

FOR INTERNAL USE WITHIN
INDIAN AUDIT AND ACCOUNTS DEPARTMENT

DRAFT

FINANCIAL (ATTEST) AUDIT MANUAL

ISSUED BY THE AUTHORITY OF
THE COMPTROLLER AND AUDITOR GENERAL OF INDIA

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Chapter 1

Introduction

1.1 The present Manual contains a framework for the process of financial (attest) audit within the Indian Audit and Accounts Department headed by the Comptroller and Auditor General (CAG) of India. It indicates the best practices to be followed in planning, execution and reporting processes in financial (attest) audit.

1.2 The Manual is based on the existing instructions within the Indian Audit and Accounts Department, Auditing Standards of the CAG of India and the best practices of the Supreme Audit Institutions (SAIs) of other countries. The Manual also seeks to incorporate the international best practices in respect of financial (attest) audit with the objective of bringing the Indian practice at par with the international best practices, as far as applicable in the context of the Indian Audit and Accounts Department.

Nature of Financial (attest) audit

1.3 Financial (attest) audit is primarily concerned with expression of audit opinion on a set of financial statements. It includes:

- examination and evaluation of financial records and expression of opinions on financial statements;
- audit of financial systems and transactions including an evaluation of compliance with applicable statutes and regulations which affect the accuracy and completeness of accounting records; and
- audit of internal control and internal audit functions that assist in safeguarding assets and resources and assure the accuracy and completeness of accounting records.

1.4 The audit responsibilities of the CAG of India (CAG) are wider than providing opinion on the financial statements of Government and extend to examination of risks to regularity, propriety and financial control. A significant portion of the audit work presently carried by CAG is termed transaction audit which essentially seeks to address the issues of risks to regularity, propriety and financial control.

1.5 Whereas the opinion on financial statements provides a positive annual assurance on the financial statements to the Parliament or Legislature, examination of risks to regularity, propriety and financial control (generally referred to as transaction audit in the Indian Audit and Accounts Department) is not linked to a specific assurance on an individual set of financial statements in a particular year.

- It does not result in a formal audit opinion on financial statements but rather in reports either to management or Parliament or Legislature;

- It focuses on the Government Department or its units rather than on the financial statements;
- It does not cover all the units of Government Departments every year, but seeks to cover them over a period of time;
- It seeks to cover risks of significant irregularity, which may not be material for the purpose of qualifying audit opinion on the financial statements.

Different types of auditee entities

1.6 The Indian Audit and Accounts Department carries out financial (attest) audits of the following entities resulting in certification of financial statements as well as preparation of separate audit reports on transactions and accounts of the entities.

Entity	Types of Financial Statements audited
Union Government	Finance Accounts; Appropriation Accounts
Union Territory Governments	Finance Accounts; Appropriation Accounts
State Governments	Finance Accounts; Appropriation Accounts
Autonomous Bodies	Balance Sheet; Income and Expenditure Account / Revenue Account
Statutory Corporations	Balance Sheet; Profit and Loss Account/ Revenue Account
Government Companies	Balance Sheet; Profit and Loss Account (This is a supplementary audit after the work of the Statutory Auditor is completed and comments of CAG, if any, are issued; audit certificate is given by the Statutory Auditor,)
World Bank Aided Projects	Statements of Expenditure relating to Projects aided by World Bank

1.7 In case of Government Companies, the financial (attest) audit is carried out by Chartered Accountants (Statutory Auditors) appointed by the CAG in accordance with the provisions of the Companies Act, 1956. The CAG carries out a supplementary audit and comments, if any, are issued. The audit opinion is issued by the Statutory Auditors. This is covered in more detail in Chapter 11 of the Manual.

1.8 Separate instructions are available in respect of the financial (attest) audits of entities like Autonomous Bodies, Statutory Corporations and Government Companies and Externally Assisted Projects, which may be updated from time to time. However, the provisions in this Manual are generally applicable for any kind of financial (attest) audit and may be suitably adapted for audit of these entities. The provisions in this Manual are also applicable irrespective of the basis of accounting (cash or accrual).

1.9 The present Manual replaces the paragraphs 1.6, 1.12, 2.9, formats of CAG's Certificates in Appendix-I of Chapter I (page 13) and Appendix- IV of Chapter II (page 20) of Manual of Standing Orders (Accounts & Entitlements), Volume II, 1st edition. It will also supersede any instructions to the contrary in the Manuals of the SAI India regarding financial (attest) audit of the Civil Departments of the Union, State and Union Territory Governments.

