance personnel to understand the process for identification of obsolete inventory and valuation adjustments. While management represented that adequate provisions had been made for obsolete inventory, the stores manager indicated during inquiry that certain obsolete items were still carried at cost due to pressure to meet profitability targets. This inconsistency prompted the auditor to reassess audit procedures.

Considering the high risk assessment and contradictory responses obtained during inquiry, the auditor decided to perform tests of controls relating to approval of inventory write-downs and review of inventory ageing reports.

Based on the results, the auditor concluded that controls over identification and valuation of obsolete inventory were not operating effectively throughout the period.

Accordingly, the auditor designed and performed substantive procedures, including detailed testing of inventory valuation, examination of subsequent sales prices, physical inspection of slow-moving items, and substantive analytical procedures. While designing these procedures, the auditor identified conditions that would constitute a misstatement in the relevant assertions relating to inventory.

While evaluating the audit evidence obtained, the auditor considered the management assertions made in representing that the financial statements are prepared in accordance with the applicable financial reporting framework, particularly assertions relating to existence, valuation, completeness, and presentation and disclosure of inventory.

Based on above, answer the following MCQs:

1. In the audit of ABC Limited, which combination of circumstances primarily justified the auditor's decision to obtain additional audit evidence for inventory valuation?

- (a) Existence of slow-moving inventory requiring management judgement
- (b) Prior period discrepancies, price volatility and contradictory inquiry responses regarding obsolete inventory
- (c) Materiality of inventory balance and availability of ageing reports
- (d) Physical dispersion of inventory across multiple warehouses



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2. The stores manager's statement that obsolete items were carried at cost due to pressure to meet profitability targets most appropriately implies that the auditor should:

- (a) Conclude that the issue relates only to operational inefficiency and does not affect financial reporting
- (b) Accept management's representation regarding adequate provisioning
- (c) Treat the information as an indicator of potential management bias and modify audit procedures accordingly
- (d) Consider the inquiry response as sufficient appropriate audit evidence

3. In the audit of ABC Limited, after obtaining contradictory responses during inquiry and before designing substantive procedures, the auditor decided to test controls specifically over approval of inventory writedowns and review of ageing reports.

This decision was primarily to determine whether:

- (a) Controls existed and operated effectively to prevent management from deferring write-downs of obsolete inventory to meet profitability targets
- (b) Inventory quantities recorded in the system matched the physical stock across warehouses
- (c) Substantive testing of inventory valuation could be restricted to analytical procedures only
- (d) Management representations regarding obsolete inventory could be accepted without further corroboration

4. After concluding that controls over identification and valuation of obsolete inventory were not operating effectively throughout the period, the auditor performed procedures such as examining subsequent sales prices, physically inspecting slow-moving items, and performing substantive analytical procedures.

These procedures were primarily designed to:

- (a) Determine whether inventory write-downs had been formally approved in accordance with internal policies
- (b) Obtain direct audit evidence to evaluate whether inventory was overstated due to delayed or inadequate write-downs
- (c) Re-assess the design of internal controls over inventory management
- (d) Corroborate management's representations regarding profitability targets

5. The auditor identified that certain slow-moving and obsolete inventory items continued to be carried at cost due to pressure to meet profitability targets.

This situation most directly affects which management assertion, thereby requiring focused audit procedures in response to the identified risk?

- (a) Existence - because slow-moving inventory may no longer physically exist
- (b) Completeness - because obsolete inventory may not have been recorded in the inventory records
- (c) Presentation and disclosure - because obsolete inventory requires separate classification in the financial statements
- (d) Valuation - because inventory may be overstated as net realisable value has not been appropriately considered

Solution: 1. (b) 2. (c) 3. (a) 4. (b) 5. (d)

General MCQs

6. During the audit of QRS Ltd. for the year ended 31 March 2025, the auditor observed that management had changed the method of depreciation from Written Down Value Method to Straight Line Method. The change was applied in the current year and disclosed in the notes to accounts. The auditor also reviewed whether the financial statements appropriately summarised the transactions and events recorded and evaluated the judgments made by management in selecting and applying accounting policies consistently.

