

*Appraisal Methods in Auditing and Critical Accounting: managerial decision making process beyond 'following the book'*

### **Corresponding author**

*Cas redactat per* Ane Elixabete Ripoll-Zarraga (2017)

External Senior Auditor and External Examiner of Accounting and Finance Postgraduate Programmes (UK)

Affiliation: Universitat Autònoma de Barcelona (UAB); email: [ane\\_rz@yahoo.com](mailto:ane_rz@yahoo.com)

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**Abstract-Teaching Notes**

The Slaughter Company, Ltd. has been previously audited by another audit enterprise, but the management decided to hire a new audit company due to some specific events happening during 2016. Therefore, this is the first period that our team is in charge of the external auditing for the reporting period 2016.

The case study involves an interesting background reflecting not only potential areas of inherent risk (regarding the financial information), but internal control systems sometimes not tested or forgotten (i.e. by junior auditors or due to lack of time). The case study highlights the relevance of the internal control systems since failing them could definitely affect the financial statements as a fair and true view of the company. In this sense it is required to state potential areas of inherent and control risks prior to apply substantive procedures: the audit plan itself.

The case study involves critical thinking beyond the usual audit procedures (substantive procedures), which normally would take place in the company to be audited and the revision of invoices; payslips; delivery notes, etc. But, provides some highlights regarding prior work to be performed as a reflection of critical and professional judgment: what could be hidden within the financial information held in the financial statements beyond audit theory and audit regulatory framework. The case study also reflects the relevance of observing and liaising with different members of the departments at all levels: the location; communication; how they work, etc. This is to gain some insights that it is not reflected in the financial statements, but could affect the fair and true view of the financial information reported.

The suggested solution highlights key areas (weaknesses in internal control systems and areas of risk of material misstatement) detected when comparing 2015 to 2016 and also the relevance of analytic review. This is before the relevant information provided by the company is acknowledged (i.e. bullet points one to eight)

This case study may be used in teaching and learning activities of financial analysis and audit modules in undergraduate programmes (i.e. covering some, but not all the areas of risk or key points for the discussion); postgraduate modules as well as training junior auditors. The critical reflection will engage more the students; will become more interesting and relevant to the extent of the knowledge and experience of the users (audience), and essentially of the

lecturer. The case study should be discussed in groups (ideally three members). The group discussion should reflect on key aspects of managerial accounting and internal control systems and potential effects in the true and fair view of the financial statements. Further analysis apply to working capital (net current assets) and net assets; to prepare the cash-flow statement and to critically reflect of the origin of cash (i.e. it seems that the company may have some liquidity problems); ratio analysis (solvency; liquidity; leverage; inventory rotation; debtors collection, etc.).

### **Intended Learning Outcomes (ILOs)**

Overall this case study increase the awareness of observing and to critically analyse and reflect regarding the internal control systems prior to start applying audit procedures (substantive sampling). This is to gain some insights of how the company works internally and to appreciate the impact of the internal control systems (appropriateness and effectiveness) in the financial statements.

- 1) To appreciate the importance of applying effectively internal control systems within companies.
- 2) To increase the awareness of the effect of the internal control systems in the financial statements. This is to critically reflect on their fairness representation of the business.
- 3) To critically reflect on potential areas of risk (inherent). To discuss and to support the personal opinion: why that specific area? How this area is affecting the financial statements overall (linking balance sheet and income statement)?
- 4) To increase the awareness of critically reflect and think about accounting make-ups when a company holds most of the shares of other companies including the relevance of price-transferring; benchmarking (competitive price) and changes in the inventory of the holding company (delivery notes; etc.)
- 5) To increase the awareness of the importance of professional judgment and skepticism.
- 6) To appreciate and to respect, to protect the auditor independence (ethical considerations)
- 7) To increase the awareness of the importance of not learning by heart the theory-audit regulatory framework; to avoid following the book regarding tests to be performed, but to discern relevance procedures depending on the specific needs of the company; to learn to reflect and to critically discuss an opinion rather than to describe.