1.10 The Manual seeks to guide and direct, rather than wholly substitute for the initiative, judgement and professionalism of the officials entrusted with the duties of financial (attest) audit.

1.11 The Manual is intended to be gender neutral. Words or expressions conveying masculine gender should be taken to include feminine gender also.

Statutory Provisions

1.12 The statutory provisions relating to financial (attest) audit by CAG, as contained in the Comptroller and Auditor's General's (Duties, Powers and Conditions of Service) Act, 1971 (hereafter referred to as the 'Act') are briefly indicated in the subsequent paragraphs.

1.13 Section 13 of the Act enjoins on the CAG the duty to audit all expenditure from the Consolidated Fund of India, of each State and each Union Territory having a Legislative Assembly, all transactions of the Union, of the States and of the Union Territories having a Legislative Assembly, relating to the Contingency Funds and Public Accounts and to audit all trading, manufacturing, profit and loss accounts and balance sheet and other subsidiary accounts kept in any department of the Union or of a State or a Union Territory. This Section also enjoins on the CAG the duty to report on the accounts, expenditure or transactions so audited.

1.14 The Act has made provisions in Sections 14 and 15 for the audit of the accounts of authorities and bodies receiving financial assistance in the form of grants and / or loans from the Government of India or a State or Union Territory, subject to certain conditions and criteria specified in those Sections. 'Authority' has been interpreted to mean a person or body exercising power or command. 'Body' has been interpreted to mean an aggregate of persons, incorporated or unincorporated.

1.15 Section 20 is another enabling provision of the Act in terms of which audit of the accounts of certain bodies or authorities, not covered by Section 19 or whose audit has not been entrusted by or under any law made by Parliament to the CAG can be entrusted to the CAG.

1.16 Under Sub-section (1) of Section 20, the CAG has the duty to audit the accounts of such authority or body if the CAG is requested in this behalf, after prior consultation, by the President or the Governor of State/Administrator of a Union Territory having a Legislative Assembly, on such terms and conditions as may be agreed upon between the CAG and the Government concerned. For the

purpose of audit, the CAG has the right of access to the books and accounts of the authority or body.

1.17 Sub-section (2) of Section 20 empowers the CAG to propose to the President or the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly to authorize the CAG to undertake the audit of the accounts of any body or authority, not entrusted to the CAG for audit, if the CAG is of the opinion that such audit is necessary because a substantial amount has been invested in or advanced to the body or authority by the Government concerned.

1.18 Audit under Sub-sections (1) and (2) of Section 20 of the Act can be entrusted to the CAG only in public interest and only after giving a reasonable opportunity to the concerned authority or body to represent in respect of the proposal for such audit.

Audit of Receipts

1.19 Section 16 of the Act provides for audit by the CAG of all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly. It also requires the CAG to be satisfied that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as the CAG thinks fit and report thereon.

Audit of Stores and Stock

1.20 Section 17 of the Act vests in the CAG the authority to audit and report on the accounts of the stores and stock kept in any office or department of the Union or a State or a Union Territory.

Audit of Government Companies and Corporations

1.21 Section 19 of the Act deals with the duties and powers of the CAG in relation to the audit of the accounts of Government Companies and Corporations. These duties and powers are to be performed and exercised under Sub-sections (1) and (2) of Section 19:

- in the case of Government Companies, in accordance with the provisions of the Companies Act, 1956 contained in Sections 617 and 619 thereof; and
- in the case other Corporations set up by or under law made by the Parliament, in accordance with provisions of the respective Legislations.

1.22 However, the position of a Corporation established by a law made by the Legislature of a State or of a Union Territory is different. Under the Constitution, only Parliament can prescribe by law the duties and powers of the CAG. Sub-section (3) of Section 19 of the Act provides that audit of a Corporation established by law by the Legislature of a State or Union Territory can be

entrusted to the CAG in the public interest by the Governor of the State or the Administrator of the Union Territory concerned after consultation with the CAG and after giving a reasonable opportunity to the concerned Corporation to make representations in respect of the proposal for such audit.

1.23 Under Section 19A of the Act, the reports of the CAG in relation to the accounts of a Government Company or a Corporation audited under Section 19 are to be submitted to the Government or Governments concerned for being laid before the Parliament/legislature.