In the above case, which of the following represents the auditor's responsibility while evaluating the financial statements?

- (a) To select the most appropriate accounting policies for the entity.
- (b) To prepare and present the financial statements in accordance with applicable statutory requirements.
- (c) To change the accounting policies where they do not reflect true and fair view.
- (d) To ensure that accounting policies selected by management are evaluated for appropriateness and consistent application and that relevant information is properly disclosed.

7. P & Co., Chartered Accountants, were appointed as statutory auditors of LMN Ltd. for the year ended 31 March 2025. Soon after completing the audit for the previous year, the engagement team began discussions for the current year's audit. Before identifying and assessing the risks of material misstatement, the auditor planned the timing of certain activities such as applying analytical procedures, obtaining an understanding of the applicable legal and regulatory framework, determining materiality and considering the need for involvement of experts.

Which of the following statements best explains the nature of audit planning as per the Standards on Auditing in the above case?

- (a) Audit planning is a separate phase that begins only after the identification of risks of material misstatement.
- (b) Audit planning is a continual and iterative process that includes consideration of analytical procedures, materiality, legal and regulatory framework and involvement of experts prior to performing further audit procedures.
- (c) Audit planning is restricted to preparation of the audit programme and allocation of audit staff.
- (d) Audit planning is required only in case of initial audit engagements.

8. While auditing a charitable trust for the year ended 31 March 2025, the auditor obtained a list of books and records maintained by the trust and verified them with the mandatory records prescribed. Based on his evaluation of internal controls, he applied test checks, complied with the applicable Accounting Standards and Standards on Auditing, considered materiality while performing audit procedures and maintained detailed working papers documenting the audit evidence relied upon for forming his opinion.

Which of the following actions of the auditor in the above case is most appropriate as per generally accepted auditing practices?

- (a) Using professional judgment to determine audit tests, applying test checks based on internal control evaluation, considering materiality and maintaining working papers to support the audit opinion.



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- (b) Applying test checks irrespective of internal control evaluation, since trust audits are not governed by internal control considerations.
- (c) Restricting compliance to Accounting Standards only, as Standards on Auditing are recommendatory in case of trust audits.
- (d) Maintaining working papers only for material items, as immaterial matters do not require audit documentation.

Solution: 6. (d) 7. (b) 8. (a)

Descriptive Questions

Question 1 (Ch-1)

You are appointed as statutory auditor of Zebra Industries Ltd. for FY 2024-25. During the course of audit, you observe that the company's management frequently delays in providing certain documents and explanations requested by you. A portion of the accounting records related to "special procurement" is supported only by basic acknowledgements without proper vendor details. You also notice that some transactions appear to be with entities that may be related to the company, but management denies the existence of any such relationships. Further, during verification, you find that some documents produced as evidence appear unusually uniform and lack standard commercial markings, raising concerns about their authenticity. Since your audit is conducted on a test-check basis, you are unable to verify all such transactions individually.

Based on the above, explain the inherent limitations of an audit that restrict the auditor from obtaining absolute assurance that the financial statements of Zebra Industries Ltd. are free from material misstatement.

Solution

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are **practical and legal limitations** on ability of auditor **to obtain audit evidence**.

- For example, an auditor **does not test all transactions and balances**.
 - ✓ He forms his opinion only by **testing samples**.
 - ✓ It is an **example of practical limitation** on auditor's ability to obtain audit evidence.
- **Management may not provide complete information** as requested by auditor.
 - ✓ There is **no way** by which **auditor can force management** to provide complete information as may be requested by auditor.
 - ✓ In case he is not provided with required information, he **can only report**.
 - ✓ It is an example of **legal limitation** on auditor's ability to obtain audit evidence.
- The **management** may consist of **dishonest and unscrupulous people** and may be, itself, **involved in fraud**.
 - ✓ It may be engaged in **concealing fraud** by designing **sophisticated and carefully organised schemes** which may be hard to detect by the auditor.
 - ✓ It may **produce fabricated documents** before auditor to lead him **to believe that audit evidence is valid**. However, in reality, **such documents** could be **fake or non-genuine**.



