

# Auditor preliminary analytical procedure



**ASSIGN  
BUSTER**

Auditors are required to prepare the preliminary analytical procedure at the planning as a part of the risk-assessment procedures under ASA 315. 6. The definition of preliminary analytical procedure is that ‘ comparison of client ratios to industry or competitor benchmarks provides an indication of the company’s performance’. The purpose of preliminary analytical procedure is to obtain understanding of the client’s company and industry. (textbook)

In common, two major stages, simple comparisons and ratio analysis, are used by auditors during analytical procedure; however ratio analysis is a better understanding of the entity. Based on the data from question 6. 33, the analysis procedure is allocated in two major stages. (textbook)

Simple comparisons.

Simple comparison is to compare amounts between the 2009 financial statements and 2010 financial statements of Gourmet Pty Ltd.

The “ net profit” increases from \$56 240 000 in 2009 to \$63 562 000 in 2010, the increasing amounts are up to \$7 3220 000.

The “ total shareholders equity” increases from \$141 300 000 in 2009 to \$204 862 000 in 2010, the increasing amounts are up to \$63 562 000.

The performance of company is better from 2009 to 2010 in respect of above data, because company owns a steady and experienced management team; attempts to extend the range of products in order to enhance competition of industry and depends on appropriate strategy to acquire other smaller competitors. The simple comparison is a general analysis, however, auditor need to use ratio analysis in order to obtaining the specific data.

## Ratio analysis

Based on 6. 33, following ratios could be calculated for analysis.

The “ current ratio” is 0. 195 in 2009 and 0. 280 in 2010. These two ratios are less than the better benchmark 2, even are lower than positive current ratio 1. 5 as well.

The “ quick asset ratio” is 0. 070 in 2009 and 0. 096 in 2010.

The “ gross profit ratio” is 0. 481 in 2009 and 0. 463 in 2010.

The “ net profit ratio” is 0. 183 in 2009 and 0. 193 in 2010.

The “ debt to equity ration” is

7. 30

(a) ‘ The inherent risk is the susceptibility of an account balance, class of transactions or disclosure to material misstatement given inherent and environmental characteristics, but without regard to internal control.’

(textbook) Based on the background information from 6. 33, following factors could impact the inherent risk:

A new finance director has joined in the company. The change of important management position would increase inherent risk. At the same time, the new finance director will face pressure to outperform pervious result; the pressure could provide an incentive for him or her to involve the misstatement and fraud of financial report. Also the inherent risk would increase.

The company owned 25 outlets of varying sizes and geographic locations, which would increase inherent risk, because it is hard to be controlled by managers of entity.

Company has signed contract regarding the construction and development of a restaurant and entertainment complex, which would increase inherent risk due to the lack of expertise about the new market.

The company installed a new computer system; the change of information technology may not work as expected or may be unreliable and could affect the accuracy of financial report. Therefore, the inherent risk would be increased.

(b)(i) Based on the audit risk model, three components consist of audit risk: inherent risk, control risk and detection risk. The increase of inherent risk will result in that misstatements likely to occur in company's financial report, which would lead to the increase of audit risk as well.(textbook)

(c) The level of materiality should be considered as a key point to plan the nature, timing and extent of audit procedure, and the relationship between audit risk and materiality is inverse. (textbook)Therefore, the amount of preliminary materiality level reduced from \$5000000 to \$3200000 after review of inherent risk, because that the inherent risk is higher than the auditor's anticipation. Thus, auditor should increase the extent of audit procedures, selecting a more effective audit procedure and performing audit procedures closer to the balance date, particularly in respect to account is considered importantly by auditors.(text book)

## 8. 34

(a) The objectives of internal auditors are that ' Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations.' (Adam Cunningham). ' The internal auditor's scope of work is comprehensive. It serves the organization by helping it accomplish its objectives, and improving operations, risk management, internal controls, and governance processes.'