### **Slaughter Company Ltd.**

Your team has been appointed to review the financial statements at the year ended 31<sup>st</sup> of December 2016. This is the first year that Slaughter Company Ltd. will be audited by the team. Therefore, the senior auditor would like to gain some insights regarding both internal and accounting systems prior to the external audit.

Slaughter Company Ltd. from now SC operates as a wholesaler of meat from cows; pigs and sheep. SC sells to national companies from 5 am to 7 am (Monday to Saturday), which collect directly their purchases of meat from the SC's warehouse. SC is located in a wholesaler-market with a range of products (fish, vegetables, flowers, etc.) Retail sales are not permitted in the market and own-consumption sales are significantly fined. SC frequently sells and buys to/from the same companies.

SC has several competitors located nearby. Additionally, SC sells products not usually consumed by human beings to Five-Four Products Ltd, which is the only company in the market dealing with wreckage. SC holds 20% of shares of Five-Four Products Ltd. (1,170 shares with €60.05 of nominal value). SC also holds 91% of Spanish-Meats Ltd., which at the year ended 2016, has €350,000.00 of capital. Spanish-Meats Ltd. has the same ordinary course of business than SC.

SC does not own either the land or building where operates, but both belong to the local authority. All the companies incur in relevant annual fees to obtain the right to operate in the market. The licenses have unlimited useful life, but the local authority could deny at any time to renew them. The building where SC operates, which includes the headquarters and warehouses, is rented on a finance lease agreement. The lease just has finished during 2016 and it has been capitalised at fair value (€1,141,923.00). The estimated remaining useful life is 10 years, and the accumulated depreciation at the end of the lease is € 830,871.53

The rest of leases are still ongoing and correspond to four cars driven by the general manager and his family (one Volvo; one Mercedes; one Toyota and one Mitsubishi). The future minimum lease payments follow,

	€
< one year	66,050.24
two to five years	62,813.16
> five years	0.00
<b>Total</b>	<b>128,863.40</b>

The overall annual interest rate is 6.24%. The financial expenses not accrued at the end of 2016 are €7,569.00

The average number of employees during 2016 has been 41. There are three managers (general manager; financial manager and purchases manager) and two technician managers who are the general manager's sons. The rest of employees include one financial accountant; one cashier and one bank-controller; eight salesperson; five drivers; and four carriers.

During 2016 the wages paid to the general manager were €152,642.00 (accrued for 12 months)

The accountant must prepare the financial statements for the financial manager on a monthly basis. He also must attend all meetings and liaise with the financial manager regarding key areas and areas of risk. It seems that the accountant is not efficient or well-organised. The accountant takes more than several breaks to smoke; his office is untidy, there are papers all over the place. Journal entries are last minute change prior to issue the monthly reports. You have been also informed that the previous audit company was not renewed. Apparently one of the members of the audit team was too close to the financial accountant. She never mentioned anything to her direct supervisor. The management has confirmed the intention to fire the accountant, but it is still strictly confidential. The management is not aware regarding the exactly date when they start dating, but during the reporting period 2016. The management has also confirmed that the female member is still working for the same audit company. Additionally, she is auditing Five-Four Products Ltd. Some employees of the SC have informed you that the accountant was willing to invite her for dinners to obtain a 'good report' (unqualified opinion).

SC operates with 10 different banks. The bank-controller is in charge of controlling all of them, which includes: withdrawing the required daily cash to pay suppliers (if required); other petty cash transactions; to make the required transfers to pay the due-date invoices and

other short-term obligations. He also is responsible for the journals entries related to bank operations.

The admin-staff schedule is from Monday to Friday from six am to three pm. There is a break allowance, but at least one member of the staff must remain in the premises to assist in any event (answering calls; making purchase-sell orders; paying suppliers in cash, etc.)

The admin team and the bank controller are located in the same room with no divisions. The accountant has his own room with the door facing to the same room where the rest of the team is located.

The general manager and the two technician managers hold 25% of the SC equity each one. The remaining 25% belongs to the general manager's wife.

