

ZAK CO

(a) With reference to ISA 520 *Analytical Procedures* explain

- (i) what is meant by the term 'analytical procedures'; (2 marks)
- (ii) the different types of analytical procedures available to the auditor; and (3 marks)
- (iii) the situations in the audit when analytical procedures can be used. (3 marks)

Zak Co sells garden sheds and furniture from 15 retail outlets. Sales are made to individuals, with income being in the form of cash and debit cards. All items purchased are delivered to the customer using Zak's own delivery vans; most sheds are too big for individuals to transport in their own motor vehicles. The directors of Zak indicate that the company has had a difficult year, but are pleased to present some acceptable results to the members.

The income statements for the last two financial years are shown below:

Income statement

	31 March 2008	31 March 2007
	\$000	\$000
Revenue	7,482	6,364
Cost of sales	(3,520)	(4,253)
Gross profit	3,962	2,111
Operating expenses		
Administration	(1,235)	(1,320)
Selling and distribution	(981)	(689)
Interest payable	(101)	(105)
Investment income	145	—
Profit/(loss) before tax	1,790	(3)
Financial statement extract		
Cash and bank	253	(950)

Required:

- (b) As part of your risk assessment procedures for Zak Co, identify and provide a possible explanation for unusual changes in the income statement. (9 marks)
- (c) Confirmation of the end of year bank balances is an important audit procedure.

Required:

Explain the procedures necessary to obtain a bank confirmation letter from Zak Co's bank. (3 marks)

(Total: 20 marks)



Key answer tips

Part (a) This was a purely knowledge based question, (i) what analytical procedures are, (ii) the types so comparisons should come to mind and (iii) when we can use them. Mentioning at the planning, testing and final stage will ensure an excellent answer.

Part (b), asks you to identify and explain with reasons for the unusual trends to the Income Statement, therefore analytical procedures are the key technique required here. A sound approach would be to identify the main features as revealed by a comparison between two years' figures and by identifying key relationships within each year's figures. Ensure you do not focus on the bank, as this is to support the interest figures.

Part (c), the words to focus on is procedures to obtain a bank letter, this is not scenario based so three points should be noted to score well.

(a) (i) Explanation of analytical procedures

Analytical procedures are used in obtaining an understanding of an entity and its environment and in the overall review at the end of the audit.

'Analytical procedures' actually means the evaluation of financial and other information, and the review of plausible relationships in that information. The review also includes identifying fluctuations and relationships that do not appear consistent with other relevant information or results.

(ii) Types of analytical procedures

Analytical procedures can be used as:

- Comparison of comparable information to prior periods to identify unusual changes or fluctuations in amounts.
- Comparison of actual or anticipated results of the entity with budgets and/or forecasts, or the expectations of the auditor in order to determine the potential accuracy of those results.
- Comparison to industry information either for the industry as a whole or by comparison to entities of similar size to the client to determine whether receivable days, for example, are reasonable.

(iii) Use of analytical procedures

Risk assessment procedures

Analytical procedures are used at the beginning of the audit to help the auditor obtain an understanding of the entity and assess the risk of material misstatement. Audit procedures can then be directed to these 'risky' areas.

Analytical procedures as substantive procedures

Analytical procedures can be used as substantive procedures in determining the risk of material misstatement at the assertion level during work on the income statement and statement of financial position (balance sheet).

Analytical procedures in the overall review at the end of the audit

Analytical procedures help the auditor at the end of the audit in forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

(b) Net profit

Overall, Zak's result has changed from a net loss to a net profit. Given that sales have only increased by 17% and that expenses, at least administration expenses, appear low, then there is the possibility that expenditure may be understated.

Sales – increase 17%

According to the directors, Zak has had a 'difficult year'. Reasons for the increase in sales income must be ascertained as the change does not conform to the directors' comments. It is possible that the industry as a whole, has been growing allowing Zak to produce this good result.

Cost of sales – fall 17%

A fall in cost of sales is unusual given that sales have increased significantly. This may have been caused by an incorrect inventory valuation and the use of different (cheaper) suppliers which may cause problems with faulty goods in the next year.

Gross profit (GP) – increase 88%

This is a significant increase with the GP% changing from 33% last year to 53% in 2008. Identifying reasons for this change will need to focus initially on the change in sales and cost of sales.

Administration – fall 6%

A fall is unusual given that sales are increasing and so an increase in administration to support those sales would be expected. Expenditure may be understated, or there has been a decrease in the number of administration staff.

Selling and distribution – increase 42%

This increase does not appear to be in line with the increase in sales – selling and distribution would be expected to increase in line with sales. There may be a mis-allocation of expenses from administration or the age of Zak's delivery vans is increasing resulting in additional service costs.

Interest payable – small fall

Given that Zak has a considerable cash surplus this year, continuing to pay interest is surprising. The amount may be overstated – reasons for lack of fall in interest payment e.g. loans that cannot be repaid early, must be determined.

Investment income – new this year

This is expected given cash surplus on the year, although the amount is still very high indicating possible errors in the amount or other income generating assets not disclosed on the balance sheet extract.

(c) Obtaining a bank letter

- Review the need to obtain a bank letter from the information obtained from the preliminary risk assessment of Zak.
- Prepare a standard bank letter in the format agreed with banks in your jurisdiction.
- Obtain authorisation on that letter from a director of Zak for the bank to disclose information to the auditor.
- Where Zak has provided their bank with a standing authority to disclose information to the auditors, refer to this authority in the bank letter.
- The auditor sends the letter directly to Zak's bank with a request to send the reply directly back to the auditors.