([http://www.theiia.org/theiia/about-the-profession/internal-audit-faqs/? i=1086](http://www.theiia.org/theiia/about-the-profession/internal-audit-faqs/?i=1086))

External auditor is to verify that the annual accounts provide a true and fair picture of the organisation's finances; and that the use of funds is in accordance with the aims and objects as outlined in the constitution.

The scope of external auditors

(b) External auditor can adopt the information from internal auditor included that:

The internal audit function as a part of the internal control, will impact the external auditor's assessment of control risk and the scope of audit procedures.

The descriptions and other documentation of internal control will contribute the external auditor to gain an understanding of the company's internal control.

The direct assistance by internal auditor will help external auditor to make substantive test or tests of controls(textbook)

(c) Along with internal auditor involved in assessing the company strategy and identifying the associated risks, which will provide helps for the external auditor regarding to undertake a business risk approach to the audit. In addition, internal auditors should hold adequate skills, knowledge, experience, integrity and objectivity to ensure the effective information for external auditor. (textbook) Based on the information on 8. 34, Gourmet Pty Ltd owns an experienced and professional internal auditing team. However, the external auditor should consider carefully for these information, because that “ the objectives of the internal auditor should be the same as the objectives of the company” (David A. Wood). Therefore, external auditor must select information under the requirement of independent audit.

(d) The objective 1, objective 2 and objective 4 are related to ensure the effective operation and acquirement of maximal benefit for company, which are not included in control activities. The control activities is that ‘ policy and procedures that pertain to performance reviews, information processing, physical controls and segregation of duties’. (Textbook) Therefore, the objective 3, objective 5 and objective 6 are related to internal control activities, which are need to be relevant to external auditor.

9. 35

(a) The related internal control must be identified effectiveness if auditors plan to rely on this control. Therefore, auditors need to set out tests of control to confirm effectiveness of controls. From this case, the audit partner

<https://assignbuster.com/auditor-preliminary-analytical-procedure/>

has decided to use the work of the internal audit group (LAG). One of the work papers from LAG is to examine payments made to creditors throughout the year and determine whether the procedures laid down in the Accounting Manual have been properly followed. On the other word, this paper is related to the tests of control about payment. The result of this test indicates some errors:

(i) Payments that were not matched to an approved purchase order, however, all other documentation was attached.

The objective of this is to test the occurrence of purchases of inventory transaction. This error implies that related transaction may not occur or the transaction is unauthorised.

(ii) Payments that were not made to an approved supplier.

The objective of this is to test the occurrence of purchases of inventory transaction. This error implies that related transaction may not occur or the transaction is unauthorised.

(iii) Payments that were authorized by a second party, although this was not required.

The notes explain that new financial accountant being unaware of firm policy. Although it has been remedied, the related transactions may do not occur or is unauthorised.

(iv) Payments that had no supporting documentation attached.

The objective of this is to test the occurrence of cash disbursements transactions. This error implies that related transaction may not occur or the transaction is unauthorised or the goods or services may not receive.

(v) Payments that did not bear evidence that computation on creditors' invoices had been checked.

The objective of this is to test the accuracy of purchases of inventory transactions. The error implies that related transactions are not recorded correctly.

Also, these errors indicate that the internal control regarding payments is not very effective, because the proportion of error is almost 28% of 60 samples. It means that the risk of this related internal control is higher than average level.

(b) Under this situation, external auditors should consider whether the evidences adopted by internal auditors are satisfied sufficiency and appropriateness. Particularly in respect of the appropriateness should be discussed here. Gourmet Pty Ltd is a large private company; therefore it must have a large volume of transactions. If internal auditors only selected 60 samples, it should be considered by external auditors that the amounts of samples are not sufficient and the control risk is higher than its actual level. Therefore, they can choose to increase the extent of test of control to try to reduce the risk level to an acceptable level. If the control is still not working as they expected, they can choose increase the extent of substantive testing in order to continual reliance on this control. If the control risk still can not be reduced by these tests of control, external auditors will give up the reliance



on the control. In effect, auditors have determined that control does not exist or the existence of control can not provide reliable evidence. (textbook)