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- ✓ Auditor is **not an expert in authentication of documents**. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.

Example

It is quite possible that entity may have entered into some **transactions with related parties**. Such transactions may be **only paper transactions** and may **not have actually occurred**.

The **auditor** may **not be aware of such related party relationships** or **audit procedures** may **not be able to detect probable wrong doings** in such transactions.

These factors collectively demonstrate that, due to practical constraints, legal boundaries, management fraud risks, and limitations in detecting related party transactions, the **auditor can obtain only reasonable assurance and not absolute assurance** regarding the accuracy of the financial statements.

Question 2 (Ch-2 Planning)

You are the Engagement Partner for the statutory audit of Strong Engineering Ltd. for FY 2025-26. While planning the audit, you observe the following practical issues:

- Two newly recruited audit assistants inform you that they are unsure about the exact audit procedures expected from them for different areas of the audit.
- The audit this year is a major assignment involving multiple units, and your team seems unable to visualise the full scope of procedures to be performed.
- Because the audit work has not been formally planned, defined and segregated, you are unable to allocate tasks to assistants on the basis of their individual capabilities.
- Last year, in the absence of a written programme, the then audit team followed a "mental plan", as a result of which certain subsidiary records were overlooked.
- During review, you notice that assistants have not signed off on procedures performed, making it difficult to trace work back to the responsible individual.
- As the principal auditor, you find it difficult to track the progress of different audit areas because no written audit programme has been initiated by assistants.
- Your firm wishes to use this year's audit documentation as a reference for planning next year's audit of Strong Engineering Ltd.
- The firm is also facing a negligence allegation on another audit, and you are concerned about having adequate evidence of exercising reasonable skill and care in this assignment.

Based on above facts, analyse why preparing a written audit programme is advantageous for the audit of Strong Engineering Ltd.

Solution

In the present case, the absence of a written audit programme has led to confusion among assistants, ineffective supervision, omission of records and lack of documentary evidence. These issues clearly establish the importance and advantages of preparing a written audit programme.

The advantages in the present case may be analysed as follows:



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- i) Clear instructions to assistants: The newly recruited assistants are unsure about the audit steps. A written audit programme provides detailed, **written instructions regarding the nature, timing and extent of audit procedures** regarding the work to be performed.
- ii) Providing a total perspective for a major audit: The current audit is a major, multi-unit assignment. A properly drafted programme gives the team a **complete perspective of all audit procedures** required.
- iii) Easier selection of assistants based on capability: You find it difficult to allocate work because tasks are not defined. Once the work is rationally planned, defined and segregated, **assistants can be assigned roles more effectively depending on their capability**.
- iv) Reduces risk of overlooking books/records: Last year some subsidiary records were overlooked due to reliance on a mental plan. A written and predetermined programme **ensures systematic and comprehensive coverage** of all books and records and ensures systematic coverage.
- v) Fixation of responsibility through sign-offs: Absence of signatures prevents linking work to individuals. A written programme **allows each assistant to sign off, accepting responsibility** for work done.
- vi) Enables control and monitoring by the principal: You are unable to track progress without a written programme. When assistants initiate and follow the programme, the **principal can control and monitor the audit progress effectively**.
- vii) Serves as a guide for next year's audit: The firm wants to use this year's work as reference for next year's planning. A properly drafted programme **acts as a useful guide for future audits**.
- viii) Provides evidence against negligence allegations: Since the firm faces **negligence allegations** elsewhere, **proper documentation is critical**.

A well-constructed programme provides evidence that the auditor exercised reasonable skill and care.

Considering all facts, preparing a written, structured audit programme will address each challenge directly, enhance audit efficiency, improve accountability, and provide strong defence evidence in case of negligence allegations. Therefore, **adopting a comprehensive audit programme is clearly advantageous** for the audit of Strong Engineering Ltd.

