

# Chapter 8: Analytical Procedures

## Examples and Case Studies

### 1. Topic: Concept of Analytical Procedures

**Illustration:** CA Amar wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2020-21. The rent amounts to Rs.50, 000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs. 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?

**Solution:** If CA Amar checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid Rs. 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Amar may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Amar applies analytical procedure i.e. **compares** the rent payment by XYZ Ltd. with the **similar payments made by companies in similar industry and similar area**, he will notice an **inconsistency** in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Amar does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

### 2. Topic: Application of Analytical Procedures

**Illustration:** Analytical procedures involve analysis of relationship among financial and non-financial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2020-21.

**Solution:** The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the **relationship between wages per worker and total number of workers** across all the factories. i.e., **Total wages = Wages per worker x Total number of workers**. Here **wages per worker is financial data** i.e. in Rs. and total **number of workers is a number which is a non-financial data**.

Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in Rs.) by analyzing the relationship between wages per worker (in Rs.) which is financial data and number of workers which is a non-financial data.

### 3. Topic: Application of Analytical Procedures

**Illustration:** CA Brijesh, while verifying the travelling expenses of PRT Ltd., may compare the travelling expenses of current year amounting to Rs. 2.50 lakhs with previous year travelling expense of PRT Ltd. amounting to Rs. 2 lakhs and infer that there has been an increase of 25% in the travelling expense incurred by the company. CA Brijesh may compare such percentage increase with the trend of the earlier several years.

Thus, CA Brijesh, can use **comparable information for prior periods** of PRT Ltd. while applying analytical procedure with respect to the expenses incurred by the company.

### 4. Topic: Techniques available as Substantive Analytical Procedures

**Trend Analysis:** The auditor may compare the **salary paid by the company during the year under audit with the salary paid by the company for several earlier years**. There may be some percentage increase in the salary expense over the years. However, an unusual increase in such expense amount may indicate that fraudulent payments are being made to fake employees.

**Ratio Analysis:** The statutory auditor can review the **Gross profit ratio** of the company for the year under audit. The auditor can further **compare** such GP ratio with the GP ratio of the company in the **earlier years** or the GP ratio of the **other companies** in the same industry for the year under audit.

**Reasonableness Test:** Interest expense against interest bearing obligations, Raw Material Consumption to Production (quantity), Wastage & Scrap % against production & raw material consumption (quantity), Work-in-Progress based on issued of materials & Sales (quantity), Sales discounts and commissions against sales volume, Rental revenues based on occupancy of premises.

## Correct-Incorrect Questions

- i. Ratio analysis is useful in analyzing revenue and expense account only.

**Incorrect:** Ratio analysis is useful for analysing **asset and liability** accounts **as well as revenue and expense accounts**.

- ii. Reasonableness test rely only on the events of the prior period like other analytical procedures.

**Incorrect:** Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon **non-financial data** for the audit period under consideration.

- iii. The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.

**Incorrect:** Analytical procedures **may be** applied to consolidated financial statements, components and individual elements of information.

## **Theoretical Questions**

- i. The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on “Analytical Procedures”?  
**Hint:** Investigating Results of Analytical Procedures – Inquiring of management, **obtaining audit evidence and performing other audit procedures.**

- ii. While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?

**Hint:** Techniques for performing Substantive Analytical Procedures – Trend Analysis, Ratio analysis, reasonableness test and structural modelling.

- iii. Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

**Hint:** Uses of Analytical procedures in planning – Understanding the entity, identifying potential RMM and determining the NET of other audit procedures.