

Understanding Basic Audit Procedures

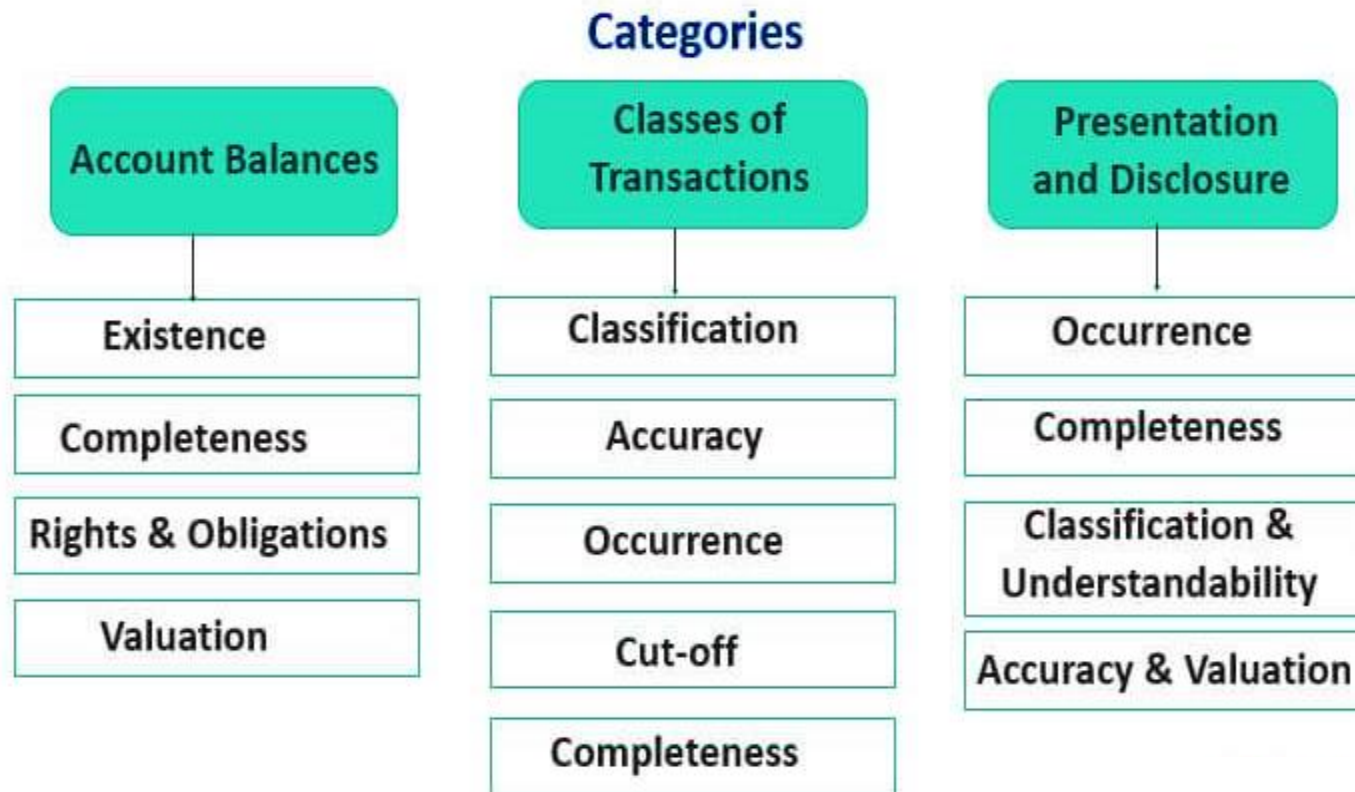


Introduction

- Audit is an *independent examination* of financial statements of an entity conducted with a view to express an opinion as to its *true and fair view*
- Auditor examines system of internal controls, check arithmetical accuracy of books of accounts, detect and prevent errors & frauds, enhances reliability of investors, financial institutions, tax authorities, ensures compliance with statutory requirements
- Ensure all necessary disclosures have been made by the management in the financial statements. Every event, transaction and any other matter disclosed by the management at the appropriate amounts, actually exist and are clearly expressed
- **Audit procedures** are methods or techniques that auditors use to obtain audit evidence and form an opinion regarding the financial statements
- Auditors perform audit procedures to test various **assertions** related to financial statement they are testing



