Gearing is a measure of external debt finance to internal equity finance. ROCE indicates the returns those investments generate.

Any change in gearing or ROCE could indicate a change in the financing structure of the business or it could indicate changes in overall performance of the business. These ratios are important for identifying potentially material changes to the statement of financial position (new/repaid loans or share issues) and for obtaining an overall picture of the annual performance of the business.

Ch 10 Problem 1 Αναλυτικές Διαδικασίες

e.g

Illustration 4: Murray Co Analytical Procedures

Murray Co Draft Financial Statements for the year ended 31 December 2012

Draft Statement of Financial Position as at 31 December 2012

	2012 $000	2011 $000
Non-current assets		
Property plant and equipment	5,350	4,164
Website development	150	0
	5,500	4,164
Current assets		
Inventory	2,109	1,555
Trade receivables	2,040	1,520
Cash and cash equivalents	48	49
	4,197	3,124
	9,697	7,288

Equity		
Share capital (50c shares)	2,100	2,100
Retained earnings	2,959	2,156
	5,059	4,256
Non-current liabilities		
Long term loan	2,800	1,500
Current liabilities		
Provisions	240	195
Trade and other payables	1,400	1,205
Accruals	18	12
Bank overdraft	180	120
	1,838	1,532
	9,697	7,288

Draft Statement of Profit or Loss for the year ended 31 December 2012

	2012	**2011**
	$000	**$000**
Revenue	21,960	19,580
Cost of sales	(18,560)	(17,080)
Gross profit	3,400	2,500
Operating expenses	(2,012)	(2,012)
Finance cost	(340)	(240)
Profit before tax	1,048	248
Taxation	(245)	(24)
Profit for the period	803	224

Information about Murray
(from ch 9 problem 2)

e.g

Illustration 3: Murray Co risk assessment

Your firm Wimble & Co has recently accepted appointment as auditor of Murray Co (a manufacturer of Sports equipment).

Having sold your shares in Murray Co, you have been assigned as audit manager and you have started planning the audit (although you were an employee of Murray Co, this was many years ago and you did not have any involvement in preparation of the financial statements). You have held a meeting with the client and have ascertained the following:

Murray Co manufactures sports equipment in its UK factory (the currency of the UK is the Pound Sterling). Components are sourced from suppliers in Europe, who invoice Murray Co in the Euro. Most items of equipment, such as tennis rackets, hockey sticks and goals, take less than one day to manufacture. Murray Co's largest revenue generating product, ergometers (rowing machines), takes up to one week to manufacture. Murray Co refurbished the assembly line for the ergometers during the year. Murray Co uses a third party warehouse provider to store the manufactured ergometers and approximately one quarter of the other equipment.

Historically, Murray Co has only sold to retailers. For the first time this year, Murray Co has made sales directly to consumers, via a new website. The website is directly linked to the finance system, recording sales automatically. Website customers pay on ordering. The website development costs have been capitalised. This initiative was implemented to respond to market demands, as retailer sales have fallen dramatically in the last two years. Some of Murray Co's retail customers are struggling to pay their outstanding balances. Several of the sales team were made redundant last month as a result of the falling retailer sales.

Murray Co is planning to list on the stock exchange next year.

Exercise:

Using the information provided, describe SIX audit risks and explain the auditor's response to each risk in planning the audit of Murray Co.

Exercise:

Using the information provided about Murray Co, perform analytical procedures on the draft financial statements above, and explain the audit risks that arise.

Solution: Murray Co analytical procedures

Audit risks identified using analytical procedures:

Calculation	Explanation of risk
Revenue has increased by 12%.	Retailer sales at Murray Co have fallen dramatically in the last two years. The increase in revenue is not consistent with this. Although Murray Co has begun selling directly to consumers for the first time this year, it is unlikely that these sales will have compensated for the loss in retailer sales at this early stage. In addition, revenue may be deliberately overstated by Murray Co in order to increase the chances of a successful listing. There is a risk that revenue is overstated.
Gross profit margin has increased from 13% to 14%.	The margins for direct consumer sales are likely to be higher than retailer sales, which may explain this increase. However, the increase could also be caused by overstatement of revenue, as explained above, or understatement of cost of sales.
Operating expenses has no movement.	This is unusual given the increase in revenue and cost of sales. There is a risk that the prior year figure has been incorrectly presented in the 2012 column.
Net margin has increased from 1% to 4%.	Net margin has increased at a greater rate than gross profit margin. Given that this is the first year of direct consumer sales, the net margin would not be expected to increase significantly as the level of operating expenses would normally be higher at this early stage. This indicates potential overstatement of revenue and understatement of operating expenses.

Inventory days has increased from 33 (1,555/17,080×365) to 41 (2,109/18,560×365) days.	As sales have increased, this could be because of an increase in demand and therefore the need to hold more inventory. However, as retailer sales at Murray Co have fallen dramatically, there is a risk that some of the inventory is bespoke, and may therefore be obsolete. There is a risk that inventory is overstated.
Trade receivables days has increased from 28 (1,520/19,580×365) to 34 (2,040/21,960×365) days.	Given that website customers pay on ordering, trade receivables days would be expected to fall. However, some of Murray Co's retail customers are struggling to pay their outstanding balances. Trade receivables may be overstated, and the allowance for doubtful debts understated.
Trade payables days has increased from 26 (1,205/17,080×365) to 28 (1,400/18,560×365) days.	The increase in trade payables days is consistent with the increase of 9% in cost of sales. However, an increase in trade payables days could be caused by understatement of cost of sales. The increase in gross profit margin also highlighted this as a potential risk.
Current ratio has improved from 2:1 to 2.3:1.	Murray Co appears to be managing its working capital effectively. However, given the plans to list on the stock exchange next year, this may be indicative of manipulation of the financial statements in order to increase the chances of a successful listing. In addition, Murray Co has increased its long and short-term finance during the year.

Test your understanding 1

You are an audit senior at JPR Edwards & Co and you are currently planning the statutory audit of Hook Co for the year ending 30 June 2013. Your firm was appointed as auditor in January 2013 after a successful tender to provide audit and tax services. JPR Edward & Co were asked to tender after the lead partner, Neisha Selvaratalm, met Hook Co's CEO, Pete Tucker, at a charity cricket match. Neisha explained that they were unhappy with the previous auditors as Pete Tucker felt their audit didn't add much value to Hook Co.

Hook Co was established in 1985 and manufacturers electrical goods such as MP3 players, smart phones and personal computers for the entertainment market. They do not retail their goods under their own name but manufacture for larger companies with established brands. Their key client, who represents 70% of their revenue, was the market leader in smart phones and MP3 players in 2012 with 60% market share.