Analytical procedures

Article by: Ger Long, BA (Hons) BFS, MBA, FCA, AITI Examiner: P2 Audit Practice, February 2016.

Analytical procedures are defined as 'evaluations of financial information through analysis of plausible relationships among both financial and non-financial data'. They also include 'such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount' (ISA 520).

The auditor will typically utilise analytical procedures at three stages of the audit as follows.

1. At the risk assessment stage as part of the detailed risk assessment and planning process (ISA 315)
2. As a substantive procedure in the detailed audit of transactions and balances, and
3. At the overall review stage of the financial statements towards the conclusion of the audit (ISA 520).

The risk assessment stage is an area where some examination candidates struggle when it is tested. This article will consider an example of how to approach such a question, which may be an optional question or embedded as part of a larger case study.

Example:

You are the audit manager in ABC, Certified Public Accountants and Statutory Audit Firm. You are engaged in planning the audit of Atatrak Ltd a private company involved in the assembly and distribution of agricultural machinery.

The draft financial statements for the year ended 31 March 2016 are attached along with comparative figures for 2015 and, in some cases, the previous year. The financial statements of the two previous years received unmodified audit reports and you are satisfied as to their truth and fairness.

Required:

Perform a preliminary analytical review on the financial information and accompanying notes. Using this information prepare notes for inclusion in the planning section of the working papers, which identify and analyse the principal audit risks to be considered in planning the audit. Your notes should include any calculations performed and any further information that should be obtained from the client to assist with audit planning.

(20 marks)

Note: Before you proceed to the suggested solution, you are recommended to attempt to address the requirements above, under examination conditions. You should allow yourself about 1.5 minutes per available mark. The draft financial statements for the year ended 31 March 2016 along with comparative figures for 2015 are shown on pages 2 to 4.

Atatrak Ltd.

Statement of comprehensive income and retained earnings for the year ended 31 March 2016

	Draft 2016 €	**Audited 2015 €**
Revenue	6,863,544	5,808,650
Cost of sales	(5,178,530)	(4,422,575)
Gross profit	1,685,014	1,386,075
Other income	88,850	25,000
Distribution costs	(97,460)	(79,700)
Advertising & marketing costs	(78,090)	(77,100)
Administrative expenses	(810,230)	(660,389)
Other expenses	(106,760)	(100,030)
Finance costs	(26,366)	(36,712)
Profit / (Loss) before tax	654,958	457,144
Corporation Tax	(278,868)	(189,559)
Profit / (Loss) for the year	376,090	267,585
Retained earnings at start of year	2,171,350	2,003,765
Dividends	(150,000)	(100,000)
Retained earnings at end of year	2,397,440	2,171,350

Statement of financial position at 31 March 2016

	Notes	Draft 2016 €	Audited 2015 €	Audited 2014 €
ASSETS				
Non-current assets				
Property, plant & equipment		2,749,945	2,521,455	2,286,002
Intangible assets		32,900	59,550	61,750
Investments		142,500	132,500	107,500
Deferred tax asset		0	2,912	2,155
		2,925,345	2,716,417	2,457,407
Current assets				
Inventories		57,380	47,920	45,050
Trade and other receivables		785,548	773,859	721,234
Cash and cash equivalents		49,700	35,075	18,478
		892,628	856,854	784,762
Total assets		3,817,973	3,573,271	3,242,169
EQUITY & LIABILITIES				
Equity				
Share capital		45,000	40,000	30,000
Retained earnings		2,397,440	2,171,350	2,003,765
		2,442,440	2,211,350	2,033,765
Non-current liabilities				
Long term loans		240,000	160,000	200,000
Finance leases		23,163	44,624	64,508
Deferred tax liability		4,309	0	0
		267,472	204,624	264,508
Current liabilities				
Short term loans		10,000	100,000	50,000
Current portion of finance leases		21,461	19,884	18,423
Bank overdraft		83,600	115,507	20,435
Trade payables		354,530	415,520	390,190
Provisions		214,823	214,870	211,637
Interest payable		2,000	1,200	0
Dividends payable		150,000	100,000	80,000
Current tax liability		271,647	190,316	173,211
		1,108,061	1,157,297	943,896
Total liabilities		1,375,533	1,361,921	1,208,404
Total equity & liabilities		3,817,973	3,573,271	3,242,169

Statement of changes in equity for the year ended 31 March 2016 (Draft)

	Share Capital	Retained Earnings	Total
	€	€	€
At 01 April 2014	**30,000**	**2,003,765**	**2,033,765**
Profit / (Loss) for the year	0	267,585	267,585
Dividends	0	(100,000)	(100,000)
Shares issued	10,000	0	10,000
At 31 March 2015	**40,000**	**2,171,350**	**2,211,350**
Profit / (Loss) for the year	0	376,090	376,090
Dividends	0	(150,000)	(150,000)
Shares issued	5,000	0	5,000
At 31 March 2016	**45,000**	**2,397,440**	**2,442,440**

Approaching the question

This may look similar to a type of question you may have seen in financial reporting and/or financial management examinations previously. However, your perspective in this case is quite different. Remember that you are an audit manager and expected to apply professional scepticism, looking for audit risks, not assuming that the draft financial statements are error-free or have not been deliberately manipulated. Your task, in fact, is to identify areas where the risk of this having happened is greatest. The initial analytical procedures will not – by themselves –prove anything but they will provide a starting point for the audit team to focus on.