Audit Assertions



Audit Procedures

Audit Materiality

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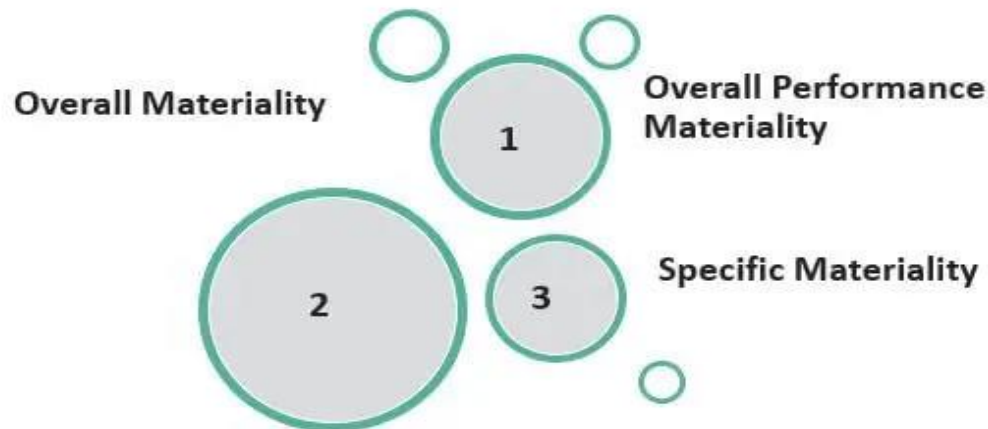
***Representation &
Communication
Letters***

Audit Materiality



Introduction

- Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true and fair view or not.
- Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements.
- Consider Materiality and its relationship with Audit risk while conducting the audit.
- Select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk.
- Auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as against at the time of evaluating the results of audit procedures.



Types of Audit Materiality

- **Overall Materiality**

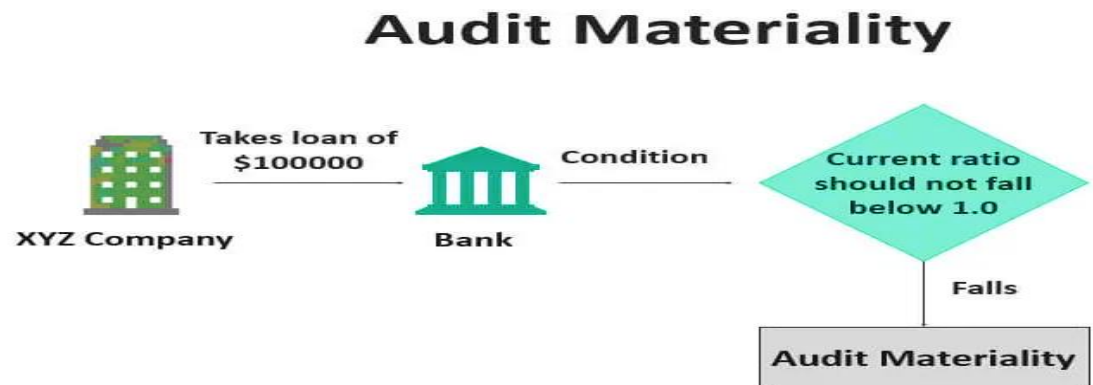
Significant level in the financial statements of the company, which can influence decision making of users of the financial statement of the company as a whole.

- **Overall Performance Materiality**

Materiality level judged by auditor. This materiality level is reduced from “overall materiality level” to consider the risk of several smaller errors or omissions which the auditor was unable to find. Typically the percentages range from **75% (low risk) to 50% (high risk)**.