Powers in connection with performance of duties

1.24 By virtue of the provisions in Sub-section (1) of Section 18 of the Act, the CAG has, in connection with the performance of his duties under the Act, the authority

- a) to inspect any office of accounts under the control of the Union or of a State, including treasuries and such offices responsible for the keeping of initial and subsidiary accounts, as submit accounts to the CAG;
- b) to require that any accounts, books, paper and other documents which deal with or form the basis of or are otherwise relevant to the transactions to which his duties in respect of audit extend, shall be sent to such place as the CAG may appoint for his inspection; and
- c) to pose such questions or make such observations as the CAG may consider necessary to the person in charge of the office and to call for such information as the CAG may require for the preparation of any account or report which it is his duty to prepare.

1.25 Sub-section (2) of Section 18 requires the person in charge of the office or department, the accounts of which are to be inspected and audited by the CAG, to afford all facilities for such inspection and to comply with requests for information in as complete a form as possible and with all reasonable expedition.

Miscellaneous Powers

1.26 Under Section 23 of the Act, the CAG is authorised to make regulations for carrying into effect the provisions of the Act, in so far as they relate to the scope and extent of audit including laying down for the guidance of the Government departments the general principles of Government accounting and the broad principles in regard to audit of receipts and expenditure. The instructions relating to audit as contained in this Manual and other departmental publications issued under the authority of the CAG are covered under the provisions of this Section.

1.27 The CAG is also authorised under Section 24 of the Act to dispense with, when circumstances so warrant, any part of detailed audit of any account or class of transactions and to apply such limited checks in relation to such accounts or transactions as the CAG may determine. The provisions in the present Manual and and other circulars / instructions issued from time to time under the authority

of the CAG on the quantum and extent of audit also derive their authority from this Section of the Act.

Duties of Indian Audit and Accounts Department

1.28 The Indian Audit and Accounts Department, functioning under the CAG, derives its authority and the powers for performance of its duties on his behalf under the provisions of Section 21 of the Act. Under the special and general directions given by the CAG from time to time, the Accountants General and other officers and establishments of the Indian Audit and Accounts Department perform such duties and functions as are imposed on or undertaken by the CAG under the provisions of the Constitution, or of any law made by Parliament.

1.29 The term 'Accountant General' occurring in this Manual includes Principal Accountant General (Audit), Director General (Audit), Accountant General (Audit), Principal Director (Audit) and Accountant General (A&E), unless the context denotes otherwise.

Chapter 2

General Concepts and Overview

2.1 This chapter explains the general concepts about financial (attest) audit and also provides an overview of the financial (attest) audit process.

Auditing Standards

2.2 A number of far-reaching changes have occurred in the realm of Finance and Governmental activities over the years and auditing has had to keep pace with these changes. This process has resulted in statements covering almost every aspect of auditing being brought together to become Auditing Standards for use by the profession. These Standards aim to improve the auditing practices. The Auditing Standards provide a framework for the auditing steps and procedures. Moreover, the fact that an audit has been conducted in accordance with certain standards gives necessary reassurance to people making use of the financial statements and audit reports.

IFAC Standards

2.3 The accounting bodies of various countries established the International Federation of Accountants (IFAC) in 1977, to develop and enhance a co-ordinated worldwide accountancy profession. The International Auditing Practices Committee (IAPC) is a standing committee of the Council of IFAC and has been assigned the specific responsibility and authority to issue standards on auditing and related services. The IFAC has issued a number of International Standards on Auditing (ISAs). The ISAs do not override the statutory, regulatory or professional regulations in a country. Though the ISAs are, by themselves, not binding on the auditors in a particular country, they nevertheless provide an authoritative view of what are internationally recognised as generally accepted auditing practices. Some countries have adopted the ISAs without any changes while some others have adopted them with such modifications as are considered appropriate in the context of the local conditions.

ICAI Standards

2.4 The Institute of Chartered Accountants of India (ICAI) issued a number of Auditing and Assurance Standards (AASs) which are generally based on the corresponding ISAs issued by IFAC, taking into consideration the applicable laws, customs, usages and business environment in India. Since, under the Companies Act, companies in India are required to be audited by Chartered Accountants, these Standards have a significant effect on the way audit of companies is conducted in India.

INTOSAI Standards

2.5 The Auditing Standards Committee of the International Organisation of

Supreme Audit Institutions (INTOSAI) issued the Auditing Standards at the XIVth Congress of INTOSAI in 1992 in Washington, D.C. as amended by the XVth Congress of INTOSAI in 1995 in Cairo, Egypt. The Auditing Standards Committee of the International Organisation of Supreme Audit Institutions (INTOSAI) issued Code of Ethics for auditors in the public sector in 1998. While they do not have mandatory application, they reflect a “best practices” consensus among the Supreme Audit Institutions (SAIs) and each SAI is required to judge the extent to which the Standards are compatible with the achievement of its mandate.