Question 3 (SA 265)

During the audit of LMN Limited, the auditor identified certain significant deficiencies in the internal control system which could adversely affect the reliability of financial reporting. The auditor is required to communicate such deficiencies to those charged with governance and also to management on a timely basis. Further, the auditor is required to ensure that the written communication clearly specifies the nature and implications of such deficiencies.

With reference to above, explain:

- i) the auditor's responsibility for communication of significant deficiencies in internal control to those charged with governance and management; and
- ii) the matters that the auditor shall include in the written communication of such significant deficiencies. (RTP May'26)

Solution

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.



The auditor shall also **communicate to management** at an appropriate level of responsibility on a timely basis: -

- a) In **writing, significant deficiencies** in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and
- b) **Other deficiencies** in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

The auditor shall include in the **written communication of significant deficiencies in internal control**:

- a) A **description of the deficiencies** and an explanation of their **potential effects**; and
- b) **Sufficient information** to enable those charged with governance and management **to understand the context** of the communication.

In particular, the auditor shall explain that:

- (i) The **purpose** of the audit was for the auditor **to express an opinion** on the financial statements;
- (ii) The audit included **consideration of internal control relevant to the preparation of the financial statements** in order **to design audit procedures** that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
- (iii) The **matters being reported are limited** to those **deficiencies** that the auditor has **identified** during the audit and that the auditor has concluded are of **sufficient importance to merit being reported to those charged with governance**.

Thus, proper written communication of significant deficiencies along with their implications and context, enables timely corrective action and enhances the effectiveness of governance and internal control systems.

Question 4 (SA 600)

"Using the Work of Another Auditor" is a critical area in the audit of entities having branches or components audited by auditors other than the principal auditor. With reference to SA 600 - Using the Work of Another Auditor, explain:

1. The need for coordination and proper understanding between the principal auditor and the other auditor; and
2. The procedures to be performed by the principal auditor to evaluate and use the work of the other auditor, including circumstances where the principal auditor may need to visit the component or examine its records.

Solution

Using the Work of another Auditor:

1. **Need for Coordination and Proper Understanding between the Principal Auditor and the Other Auditor**
When the accounts of the branch are audited by a person other than the company's auditor (principal auditor), there is **need for a clear understanding of the role** of such **other auditor** and the **company's**



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auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole. There is also great necessity for a **proper rapport between these two auditors** for the purpose of an effective audit.

In recognition of these needs, SA 600 makes it clear that:

- The **principal auditor should advise the other auditor** of the **use** that is to be made **of the other auditor's work and report** and make sufficient arrangements for **coordination** of their efforts at the **planning stage** of the audit.
- The principal auditor would **inform the other auditor** of
 - ✓ **matters requiring special consideration,**
 - ✓ procedures for the identification of **inter-component transactions** that may require disclosure,
 - ✓ and the **time-table for completion** of audit.
- The principal auditor should advise the other auditor of the **significant accounting, auditing and reporting requirements** and **obtain representation** as to compliance with them.

2. Procedures to be Performed by the Principal Auditor to Evaluate and Use the Work of the Other Auditor

SA 600 requires that the principal auditor should **perform procedures to obtain sufficient appropriate audit evidence** that the **work of the other auditor is adequate** for the principal auditor's purposes in the context of the specific assignment.

The principal auditor might:

- **Discuss** with the other auditor the **audit procedures applied**; or
- **Review a written summary** of the **other auditor's procedures and findings**, which may be in the form of a completed **questionnaire or checklist**.

The principal auditor may also wish to **visit the other auditor**.

The nature, timing and extent of such procedures will depend on

- the **circumstances of the engagement** and
- the **principal auditor's knowledge of the professional competence of the other auditor**. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Further, in certain situations, the statute governing the entity may confer a **right on the principal auditor to visit a component and examine the books of account and other records** of the said component, if he thinks it necessary to do so.

Where another auditor has been appointed for the component, the principal auditor would normally be **entitled to rely upon the work of such auditor unless there are special circumstances** making it essential for him to visit the component and/or examine its books of account and other records.