- **Specific Materiality**

It refers to materiality level set to identify potential misstatements. These may exist in different areas, for certain classes of transactions, for the account balances that may affect the economic decisions of the users of the financial statements



Steps in determining the overall materiality

Auditors usually follow three steps in determining the overall materiality level including:

1. Choosing appropriate benchmark
2. Determining level of the chosen benchmark
3. Document justification of the choice



Materiality = quantity (amount) + quality (nature)

Use of Benchmarks in Determining Materiality

The first step to determine materiality is to choose what benchmark to use. Factors that affect the identification of an appropriate benchmark include the following –

- The elements of the financial statements i.e. Balance sheet and Profit and loss account.
- Whether there are items on which the attention of the users of the particular entity's financial statements tend to be focused.
- Nature of entity, where the entity is at in its life cycle, and the industry and the economic environment in which the entity operates.
- The entity's ownership structure and way it is financed.
- The benchmark that auditors usually use in determining materiality include:
 - Total Revenues
 - Total Assets
 - Total Expenses
 - Profit before tax
 - Net Assets / Equity

Determining the Level of Chosen Benchmark

- The next step auditors usually do is deciding what percentage of such benchmark to use as materiality.
- There is no specific rule or standard that states how many percent to use on which benchmark to determine materiality. However, there is a rule of thumb that applies as below:
 - 0.5% to 1% of total revenues or expenses
 - 1% to 2% of total assets
 - 5% to 10% of net profit before tax
- Auditors still need to apply their professional judgment when determining what percentage to use in the benchmark.
- They may decide to use higher or lower than the above percentage based on their experiences and professional judgment.

Document Justification of the Choice

- The last step of determining materiality in audit is documenting the choice that they use with proper justification.
- Auditors need to document the thought process with their experiences in determining the materiality here into a file.
- It is important to have proper documentation of the process in determining the materiality as the regulators may review such process in the documentation and evaluate whether the materiality have been appropriately determined by auditors with sufficient experiences.

Materiality Template

Consideration of Materiality in Planning and Performing Audit of [Company Name] - Date

#Below bench mark are selected on the basis of following factors

- 1)Concentration of Ownership
- 2)Debt Arrangement
- 3)Business Environment
- 4)Other sensitivities

Materiality will be considered from the audit sample selected by the auditors

#These benchmarks can be modified during the audit by the engagement partners after analysis of the client financials and internal controls

S.No	Factors	Amount (\$)	Minimum Materiality (3%)	Maximum Materiality (5%)	Average
Net Benchmark					
1	Profit before Tax				
2	Net Asset / Equity				
S.no	Factors	Amount	Minimum Materiality (0.5%)	Maximum Materiality (1%)	Average
Gross Benchmark					
1	Total Assets				
2	Total Revenue				
3	Total Expense				

After analysing all factors of materiality and considering [Company Name] is registered with SEC and regulated by US Federal Laws , we have marked amount \$XXX (Average of total profit before tax materiality benchmark) as a benchmark of materiality for Audit of FY XXX

We had applied 50% haircut in materiality for the individual transaction in each accounts amounted \$XXX.

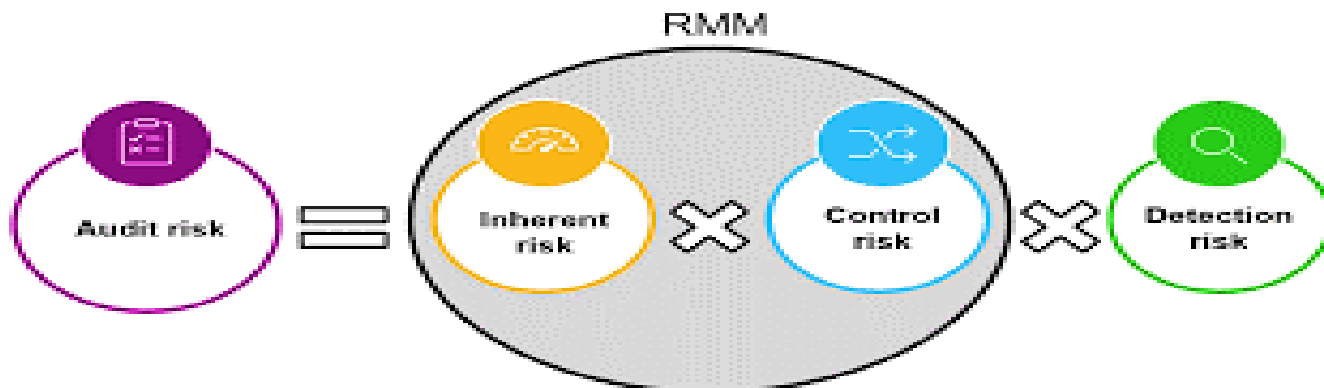
Example of Materiality Threshold in Audits

