Audit problem 4-58 essay

Ratio analysis uses a combination of financial or operating data from a company or industry to provide a basis for comparison. Every ratio in the analysis measures a distinctive association that may have an impact on another ration. An auditor use a financial or accounting ratio to evaluate the overall financial condition of a company. Current and prospective stockholders and creditors used ration analysis to gauge viability and future performance of a company. The performance of a company is usually evaluated by comparing its current and past figures with those of the industrial average.

A successful auditor used ration analysis to read between the lines of financial statements and make sense of the numbers in the statement. The auditor uses it to compare what they expect from the clients with the actual figure the clients produce. Ratio analysis is a most effective measure because it makes use of economic relationship between two or more accounts. There is a question mark regarding the ratio analysis of Indianola Pharmaceutical Company. Comparing the current year ratio with the previous three years and the current industry ratio does not produce identical figures.

There are a lot of inconsistencies between the current year ratios and the current industry ratio. Based on the ratio analysis provided, it is reasonable to conclude that there is a high financial reporting risk in the balance sheet of Indianola Pharmaceutical Company. Current ratio is a liquidity ratio that measures a company’s ability to pay short-term obligations. Current ratio is about a firm’s ability to use its short-term assets to pay back the short-term liabilities. A higher current ratio means the company is more capable in paying its obligations.

There are many reasons as to why the company is experiencing a low current ratio. It could be because the company is having trouble getting paid on their receivables or have a long inventory turnover. Another liquidity ratio that needs to be considered is the quick ratio. The quick ratio is a liquidity indicator that defines the current ratio further by measuring the amount of the most liquid current assets there are to cover current liabilities. The quick ratio is seen as more conservative than the current ratio because it exclude inventory and other current asset which are could not be easily turn into cash.

There are dissimilarities in the quick ratios of Indianola Pharmaceutical Company. Like the current ratio, the quick ratio of the company has been decreasing from the previous three years. There is also a wide margin between the current quick ratio and the average of the current industry. The lower quick ratio indicates that the company is having problem with its liquidity level. Times interest earned or interest coverage ratio is another financial risk ratio that raised concern about the company’s health.

The times interest earned indicates the degree of protection available to creditors by measuring the extent to which earnings available for interest covers required interest payments. A company with a lower interest coverage ratio has a higher burden and greater possibility of default. The interest coverage ratio acts as a safety gauge for creditors and bond holders. It gives a sense of how far a company’s earnings can fall before it will start defaulting on its bond payments. The times interest earned of Indianola Pharmaceutical Company put the company in a very difficult situation.

The figures in the analysis are an indication that the company is having a hard time meeting its interest payments. Indianola had a high interest coverage ratio in the last three years and it drop to about half in the current and previous years. The current and previous year figures are no close to the current industry average. Such a wide margin between the current and the industry average need to be investigated by the audit engagement team. The debt equity ratio also has to be considered in performing the audit. The debt equity ratio is a company’s financial leverage.

It is used as an indicator as to what proportion of equity and debt the company is using to fund its assets. It is a leverage ratio that compares a company’s total liabilities to its total shareholders. A company with a high debt equity ratio means that the company is using a lot of outside financing to finance their company. A lot of the business expenses would be used towards repaying these loans. The current high debt to equity ratio of Indianola Company is an indication that the company is using a lot of outside financing to finance its operations instead of using revenue.

The company has a current debt to equity ratio which is more than half to the current industry ratio. Comparing the current to the previous two years also show an increase in debt to equity ratio of more than half. This does not put the company in a suitable position. The auditor needs to set a high audit risk in planning the audit because of the risky nature of the company’s financial statement. The auditor need to obtain sufficient understanding of the internal control structure of Indianola Pharmaceutical Company to determine the nature, timing, and extent of tests to be performed.

The auditor has to use the audit risk model in planning the audit. The audit risk model is comprised of inherent risk, control risk, and detection risk. The inherent risk help the auditor evaluate how susceptible the financial statements assertions are to material misstatements given the nature of the clients business. Inherent risk is affected by a number of factors including environmental and external factors. Rapid change in a company's inventory level due to high obsolete could experience high inherent risk. Expiring patent could also bring about inherent risk.

If Indianola Pharmacy has a patent which is expired or expiring soon, it could face high inherent risk because of the competition the company might be facing. Prior period misstatement could also course Indianola to have high inherent risk. The auditor has to examine the inherent risk and factors that affect it in planning the audit. Control risk is related to the effectiveness of client's internal control policies and procedures. It is a risk that misstatements could occur in an account balance or class of transactions and could be material, individual.

The risk associated with the Pharmaceutical Company could be as a result of weak internal control. Material errors could not be detected if there is a weak internal control. The auditor needs to test the Indianola internal control over financial reporting in conducting the audit. Detection risk occurs when the auditor does not use the right audit procedures or use them incorrectly. After assessing inherent and control risk, the auditor then solve the audit risk equation by assigning detection risk to reduce the audit risk to an acceptable level.

It is unlikely to eliminate detection risk completely because it will be impossible for the auditor to look at each and every transaction. It is the responsibility for the auditor to plan the audit using the audit risk model described above. Other important background information that need to be obtained in planning the audit include understanding the business and its risk, understanding key business processes and understanding management's risk management and control processes.

The auditor would have to make use of various tools at its disposal to understand the client's business and its business risk. The auditor needs to monitor the financial press and various Security and Exchange filings of various businesses within the clients industry. In the case if the Indianola, the audit clients need to understand the Pharmaceutical business by looking at carious Security and Exchange Commission filings and brokerage analysis. This will enable the audit team on the engagement learn about the client and the business it is operating.

The audit team also has to understand key business processes. It needs to look at the company and identify its key competitive advantage. The audit team also has to understand management's risk management and control. The auditor would usually adopt a number of techniques to understand the risk management and control processes. Such techniques include developing understanding of the processes used by Indianola's board of directors and management to evaluate and manage risk. The engagement team also has to interview management and key employees about its risk approach.

Every company has the approach it uses to manage its internal and external risk. Key document about risk also has to be reviewed. Based on the information supplied in the analysis, it could be viewed that the company took a drastic actions in the immediate preceding year. Observing the figures indicate a similarity between the current and the immediate preceding year. Comparing the two current years with the two previous years, it is evident that Indianola Pharmaceutical Company made some changes in its financial statements.