Other points to be remembered include the following

- At this level not many marks will be awarded for the mere calculation of ratios – much more important are the decision around which ratios to calculate and the interpretation of them.
- You should calculate ratios to the level of detail the information provided allows – normally ratios to one place of decimals are sufficient unless there is a contrary indication in the question. Statistics that are traditionally given in days (such as inventory holding periods) should be rounded to the nearest day. Otherwise as long as you calculate the ratio in a reasonably sensible and logical way, utilising the information provided you will receive the available marks.
- You are not primarily concerned with the performance of the company (as you would be in, say, a financial management examination); but please remember that particular difficulties could give rise to, for example, extensive testing around going concern.
- Always look for, and exercise professional scepticism in relation to, inconsistencies between what the scenario tells you and what the figures say e.g. an increase in turnover could occur purely due to a decrease in price and could be in spite of a decrease in the volume of sales (and vice-versa).
- You are quite often asked in these questions (as in this case) for other information you would you need/request from the client. This is quite an important point.

Suggested solution

Ataturk Ltd.

Preliminary Analytical Review of Financial Statements

Year Ended 31 March 2016

Calculations based on the information supplied reveals the following:

Ratios	**2016**	**2015**
Increase in turnover (in percentage terms)	18.2%	n/a
Gross Profit percentage	24.6%	23.9%
Net Profit percentage (before tax)	9.5%	7.9%
Effective rate of corporation tax	42.6%	41.5%
Dividend Payout ratio (based on current year)	39.9%	37.4%
Current Ratio	0.81	0.74
Liquid Ratio	0.75	0.70
Inventory Turnover (Cost of Sales / Average Inventory)	98.36	95.14
Inventory holding period in days	4	4
Receivables days(based on average receivables)	41	47
Payables days(based on average payables)	27	33
Asset utilisation - PPE	2.5	2.3
Gearing; Non Current Liabilities; Shareholders funds	11.0%	9.3%
Return on Investment (Profit after tax as a percentage of shareholders' funds plus non-current liabilities)	13.9%	10.9%
Finance Costs as percentage of long term debt	9.9%	17.9%

General Comments: The financial performance of the company would appear to be stable, consistent, and profitable, and to show a satisfactory return on investment. Most of the key indicators would appear to have improved in the past year – turnover, rate of gross profit, liquidity, rate of asset turnover, and return on investment have all apparently improved. The company's cash balances have improved over the last couple of years but the company is not particularly cash rich. This, combined with our previous cumulative auditing knowledge and experience, would suggest that this is a low risk assignment.

One other point of note is that the company is below the current €8,800,000 threshold requirement for actually having an audit so we should be sure that the client is informed about the possibility that they may be eligible for audit exemption.

The Statement of Comprehensive Income and Retained Earnings:

The company increased its revenue by 18% during the period under review and simultaneously improved the gross and net profit percentages. This, if valid, represents a very considerable achievement. We should, however, exercise professional scepticism because there is a risk that revenue is overstated and/or certain expenses which should have been included in cost of sales have been concealed or understated. However, for this company, misstatement of inventory is less of a risk due to the low level being carried (see below).

In relation to other expenses, finance charges as a percentage of long term loans have plummeted so there is a risk that finance charges are understated. More detailed information about the dates various loans were drawn down or repaid would assist us in assessing the reasonableness of the finance charge.

The effective rate of corporation tax appears to be extremely high (albeit consistent with last year) so we will need, at a minimum, to request a breakdown from the client how the charge is calculated and to be satisfied that it is not being overstated. Management should also be asked about the increase in the current tax liability from last year to this year.

The Statement of Financial Position

Asset utilisation

The company obviously operates some type of Just-in Time inventory control and inventory is kept exceedingly low. This nearly eliminates any material risk of obsolescence or overstocking. We will concentrate on the inventory system, and seek to test controls embedded in the system, rather than year- end counts.

We appear to have become more efficient at collecting debts during the year which is, again, an achievement considering that turnover increased by 18% during the year. We are, however, still taking a third longer to collect our debts than to pay our trade payables. However, there is nothing in particular to suggest that there are any unrecorded trade payables or impaired trade receivables.

Gearing

Gearing is, by any standards, low although it has increased by a small amount during the year under review.

Provisions

These are fairly substantial across the three dates for which we are given figures. There is a risk that such a substantial figure is not warranted; that the criteria in IAS 37 are not fulfilled.

Finance Leases

The current draft of the financial statements includes a liability identified as being in respect of finance leases. However, details of property, plant and equipment on the SOFP does not distinguish assets held under finance leases. This is a requirement of IAS 17 and currently represents a risk of material misstatement.

Suggested Marking Scheme

This is typical of what a marking scheme for this type of question would look like.

	Max Mark
Calculation of Ratios (an appropriate calculation of a range of ratios, percentages, or other statistics covering both years and including profitability, liquidity, solvency, etc would be required for full marks)	6
General Comments covering financial performance of business as whole, audit threshold or similar matters	5
Comments specific to SOCI and retained earnings including extra information to be requested from client	4
Comments specific to SOFP including extra information to be requested from client and covering asset utilisation, gearing, and other sundry observations	6
Other relevant comments	3
Maximum available marks	**24**
Maximum marks that may be awarded	**20**