- There are two transactions – one is an expenditure of \$1.00, and the other transaction is \$1,000,000.
- Clearly, if the \$1.00 transaction was misstated, it will not make much of an impact for users of financial statements, even if the company was small. However, an error on a transaction of \$1,000,000 will almost certainly make a material impact on the user's decisions regarding financial statements.
- For a company with \$5 million in revenue, the \$1 million misstatement can represent a 20% margin impact, which is very material.
- However, if the company has \$5 billion in revenue, the \$1 million misstatement will only result in a 0.02% margin impact, which, on a relative basis, is not material to the overall financial performance of the company.
- If the \$1 million error was due to fraudulent behavior (perhaps an executive employee embezzling money from the company), this misstatement can be considered material since it involves potential criminal activity.
- Therefore, it is crucial to consider not only the absolute and relative amounts of the misstatements but also the qualitative impacts of the misstatements.
- Few more examples of qualitative misstatements:
 - The inadequate or improper description of an accounting policy
 - Failure to disclose a breach of regulatory requirements when the imposition of regulatory restriction will significantly impair operating capability

Audit Risk & Materiality

- Audit risk is the risk that the auditor may unknowingly fail to modify the opinion on the financial statements that are materially misstated
- Audit risk and materiality should be considered together in designing the **nature, timing and extent** (NTE) of audit procedures and in evaluating the results of those procedures.
- There is an inverse relationship between Audit Risk and materiality. More material a misstatement is, the less likely it is that the auditor will not detect it.

$$\begin{array}{ccc}
 \text{Audit Risk} & = & \text{Risk of Material Misstatement} * \text{Detection Risk} \\
 \text{(should be low)} & & \text{(assessed by auditor)} \quad \quad \quad \text{(controlled by auditor)}
 \end{array}$$

