

CA FINAL
M-BOOK

CA Aseem Trivedi's
STANDARDS ON AUDITING
SA 520



*Highbrow*MENTOR
Knowledge Series

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SA-520 (R)

SA-520 - Analytical Procedures - [Effective Date 01.04.2010]

Q.1. Why This SA?

This Standard on Auditing (SA) deals with the Auditor's use of Analytical procedures as Substantive procedures ("Substantive analytical procedures"), and as procedures near the end of the audit that assist the Auditor when forming an overall conclusion on the Financial Statements.

The objectives of the Auditor are:

- ◆ To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- ◆ To design and perform analytical procedures near the end of the audit that assist the Auditor when forming an overall conclusion as to whether the financial statements are consistent with the Auditor's understanding of the entity.

Q.2. What do you mean by Analytical Procedure?

“Analytical Procedures” means

- ◆ Evaluations of Financial Information
- ◆ Through analysis of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass 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.

Q.3. What do you mean by Substantive procedures?

Substantive procedures are intended to create evidence that an Auditor assembles to support the assertion that, there are no Material misstatements in regard to the completeness, validity, and accuracy of the financial records of an Entity. Thus, Substantive Procedures are performed by an Auditor to detect whether there are any Material Misstatements in

accounting transactions. Analytical procedures are also one of the Substantive procedures.

Q.4. To what extent an Auditor can rely on Analytical Procedures?

The EXTENT of reliance that the Auditor places on the results of Analytical procedures depends on the following factors:

- ◆ **Materiality of the items involved**, For Example, when inventory balances are material, the Auditor does not rely only on Analytical procedures in forming conclusions. However, the Auditor may rely solely on Analytical procedures for certain income and expense items when they are not individually material;
- ◆ **Other Audit procedures directed toward the same Audit objectives**, For Example, other procedures performed by the Auditor in reviewing the collectability of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;

- ◆ **Accuracy with which the expected results of analytical procedures can be predicted.** For example, the Auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and
- ◆ **Assessments of inherent and control risks,** For Example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.



CASE STUDY

Q.5. A LTD. is a multi-product company of which you are an Auditor. Article of your firm reported that despite of double turnover, net profit of the entity has gone down by less than half of last year.

He concluded following:

- ◆ Average purchase price per unit is same
- ◆ Average sales price per unit is same
- ◆ Direct and indirect cost per unit is same
- ◆ No extraordinary item in profit and loss statement
- ◆ No change in Accounting Policies
- ◆ No change in estimates

Illustrate your article the reason with the help of an example.

In given case, it's a multi-product company whose turnover is doubled when compared to last year's while net profit has gone down to half in spite there is no change in average purchase/ sales price, direct/

indirect cost, fixed overhead, no extra ordinary items and no change in Accounting Policies and estimates.

In a multi-product company such situation may arise due to variation in sales mix. It may happen that the sales price of product is high while the contribution of the same per unit may be less while other side some products may have high contribution while selling price may be low when compared to contribution.

Q.6. During the Audit of an entity you found that there was huge cash in hand throughout the year. What additional procedures would you like to apply?

During the Audit of an entity we found huge cash in hand throughout the year. As an Auditor we should we should check that whether the nature of business requires such cash in hand or not. Generally some industries are cash intensive in a nature, because there maximum business is in cash i.e. their purchase and sales are in nature of cash payments and receipt, this is one of the main reason why that there is requirement of business to hold as much cash as they are holding on continuous basis. And to conform that firm is

maintaining the cash as shown in cash book, Auditor should physically verify the cash and also ensure that if there is any insurance policy taken or not by an entity. There can be another reason for having such a huge amount of cash in hand, which the cash collection happens in the 2 half of the day in an entity when the banks are closed. Here Auditor should check whether the same cash collected is deposited in bank next day or not. This kind of cash cycle is generally found in retail business.

Auditor should also check the cash flow statement and also see the financing activities of an entity and the inflow of cash due to this and also outflow from operating activities.

Auditor also needs to check the Balance Sheet, for viewing the status of the fund. If it is found that the cash in hand is huge and the C.C. or O.D. of an entity is also utilized at maximum level, there are chances that company is having low cash in hand, actually there may be chances of Misstatement and improper presentation. In this situation Auditor should take appropriate action on an entity for physical verification of cash.



PRACTICE PROBLEMS

Q.7. Analytical procedures are unable to help the Auditor in determining the Nature, Timing and Extent of other Audit procedures at the planning stage.

False, SA-520 “Analytical Procedure” states that application of Analytical procedures helps the Auditor to understanding the entities business and performances and it will also assist him in determining the nature, timing and extent of Audit procedures.

Q.8. A trader is worried that in spite of substantial increase in sales compared to earlier year, there is considerable fall in Gross profit after satisfying himself that sales and expenses are correctly recorded and that the valuations of inventories is on consistent basis, he wants to ensure that purchases have been truthfully recorded. How will you proceed with this assignment?