During 2016, the transactions between SC and the affiliated company and subsidiary follow,

	<b>Sales (to) €</b>	<b>Purchases (from) €</b>
Spanish-Meats, Ltd.	5,025,498.00	8,375.00
Five-Four Products, Ltd.	1,600,068.22	147,420.00
<b>Total</b>	<b>6,625,566.22</b>	<b>155,795.00</b>

The relevant events identified follow,

- 1) During 2016 a land is purchased by €558,088.27 There is no intention to use the land in the core business. It has not been detected obsolete non-current assets or assets sold during the reporting period.
- 2) Most of the balance of pre-paid expenses corresponds to a customer with an update balance of €80,041.52 regarding a debt owe since 2007. This amount is enclosed in trade receivables. This customer sued SC and the case was lost in favour of the customer without possible appeal. During 2016 SC has paid a compensation of €146,540.38 SC has also deferred the trial costs for four years (48 months). During the same reporting period, two credit notes have been issued by SC (€73,270.19 each one). The customer has issued an invoice for €66,701.26 (including VAT at 21%).

- 3) The balance with Spanish-Meats, Ltd. amounts to €580,426.32
- 4) Other payable accounts contain the balance due to the local authority that amounts to €656,915.67
- 5) The overall provisions accrued during the reporting period amount to €62,131.04, which includes €33,068.81 of bad debts written off.
- 6) The extraordinary results correspond to losses due to Health and Safety fines (€10,148.65) and income proceeding from the cancellation of several invoices issued by creditors in previous years (€65,070.18), which were accrued, but never paid. There is no evidence that these debts will be claimed. The police have confirmed that the owner is on the run. The payment by the insurance company amounts to (€19,333.37 euros)
- 7) The operating expenses disclosures follow,

	2016 €	Variation €	2015 €
Rent	169,303.83	-18,543.97	187,847.80
Maintenance	101,700.00	13,432.84	88,267.16
Professional Services	129,149.91	-1,623.80	130,773.71
Transport	943,708.40	-185,867.01	1,129,575.41
Insurance	203,902.78	-19,105.82	223,008.60
Bank Services	3,253.98	-5,971.82	9,225.80
Publicity	27,293.42	-7,111.04	34,404.46
Utilities	132,076.17	-15,284.54	147,360.71
Other Expenses	142,947.20	-146,711.03	289,658.23
<b>Total</b>	<b>1,853,335.69</b>	<b>-386,786.19</b>	<b>2,240,121.88</b>

8) Further information

The customers' receipts from Spanish-Meats (cheques) are collected by SC and cleared in SC's banks. The journal entry shows Banks (debit); affiliated companies (credit).

The invoices issued to Spanish-Meats are never paid, but SC compensates the trade receivables (Spanish-Meats) with the cheques cleared in the SC's banks. At the end of the financial period SC cancels both balances issuing an invoice to be received by the company that has the right among the remaining balance.

**Required:**

Following the International Standards in Auditing (IASs) prepare a brief report regarding the main areas of risk (inherent and control). You may decide cover the following bullet points,

- a) Prepare a planning of the key stages to perform the audit. For each stage state the procedures and documentation required.
- b) Identify areas of risk and areas of control including stating weakness and potential risks.
- c) Apply analytic procedures and critically discuss the areas that may contain inherent risk.
- d) Discuss the level of materiality (per area if required)
- e) Discuss the most adequate sampling method (per area if required)
- f) Discuss potential externalities affecting the initial size of the samples chosen
- g) Propose the relevant initial adjustments (journal entries) to ensure that the financial statements reflect a fair and true view of the company.