Bridging Document

2.6 Recently, INTOSAI issued a INTOSAI Auditing standards Bridging Document to provide a link between INTOSAI Auditing Standards and International Standards on Auditing (ISAs) issued by IFAC’s IAASB. INTOSAI Standards will continue to provide the necessary framework and overriding principles for financial audit by SAIs. INTOSAI plans development of its own implementation guidelines or ‘Practice Notes’ by building on the more detailed value of the additional guidance contained in ISAs, in so far as it is relevant to the work of SAIs. While the Bridging Document and Practice Notes aim to support INTOSAI members in the application of ISAs, it will the responsibility of each SAI to consider the relevance of each ISA to its own particular circumstances.

Auditing Standards of the CAG of India

2.7 In SAI, India, Auditing Standards of the CAG of India were first issued in 1994. The Standards were comprehensively restructured and updated in a second edition of the Auditing Standards issued in 2002. These Standards are in harmony with the INTOSAI Auditing Standards.

2.8 The Auditing Standards of the CAG of India comprise of:

- General Standards;
- Field Standards; and
- Reporting Standards.

2.9 The General Standards should be distinguished from Field Standards and Reporting Standards. The former are concerned with the relationship of the auditor to the audited organisation and with the personal conduct of the auditor in carrying out the audit; the latter are concerned with the audit itself. Field Standards regulate the audit activity. Reporting Standards regulate what the auditor has to say after completing the audit. For details, the text of the Auditing Standards of the CAG of India should be taken as the principal reference.

2.10 The Auditing Standards of the CAG of India are mandatory in Audit and Accounts Department. Every member of the audit team should be conversant with them.

Consequences of failing to observe Auditing Standards

2.11 An auditor's failure to observe the audit standards set by the CAG of India will render the auditor answerable for such failure.

2.12 Failure to observe Auditing Standards may affect the quality of the audit work done. If the auditor's work were ever called into question - in a court of law, or otherwise, compliance with the Auditing Standards governing the audit would be an important factor in deciding whether the auditor had acted with reasonable care and skill. Hence, any decision to depart from the Standards in a given situation should be taken at an appropriately high level with the approval of the Headquarters Office of the CAG of India and it should be clearly documented.

General Principles and Practices of financial (attest) audit

2.13 The directions provided in this Chapter or in the subsequent Chapter are by no means exhaustive. They should not be taken as limiting the scope of audit rigidly to the lines indicated therein. It is of considerable importance that the audit checks prescribed should be observed in spirit and not merely in the letter.

Audit Objectives

2.14 In relation to Financial (Attest) Audit, it is necessary to clarify the following concepts:

- the primary objective of financial audit;
- objectives which might be set by the CAG or Statute;
- the general audit objective of any financial audit.

The primary objective of financial (attest) audit

2.15 Financial audit may be defined as a process of attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions on financial statements.

2.16 The Primary objective of financial audit is, therefore, the "expression of an opinion" on the financial statements.

Objectives set by CAG or Statute

2.17 While the primary objective of financial (attest) audit is to give an opinion on the financial statements (accounts), the CAG's objectives may determine the way the financial audit is carried out. The objectives set by the CAG would reflect his audit mandate and policy. For example, the CAG of India may set his audit objectives taking into account the provisions of the Constitution of India, the CAG's (Duties, Powers and Conditions of Service) Act, 1971 and any governing

legislation (like the Companies Act, 1956) in the case of Government Companies and any special governing legislation in the case of a Statutory Corporation (like the Damodar Valley Corporation Act, 1948). For instance, while carrying out financial audit of Finance and Appropriation Accounts of a State Government, verification of the adequacy of the internal controls in the systems followed in the compilation of accounts leading to the preparation of Finance Accounts and Appropriation Accounts in the Office of the Accountant General (A&E) may be specified as an objective. Sometimes, the Statute (the legislation governing the audit) may also lay down the audit objectives.

2.18 In the case of supplementary audit of Government Companies, the provisions of the Companies Act, 1956 and the orders/instructions issued thereunder and the instructions issued by the Headquarters Office of the CAG from time to time should be kept in view, while framing the audit objectives.

The general financial audit objectives : Assertions in Financial Statements

2.19 It is the responsibility of an auditor, before certifying an account, to make sure that competent, relevant and reasonable evidence was obtained to support the auditor's judgement and conclusions. There are some general audit objectives designed to ensure that the right sort of evidence is obtained; for example, to show whether the accounts are complete and whether the recorded transactions have properly occurred and are properly classified.

