

## Analytical procedures

- Include both financial & non-financial information
- Analytical procedures may help identify the existence of
  - **unusual transactions** or
  - events and amounts,
  - ratio and trends
    - that might indicate matters that have audit implications.
- Unusual or unexpected relationships may assist the auditor in identifying ROMM
- Analytical procedures using high-level aggregated data, often employed in risk assessment, offer a general initial indication of potential material misstatements
- In such cases combining these results with other gathered information helps auditors in evaluating and understanding these initial findings.

CA Srishti, while auditing KSM Private Limited for the first time, utilised software to analyse financial data, comparing amounts recorded in the financial statements for the current audit year with the preceding two years. Her objective was to evaluate the risk of material misstatement.

Identify the type of audit procedure performed by CA Srishti in the given case, discuss its relevance, and explain whether an auditor's opinion can solely rely on such procedures

**1. Analytical Procedures Include Financial & Non-Financial Information**  
 👉 The auditor reviews SuperMart's sales growth rate (financial data) and customer footfall trends (non-financial data). If sales are rising but footfall is declining, this inconsistency requires further investigation.

**2. Identifying Unusual Transactions or Events**  
 👉 The auditor notices an unusually high advertising expense in one month. Further review reveals that SuperMart made a bulk prepayment to an advertising agency, which is an irregular transaction.

**3. Identifying Unusual Amounts, Ratios & Trends**  
 👉 The auditor compares Gross Profit Margin (GPM) of SuperMart Ltd. over the last three years:

- Year 1: 32%
- Year 2: 30%
- Year 3: 18% (sudden drop)

The sharp decline in GPM raises suspicion. The auditor investigates and finds that purchase costs increased significantly, but sales prices were not adjusted, leading to margin erosion.

**4. Identifying ROMM through Unexpected Relationships**  
 👉 The auditor observes that inventory costs have increased, but sales revenue has not proportionally increased. Normally, if purchases rise, sales should also rise. This unusual relationship suggests:

- Overstatement of inventory (possible misstatement in accounts).
- Theft or fraud in inventory records.

The auditor digs deeper into inventory records and identifies bogus purchase entries, confirming the risk of fraud.

**5. Using Aggregated Data for Risk Assessment**  
 👉 At the start of the audit, the auditor examines:

- Total revenue trend for five years.
- Industry growth rate compared to SuperMart's growth.
- Major expense heads (rent, salaries, utilities, etc.) over time.

The auditor notices that SuperMart's revenue grew only 5% while the industry grew by 12%, indicating possible operational inefficiencies or revenue recognition issues.

**6. Combining Analytical Results with Other Evidence**  
 👉 After noticing the unusual inventory cost increase and declining sales, the auditor:

- Examines supplier invoices to verify purchase amounts.
- Conducts physical inventory verification at warehouses.
- Interviews the store managers about slow-moving stock.

This combination of analytical insights + detailed verification helps confirm whether the issue is a misstatement, fraud, or genuine business downturn.

Observation and inspection	
Observation and inspection may <u>support inquiries</u> of management and others, and may also provide information about the entity and its environment.	
Examples of such audit procedures include observation or inspection of the following	Entity's operations
	Documents (business plans and strategies), records, and IC manuals.
	Reports prepared by MGMT (quarterly management reports and interim FS) and TCWG (minutes of BOD's meetings)
	Entity's premises and plant facilities

## Understanding the entity—a continuous process 🔥

Understanding an entity

- is a **continuous, dynamic** process
- Establishes a **frame of reference** for planning of audit and professional judgment for the following
  - Assessing **ROMM - SA 315**
  - Determining **Materiality** as per SA 320
  - Considering appropriateness of selection and application of **accounting policies**
  - Identifying areas where **special audit consideration** may be necessary - SA 315
  - Developing **expectations** for use when performing **analytical** procedures - SA 520
  - Evaluating the **sufficiency** and **appropriateness** of audit **evidence** - SA 500

## Why is understanding the entity and its environment significant?

- Helps in
  - **planning** the audit
  - **Identifying** areas requiring **special attention**.