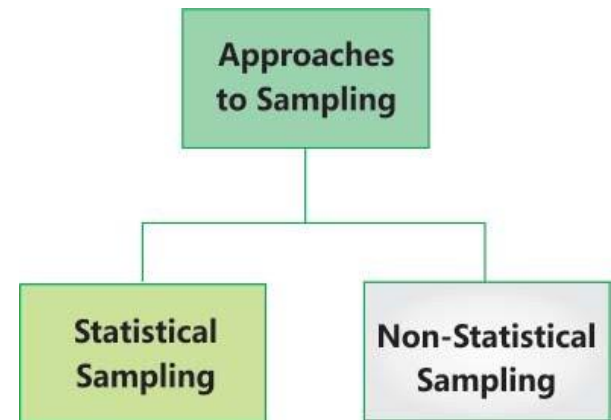


Audit Sampling

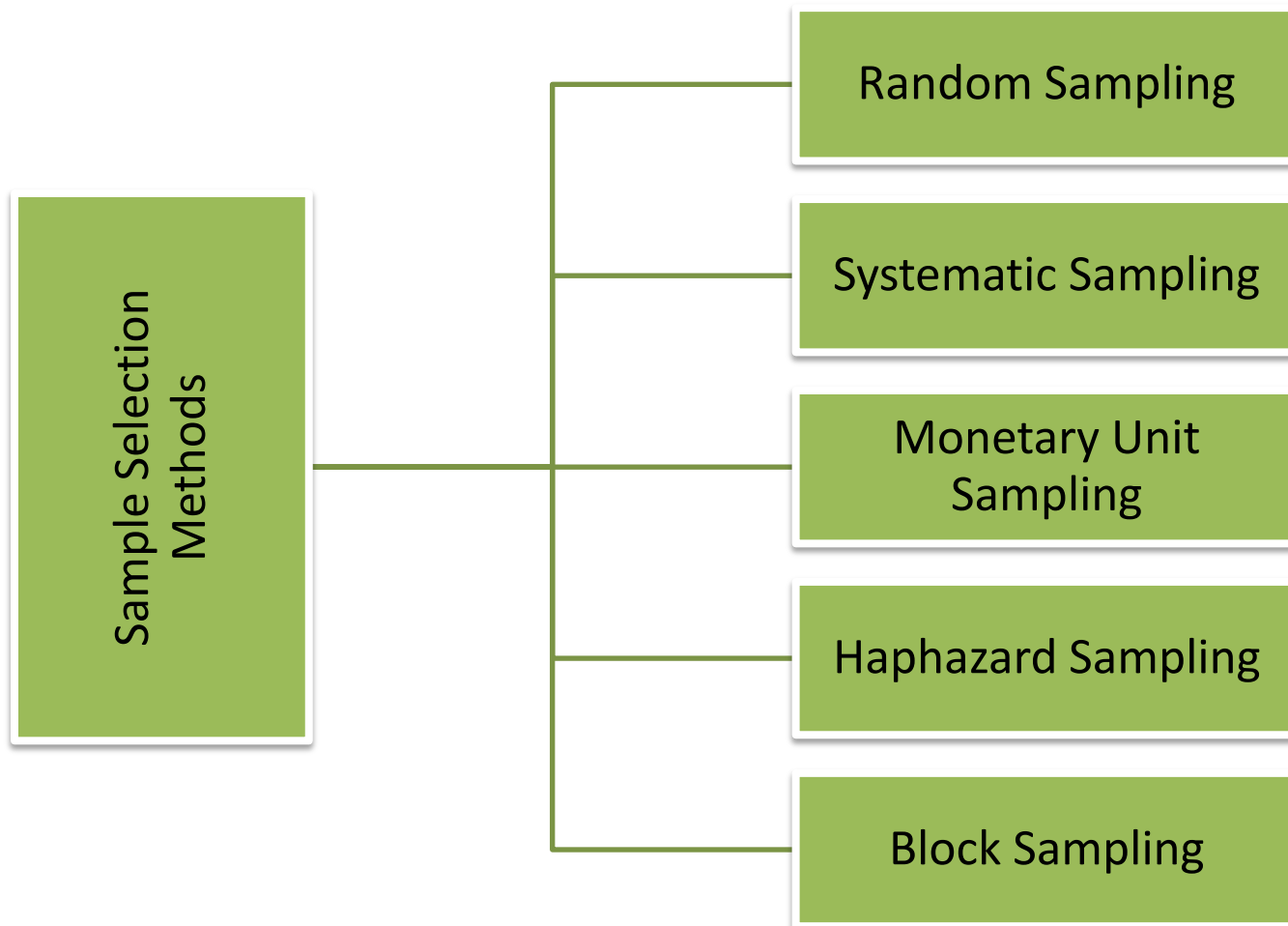


Audit Sampling

- Audit Sampling means applying audit procedures to *less than 100%* of items within a population of audit relevance such that all sampling units have a chance of selection;
- To provide the auditor with a **reasonable** basis on which to draw conclusions about the entire population.
- **Population** refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
- Audit sampling can be applied using either *non-statistical or statistical sampling* approaches:
 - **Statistical sampling** is an approach wherein auditors specify the sampling risk they are willing to accept and then calculate sample size that provides that degree of reliability. Results are evaluated quantitatively.
 - **Non-statistical sampling** is the selection of a test group that is based on the examiner's judgment, rather than a formal statistical method.