## Statement of Financial Position Slaughter Company, Ltd. (31/12/2016)

	Notes	31/12/2016	Variation		31/12/2015
			[+] / [-]	%	
<b>Non-Current Assets</b>		<b>1,990,982.18</b>	<b>405,414.78</b>	<b>25.57</b>	<b>1,585,567.40</b>
<b>Intangible Assets</b>		<b>113,914.04</b>	<b>39,806.72</b>	<b>53.71</b>	<b>74,107.32</b>
Software		113,914.04	39,806.72	53.71	74,107.32
<b>Property, Plant and Equipment</b>		<b>1,424,225.18</b>	<b>373,594.19</b>	<b>35.56</b>	<b>1,050,630.99</b>
Land and buildings	(1)	869,139.74	535,249.81	160.31	333,889.93
Equipment		555,085.44	-161,655.62	-22.55	716,741.06
<b>Long Term Investments</b>		<b>452,842.96</b>	<b>-7,986.13</b>	<b>-1.73</b>	<b>460,829.09</b>
Affiliated Companies		318,500.00	0.00	0.00	318,500.00
Other Financial Investments		134,342.96	-7,986.13	-5.61	142,329.09
			<b>0.00</b>		
<b>Current Assets</b>		<b>6,135,435.45</b>	<b>-683,812.91</b>	<b>-10.03</b>	<b>6,819,248.36</b>
<b>Non-Current Assets held for Sale</b>		<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Inventories</b>		<b>855,608.04</b>	<b>143,132.78</b>	<b>20.09</b>	<b>712,475.26</b>
Goods		815,808.82	147,570.16	22.08	668,238.66
Raw Materials		39,799.22	-4,437.38	-10.03	44,236.60
Trade Receivables		4,422,233.66	-1,627,353.76	-26.90	6,049,587.42
<b>Short-term Investments</b>		<b>492,681.25</b>	<b>-566,339.64</b>	<b>-53.48</b>	<b>1,059,020.89</b>
Short-term Investments		18,625.75	0.00	0.00	18,625.75
Credits to companies		0.00	-396,339.64	-100.00	396,339.64
Other Financial Investments		474,055.50	-170,000.00	-26.40	644,055.50
<b>Prepayments</b>	(2)	<b>127,426.25</b>	<b>108,789.05</b>	<b>583.72</b>	<b>18,637.20</b>
<b>Cash and Equivalents</b>		<b>237,486.25</b>	<b>1,257,958.66</b>	<b>-123.27</b>	<b>-1,020,472.41</b>
Cash and Banks		237,486.25	1,257,958.66	-123.27	-1,020,472.41
Cash Equivalents		0.00	0.00	0.00	0.00
<b>Total</b>		<b>8,126,417.63</b>	<b>-278,398.13</b>	<b>-3.31</b>	<b>8,404,815.76</b>

	Notes	31/12/2016	Variation		31/12/2015
			[+] / [-]	%	
<b>Equity</b>		<b>4,471,964.11</b>	<b>208,162.90</b>	<b>4.88</b>	<b>4,263,801.21</b>
<b>Ordinary Shares</b>		<b>1,360,806.17</b>	<b>0.00</b>	<b>0.00</b>	<b>1,360,806.17</b>
<b>Reserves</b>		<b>3,111,157.94</b>	<b>208,162.90</b>	<b>7.17</b>	<b>2,902,995.04</b>
Legal Reserve Fund		273,088.03	3,000.00	1.11	270,088.03
Retained Earnings		2,838,069.91	205,162.90	7.79	2,632,907.01
<b>Non-Current Liabilities</b>		<b>80,178.47</b>	<b>-86,462.53</b>	<b>-51.89</b>	<b>166,641.00</b>
Long-Term Borrowings		80,178.47	-86,462.53	-51.89	166,641.00
<b>Current Liabilities</b>		<b>3,574,275.05</b>	<b>-400,098.50</b>	<b>-10.07</b>	<b>3,974,373.55</b>
<b>Current Liabilities</b>		<b>2,215,726.32</b>	<b>-96,674.96</b>	<b>-4.18</b>	<b>2,312,401.28</b>
Short-term borrowings		2,202,380.72	89,842.12	4.25	2,112,538.60
Other short-term borrowings		19,458.64	-181,368.04	-90.31	200,826.68
Other current liabilities		-6,113.04	-5,149.04	534.13	-964.00
<b>Affiliated Companies</b>	(3)	<b>-580,426.32</b>	<b>-49,345.34</b>	<b>9.29</b>	<b>-531,080.98</b>
<b>Payable Accounts</b>		<b>1,938,975.05</b>	<b>-254,078.20</b>	<b>-11.59</b>	<b>2,193,053.25</b>
Trade Payables		963,402.07	-40,017.24	-3.99	1,003,419.31
Other Payables	(4)	866,374.36	27,491.61	3.28	838,882.75
Personnel		0.00	-9,000.00	-100.00	9,000.00
Tax Payable		3,035.09	-10,943.63	-78.29	13,978.72
Other Taxes		106,163.53	-107,640.32	-50.35	213,803.85
Prepaid Income		0.00	-113,968.62	-100.00	113,968.62
<b>Total</b>		<b>8,126,417.63</b>	<b>-278,398.13</b>	<b>-3.31</b>	<b>8,404,815.76</b>