While verifying whether purchases are truthfully recorded or not, the Auditor has to apply following procedures.

1. Apply Analytical procedures.
2. Apply Tests of Controls.
3. Apply detailed Substantive Procedures.

Apply Analytical Procedures: - Auditor shall perform the ratio analysis as Cost of sales, Average purchase price of last year as compare to the previous year, Inventory turnover ratio etc. This will guide him to apply further Audit procedures.

Study and evaluation of internal control system

- ◆ Requisitioning the goods: The purchase requisition is sent to the purchase department from the stores department only on reaching to reorder level.
- ◆ Ordering the goods requisitioned: Whether all purchase orders are being issued only from purchase department and either approved by purchase manage or by Board of directors (if required in case of high value purchases) and whether serially numbered purchase orders have been generated.

- ◆ Receiving the goods ordered: Goods ordered should be inspected and counted by the Store department. If satisfied, it prepares serially numbered MRN (material received note) and forwards its copies to the stores, purchase department and accounts department.
 - ◆ Release of the payment: The accounts department is processing the payment only after getting the copies of invoice, MRN, PO, and QC report about the material.
 - ◆ Physical controls at stores department over the inventory are proper or not.
3. **Vouching of purchases transactions:** - The Auditor should vouch credit purchase in the following manner:
- The Auditor should examine the transactions recorded in the purchase book with reference to related purchase invoice.
 - The Auditor should select a small sample of vendor's invoices at random and should conduct in-depth Audit on them to verify the invoices, MRNs, Pos, QC reports etc.

- The Auditor should ensure the numerical sequence of source documents.

Q.9. Give various factors, which result in increase in Gross Profit.

Followings may be the factors affecting Gross Profit:

- ◆ Under valuation of opening stock;
- ◆ Overvaluation of closing stock,
- ◆ Changes in policy for valuation of closing stock,
- ◆ Entry of fictitious purchases to boost up the profits,
- ◆ Inclusion in the closing stock rejected goods due for return,
- ◆ Inclusion in the closing stock goods received and unapproved,
- ◆ Understatement of direct wages and other direct expenses,
- ◆ Change in sales mix if the entity is dealing in multi products and quantity of the goods sold with higher margin

Q.10. While auditing accounts of Shayam Industries Limited you discover that the rate of gross profit on sales has sharply risen in comparison to the previous year. State 8 possible causes of such increase and the steps you would take to satisfy yourself.

Possible 8 causes may be: -

- ◆ Increase in sales price,
- ◆ Decline in raw material / labour cost,
- ◆ Mechanization or automation of process,
- ◆ Changes in sales Mix,
- ◆ Inclusion of goods sold on approval in sales,
- ◆ Change in valuation method of inventory,
- ◆ In appropriate cut off procedure,
- ◆ Discontinuance of discounting policies.

Q.11. A trader is worried that in spite of the substantial increase in sales as compared to the earlier year there is considerable fall in gross profit. After satisfying himself that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants you to ensure that the purchases have been truthfully recorded. In this circumstances, how would you proceed with the assignment?

- ◆ Evaluation of the internal control procedure from indent to payment against invoice.
- ◆ Verification of invoices with purchase register.
- ◆ Verification of authorization of purchases.
- ◆ Verification of total of purchase invoices.
- ◆ Verification of debit note issued and credit note received.
- ◆ Analysis of increase in purchase price during the period and its reasonability.
- ◆ Material purchased for capital project purposes included in purchases.

◆ Reconciliation of account of big and regular suppliers.



THIS SA IN EXAM

Q.12. The reliability of data is influenced by its Source and Nature and is dependent on the circumstances under which it is obtained. Accordingly, what are the relevant criteria, which determine whether the data is reliable for the purpose of designing Substantive Analytical procedures? (Nov 15/ 4 Marks)

The relevance of the data for the purpose of designing the substantive analytical procedures can be derived from:

- ◆ The test of details; and
- ◆ Analytical procedures

The decision about which if the above is to be used to achieve a particular audit objective is based on the Auditor's judgment about the expected effectiveness and efficiency of the available procedures in reducing the detection risk for specific assertions in the financial statements.

Q.13. In the Audit of Hotel Great Stay Ltd. its Auditor wants to use the analytical procedure as substantive Procedure in respect of room rental income as well as payroll costs. Guide him as to how it can be done. (Nov 13/ 4 Marks)

Hint: As per SA 520 on “Analytical Procedures”, in some cases, even an unsophisticated predictive model may be effective as an analytical procedure. In case of Payroll cost - Where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the Auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing Audit Evidence for a significant item in the Financial Statements and reducing the need to perform tests of details on the payroll. In case of Room Rental Income of Hotel- Different types of analytical procedures provide different levels of assurance. Analytical procedures involving the prediction of total rental income in case of Hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and

may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified.