Methods of Audit Sampling



Methods of Audit Sampling

- **Random Sampling:** This ensures all items in the population or within each stratum have a known chance of selection.
 - E.g. In organization of 500 employees, HR team decides on conducting team building activities, it is highly likely that they would prefer picking chits out of a bowl. In this case, each of the 500 employees has an equal opportunity of being selected.
- **Interval Sampling or Systematic Sampling:** Systematic selection is method in which number of sampling units in population is divided by sample size to give sampling interval,
 - E.g. 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.
- **Monetary Unit Sampling:** It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- **Haphazard sampling:** The auditor selects sample without following a structured technique. Haphazard selection is not appropriate when using statistical sampling.
- **Block Sampling:** This involves selection of block(s) of contiguous items from within the population.
 - E.g. An auditor examines all the remittances from customers in the month of January. Similarly, the auditor may only examine remittance advices that are numbered 300 to 340.

Payroll



Introduction

A payroll audit is an analysis of a company's payroll processes to ensure accuracy. Payroll audits examine things like the business's active employees, pay rates, wages, and tax withholdings

Obtain a clear understanding about the organization and its hiring, appraisal and termination / retirement process in the following manner:

Test the controls the entity has set around employee benefit payment process i.e. Maintaining of attendance records, authorization and approval of monthly payroll processing and disbursement etc. and obtain Employee Master

Select a random sample of transactions from Employee master. Examine related appointment letters, appraisal letters, attendance records, etc.

Perform Substantive & analytical procedure : Monthly expense reasonability, comparison with previous accounting period etc.

Compare that with the client's business operations and overall trend in the industry.

Federal, State & Local Payroll Taxes

Level	What it is	Type of Tax	How it works	Who's Responsible
Federal	Federal Income Tax (FIT)	Withholding tax	<ul style="list-style-type: none"> FIT is considered as pay-as-you-go tax that's withheld of an employee's paycheck 	<ul style="list-style-type: none"> The employer is responsible for withholding FIT by taking it out of the employee's paycheck with each payroll.
	Federal Insurance Contribution Act (FICA) Taxes	Shared tax	<ul style="list-style-type: none"> These are Medicare and Social Security Taxes 	<ul style="list-style-type: none"> FICA taxes are split evenly between the employer and employee. The employer is responsible for withholding the employee amount and depositing the employer amount with each payroll
	Federal Unemployment Tax (FUTA)	Employer Tax	<ul style="list-style-type: none"> FUTA funds the federal unemployment program that provides support to employees who leave a company involuntarily. 	<ul style="list-style-type: none"> FUTA taxes are 100% employer paid according to set percentages. Employers may also receive a credit on their FUTA taxes based on their payment of SUTA taxes.
State	State Income Tax (SIT)	Withholding tax	<ul style="list-style-type: none"> Every state, with the exception of Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming has an income tax. Tennessee & New Hampshire only have tax dividends & interest income, but not wages. 	<ul style="list-style-type: none"> The employer is responsible for withholding state income tax by taking it out of the employee's paycheck with each payroll.
	State Unemployment Tax (SUTA)	Employer Tax	<ul style="list-style-type: none"> Every state has an unemployment tax that works in conjunction with the federal tax 	<ul style="list-style-type: none"> In most states, SUTA taxes are employer-paid. In Alaska, New Jersey & Pennsylvania, both the employee & the employer contribute to these taxes
Local	Local Taxes		<ul style="list-style-type: none"> These can be local income, school board, transit, municipality or almost any kind of taxes 	<ul style="list-style-type: none"> Responsibilities vary depending on the tax authority & type of tax.

Employment Payroll Tax and Returns

Following are the major tax returns that need to be filed with IRS for Payroll Taxes:

- **Form 940:**
 - an annual form that is filed by a business having employees
 - It reports the business' federal unemployment taxes pursuant to FUTA
 - business is responsible for such tax and does not come from employee wages;
- **Form 941:**
 - employer's quarterly federal tax returns
 - used for reporting and paying withheld federal taxes to the US Government;
- **Form W-2:** It is the official Wage and Tax Statement that reports an employee's annual wages and the amount of taxes withheld from their paycheck;
- **Form W-4:** It is the employee's withholding allowing certificate that he must file to indicate his tax situation to the employer. This form tells the employer the correct amount of tax to withhold from an employee's paycheck.