## Income Statement Slaughter Company Ltd. (31/12/2016)

	Notes	31/12/2016	Variation		31/12/2015
			[+] / [-]	%	
<b>Sales</b>		<b>39,532,312.84</b>	<b>-6,711,024.22</b>	<b>-14.51</b>	<b>46,243,337.06</b>
<b>Cost of Sales</b>		<b>-35,930,657.11</b>	<b>6,276,003.06</b>	<b>-14.87</b>	<b>-42,206,660.17</b>
Cost of Raw Materials and others		-34,452,568.47	6,249,516.24	-15.35	-40,702,084.71
Outsourced Activities		-1,478,088.64	26,486.82	-1.76	-1,504,575.46
<b>Other Operating Income</b>		<b>3,729.60</b>	<b>-4,119.98</b>	<b>-52.49</b>	<b>7,849.58</b>
<b>Gross Margin</b>		<b>3,605,385.33</b>	<b>-439,141.14</b>	<b>-10.86</b>	<b>4,044,526.47</b>
Wages and Salaries		-872,661.84	93,326.90	-9.66	-965,988.74
Social Security		-257,959.00	14,135.94	-5.20	-272,094.94
Depreciation		-213,292.72	59,618.16	-21.85	-272,910.88
Operating Expenses	(7)	-1,853,335.69	386,786.19	-17.27	-2,240,121.88
Taxes		-25,506.05	1,157.07	-4.34	-26,663.12
Bad-Debts written off	(5)	-62,131.04	-215,539.15	-140.50	153,408.11
Other Operating Expenses		-12,701.25	-9,508.71	297.84	-3,192.54
<b>Operating Result</b>		<b>307,797.74</b>	<b>-109,164.74</b>	<b>-26.18</b>	<b>416,962.48</b>
Results on Disposals of Assets		0.00	-5,387.93	-100.00	5,387.93
Other Extraordinary Results	(6)	101,869.77	82,752.43	432.87	19,117.34
<b>Result from Operating Activities</b>		<b>409,667.51</b>	<b>-31,800.24</b>	<b>-7.20</b>	<b>441,467.75</b>
Financial Income from Long-term Investments		21,179.29	-55,825.33	-72.50	77,004.62
Financial Expenses from Loans		-173,961.64	68,076.20	-28.13	-242,037.84
Exchange Rates		-7,880.54	-20,709.90	-161.43	12,829.36
Results on Disposal Financial Investments		0.00	37,764.25	-100.00	-37,764.25
<b>Financial Result</b>		<b>-160,662.89</b>	<b>29,305.22</b>	<b>-15.43</b>	<b>-189,968.11</b>
<b>Result before Taxes</b>		<b>249,004.62</b>	<b>-2,495.02</b>	<b>-0.99</b>	<b>251,499.64</b>
<b>Corporate Tax</b>		<b>-40,841.72</b>	<b>-13,432.80</b>	<b>49.01</b>	<b>-27,408.92</b>
<b>Result after Taxes</b>		<b>208,162.90</b>	<b>-15,927.82</b>	<b>-7.11</b>	<b>224,090.72</b>
<b>Result from Discontinued Operations before Taxes</b>		<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Result for the period</b>		<b>208,162.90</b>	<b>-15,927.82</b>	<b>-7.11</b>	<b>224,090.72</b>