2.20 For the purpose of expressing an opinion on the financial statements being audited, an Auditor collects evidence. To be relevant, audit evidence must relate to the general audit objectives (also called 'assertions'). Assertions are positive statements about the "state of being". For example, an assertion may be that all receipts were accounted for, or that all the investments shown in accounts were really owned by the entity. These general audit objectives (assertions) are designed to ensure that the auditor obtains evidence to support all aspects of the opinion required to be expressed on an account.

General Financial Audit Objectives ('Assertions')

For receipts and payments or income and expenditure account items

2.21 There are five general audit objectives as indicated below.

- Completeness
- Occurrence
- Measurement
- Disclosure
- Regularity

2.22 These objectives are explained below.

Completeness: 'Completeness' means that all transactions relevant to the year

of account have been recorded. This implies that no transaction has been overlooked. This assertion directly tests for potential understatement of figures in accounts. To take an example, if the accounts are prepared for the financial year 2005-06 and an item of expenditure which takes place during 2005-06 is omitted from accounts, the 'completeness' objective is not fulfilled.

Occurrence: 'Occurrence' means that all recorded transactions occurred and were relevant to the year of account. For instance, if an item of receipt was booked in the accounts for the financial year 2005-06, to satisfy the 'occurrence' objective, the item should properly relate to only 2005-06 and not to any other financial year. This assertion directly tests for potential overstatement of figures in the accounts.

Measurement: 'Measurement' means that the recorded transactions have been correctly valued, properly calculated, or measured in accordance with established accounting policies, on an acceptable and consistent basis. This involves much more than clerical accuracy as it requires the auditor to check the conformity with established accounting policies and standards and the consistency in the measurement.

Disclosure: 'Disclosure' means that the recorded transactions have been properly classified and disclosed where appropriate. This implies that the receipts and expenditure were booked to the proper account head and the disclosures in the notes and foot notes in the accounts are appropriate and adequate.

Regularity: 'Regularity' is a unique requirement for Government Accounts. This requires that the recorded transactions are in accordance with the primary and secondary legislation and other specific authorities required by them.

2.23 It has to be carefully noted that in case of audit of Government Accounts, **regularity** of the expenditure and receipts is an important element to be considered.

<i>Example</i>
A payment may be correctly recorded and properly disclosed in the right year of account at the right value, but the payment would be irregular if it did not accord with the requirement of the governing legislation or regulations.

For balance sheet or items of assets and liabilities

2.24 There are five general audit objectives as indicated below.

- Completeness
- Existence
- Valuation
- Ownership
- Disclosure

2.25 These objectives are explained below.

Completeness: 'Completeness' means that all assets and liabilities have been recorded in the accounts and nothing was omitted. This objective directly tests for potential understatement of assets and liabilities. For example, if the accounts omit some investments or liabilities, the 'completeness' objective is not satisfied.

Existence: 'Existence' means that all recorded assets and liabilities exist. This objective directly tests for potential overstatement of assets and liabilities. For example, if the accounts show some amount as cash balance, which does not exist, the 'existence' objective is not satisfied.

Valuation: 'Valuation' means that the values given to the assets and liabilities are accurate and have been arrived at in accordance with the established accounting policies on an acceptable and consistent basis. This goes beyond mere arithmetical accuracy and requires conformity with accounting policies and standards and their consistent application.

Ownership: 'Ownership' means that the assets are owned by the entity, the liabilities are properly those of the entity and both arise solely from regular activities. The balance sheet represents an accumulation of the entity's rights and obligations. 'Ownership' assertion requires that the assets and liabilities reported actually represent those rights and obligations. For example, if an item is shown in the accounts as amount receivable, the entity should have the legal right to sue and collect the amount.

Disclosure: 'Disclosure' means that the assets and liabilities have been properly disclosed in accordance with the applicable reporting framework. This implies that the assets and liabilities were booked to the proper account head and the disclosures in the notes and foot notes in the accounts are appropriate and adequate. For instance, if obligations under guarantees given by the entity are not shown in the accounts, the requirement of 'disclosure' is not satisfied.