Property, Plant and Equipment



Introduction

Property, Plant & Equipment (PPE) or Fixed assets are economic resources **owned** by a business, which cannot be easily liquidated (converted into cash). These are usually larger assets that a company uses in its **operations** and are considered a long-term investment for the business. They are usually listed on a company's balance sheet.

There are two types of Fixed Asset –

- **Tangible Assets –**
 - It is an asset that has a finite monetary value and usually a physical form.
 - It can typically always be transacted for some monetary value though the liquidity of different markets will vary.
 - They are the opposite of intangible assets which have a theorized value rather than a transactional exchange value.
- **Intangible Assets –**
 - An intangible asset is an asset that is not physical in nature.
 - Goodwill, brand recognition and intellectual property, such as patents, trademarks, and copyrights, are all intangible assets.
 - They exist in opposition to tangible assets, which include land, vehicles, equipment, and inventory.

Audit Procedures – Tangible Assets

- **Existence** : Review entity's plan for performing physical verification of PPE. Evidence of appropriate supervision of those performing physical verification of PPE should be examined. If off-shore audit is done, must obtain **videos / still photos**.
- **Completeness** : Verify the movement in the PPE schedule (asset class-wise like building, Plant & machinery etc.) compiled by the management i.e. Opening balances + Additions during the period - Deletions during the period = Closing balances. Tally the closing balance to the entity's books of account.
- **Appropriately Valued** :
 - Verify that the entity has charged depreciation on all items of PPE according to the *useful lives defined*
 - Assess that the depreciation method used- **MACRS vs. SLM**
- **Right of the entity** :
 - Verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
 - Check conveyance deed/sale deed for all the additions to land and building in particular, verify whether the entity is the legal and valid owner or not.

Confirmations



Introduction

- Obtaining and evaluating audit evidence through a representation of information or an existing condition **directly from a third party** in response to a request for information.
- Steps involved in obtaining external confirmation:
 - Determining the information to be confirmed
 - Selecting the appropriate parties from whom confirmation is required
 - **Designing** the confirmation requests, being properly addressed with information for responses to be sent directly to the auditor; and
 - Sending the requests, including follow-up request.
- Types of Confirmations:
 - **Positive confirmation request** – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
 - **Negative confirmation request** – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Areas of Confirmations Required

Bank

Accounts Receivable

Accounts Payable

Related Party Loans

Stock Transfer Agent

BD Clearing Firms

Representations & Communication

**LETTER OF REPRESENTATION
CONTENTS & REQUIREMENTS**



Management Representation Letter

- The letter should be addressed to the auditor.
- Request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.
- Request management to provide a written representation that:
 - Preparation of the financial statements in accordance with the applicable financial reporting framework;
 - Provided the auditor with all relevant information and access as agreed in the terms of the audit engagement; and
 - Recorded and reflected all transactions in the financial statements.
- This shall be for all financial statements and period(s) referred to in the auditor's report.
- Disclosures of all the related party relations and summary of un-adjusted differences by the management.
- The representations should be made **as of the date of the auditor's report**.

Audit Committee Communication Letter

The purpose is to communicate (verbally or in writing) the Board of Directors, Audit Committee, President, or the Management **prior to the issuance** of the auditor's report;

- Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention
- Establish an Understanding of the Terms of the Audit
- Obtaining Information and Communicating the Audit Strategy
- Results of the Audit
- Auditor's Evaluation of the Quality of the Company's Financial Reporting
- Other Information in Documents Containing Audited Financial Statements
- Difficult or Contentious Matters for which the Auditor Consulted
- Management Consultation with Other Accountants
- Going Concern
- Uncorrected and Corrected Misstatements
- Material Written Communications
- The Auditor's Report (draft)
- Disagreements with Management
- Difficulties Encountered in Performing the Audit
- Other Matters including suggestions, if any

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Thank You!!

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