Gaining knowledge about a client's business is one of the important principles in developing an overall audit plan.

### Understanding the Entity and its Environment 🔥

As per SA 315, auditor should obtain an understanding of following:

- Relevant **industry, regulatory** & other **external** factors including AFRF
- Nature of the entity including
  - its **operations**;
  - its **ownership** and governance structures;
  - **types** of **investments** that entity is making & plans to make
  - **way entity** is **structured** and **how** it is **financed**;
- Entity's selection and application of **accounting policies**, including reasons for changes thereto.
- Entity's **objectives** and **strategies**, and **business risks** that may result in ROMM
- Measurement and review of the entity's **financial** performance

### Relevant industry, regulatory and other external factors including AFRF

#### Industry Factors:

- Competitive environment, supplier and customer relationships, technological developments.
- Auditor considers market competition, seasonal activities, and product technology.
- Industry-specific risks due to business nature or regulation.

#### Regulatory Factors:

- Regulatory environment includes financial reporting framework, legal, and political environment.
- Auditor considers accounting principles, industry practices, regulations, taxation, government policies, environmental requirements.

#### Other External Factors:

- General economic conditions, interest rates, financing availability, inflation.

Knowledge of client's business is essential for audit.

Without adequate knowledge, a proper audit is not possible.

SA 315: Auditor must understand industry, regulatory, and external factors, including the financial reporting framework.

Substantiate with examples.

### The nature of the entity

- Understanding the nature of the entity helps the auditor assess complex structures (e.g., subsidiaries) that may create ROMM.

- Also helps in identifying and evaluating related party transactions.
- Examples of matters that the auditor may consider
  - Business **operations**
    - nature of revenue sources, products or services, conduct of operations, location of production facilities, key customers and suppliers of goods and services
  - Investment **activities**
    - capital investment activities and planned or recently executed acquisitions
  - Financing **activities**
    - major subsidiaries, debt structure etc.
  - Financial reporting
    - accounting principles and revenue recognition practices

### The entity's selection and application of accounting policies, including the reasons for changes thereto.

Evaluate whether the entity's a/c policies are appropriate for its business and consistent with AFRF and a/c policies used in the relevant industry

### The entity's objectives and strategies, and those related Business risks that may result in ROMM

- Entity's **Objectives, Strategies & Business Risks**: Help navigate changes & risks, including ROMM.
- **Business Risk vs. ROMM**: Business risk is broader but includes ROMM; arises from change or complexity.
- Auditor's **Role**: Understanding business risks aids in identifying ROMM but not required to assess all risks.
- Matters **Auditor May Consider**:
  - **Industry Developments**: Lack of personnel/expertise to handle industry changes.
  - **New Products & Services**: Increased product liability.
  - **Business Expansion**: Inaccurate demand estimation.

### The measurement and review of the entity's financial performance

- **Measurement & Review of Financial Performance**: Helps assess pressure to meet targets, increasing ROMM & fraud risk.
- Matters Auditor May Consider:
  - Key Ratios, Trends & Operating Statistics
  - Period-on-Period Financial Performance Analyses
  - Budgets, Forecasts, Variance Analyses & Performance Reports
  - Credit Rating Agency Reports

**Information obtained by performing risk assessment procedures  
- Used as audit evidence**

- Auditors can use information obtained through RAP & related activities as audit evidence to support their assessments of ROMM
- The auditor also may choose to perform SP or TOC concurrently with RAP because it is efficient to do so.

**Short Forms**

IR	Inherent Risk
CR	Control Risk
ROMM	Risk of Material Misstatement
TOC	Test of Control
SP	Substantive Procedures
IC	Internal Control
AFRF	Applicable Financial Reporting Framework
RAP	Risk Assessment Procedures
FR	Financial Reporting
SAAE	Sufficient Appropriate Audit Evidence