2.26 The following examples illustrate the way in which the general audit objectives are used.

Examples
(a) One of the audit concerns is whether the transactions were properly disclosed. If some item of revenue expenditure is misclassified as capital expenditure, it can be said that the disclosure is not proper. The auditor has to be satisfied about the classification of transactions.
(b) To take another example, another concern of the auditor is whether any items have been omitted from the account. The auditor must obtain evidence to the effect that all transactions relevant to the year of account have been recorded. This is the completeness objective. The auditor has to design audit tests to ensure that the completeness objective is met. If the monthly accounts of some Treasuries or Public Works Divisions are

excluded from the Accounts of a State Government, it affects the completeness objective.

2.27 Though the various Financial and Accounting Rules may not expressly state the above general objectives, nonetheless the general audit objectives have to be built in during the audit process.

Nature of Assurance by the CAG of India

Reasonable and not absolute assurance

2.28 The audit opinion provides reasonable assurance that the financial statements are free from material misstatement and irregularity. An understanding of the terms "reasonable assurance" and "material" is central to an understanding of the audit and the audit opinion.

2.29 Financial statements are not required to be absolutely correct. No system of internal control can guarantee completeness and accuracy of accounting records; nor can it be absolute proof against human error and fraud. Audit opinion should be based on reasonable assurance since to do so with absolute certainty would be vastly expensive.

2.30 Audit can give an unqualified certificate on the financial statements under audit as long as the level of error is not judged to be material. The accepted level of error for any particular account is determined in accordance with guidelines for materiality laid down by the CAG of India.

Audit Materiality

2.31 The concept of materiality underlines the whole process of financial audit. The users of financial statements do not need absolute accuracy to make informed decisions. A matter is, therefore, considered material if its omission or misstatement would reasonably influence the decision of an intended user of the audit report.

2.32 The concept of Materiality underlies the whole process of financial audit. Materiality should be considered by Audit when:

- a) determining the nature, timing and extent of audit procedures; and
- b) evaluating the effect of misstatements.

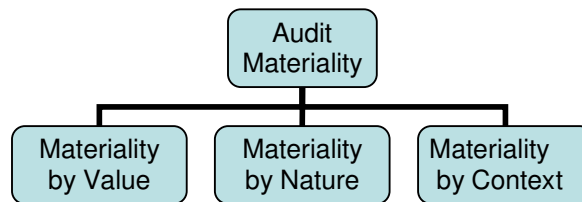
2.33 The concept of materiality is used both at the planning stage of the audit, when deciding what and how much work needs to be done, and in evaluating the results of the audit. These are sometimes known as "planning materiality" and "reporting materiality" respectively.

2.34 Since Audit has to report only errors which the auditor judges to be material, the audit work can be planned in the knowledge that it need detect only errors that are material.

2.35 In assessing materiality, the prime consideration is the total value of the errors in the account. However, value is not the sole consideration. The nature of the error, or the context in which the transaction occurs, are sometimes more important and Audit must always consider these factors, as well as the value, when deciding whether an error is material.

2.36 Thus, materiality is of three types, viz.,

- Materiality by Value;
- Materiality by Nature;
- Materiality by Context.



Materiality by Value

2.37 The point where **the total value of errors** in an account becomes unacceptable to Audit, so that Audit would have to qualify the audit opinion, is called the materiality level of that account. Audit has to judge the materiality level of a particular account through the eyes of the intended users of the account. In doing this, Audit will be judging the sensitivity of the account.

2.38 The materiality thresholds depend on the basis of accounts and their sensitivity. The norms generally followed are indicated below, as an example. The audit team members should make sure that they follow any guidelines laid down by the CAG of India in this regard.

2.39 Materiality is a relative term and requires the exercise of professional judgment.

2.40 Materiality should be chosen to reflect the drivers behind the account, and could be expenditure, income, average surplus or asset values. The level of materiality by value is set at the outset of the audit, but should only be considered as a guide. It should not be considered a hard and fast figure. A range of values can be considered for materiality and the audit plan should contain a justification of the choice.

2.41 Audit materiality should be based on its individual circumstances. When deciding on a figure to use as materiality you should be guided by two questions:

- How great is Parliament's / Legislature's and other users' interest likely to be?
- What are they most likely to be concerned about?

The level of interest in the account dictates the sensitivity of the account, more interest in the account results in less error being tolerated before the financial statements are felt to no longer give a true and fair view of the state of affairs of the body. The process should be informed by the work done in understanding the business.

For Accounts prepared on Cash Basis (for example, Finance and Appropriation Accounts)

2.42 The materiality level is usually set at a percentage of gross expenditure, depending upon the sensitivity of the account, as indicated in the following table. It could be based on gross receipts if, in the circumstances of the particular account, receipts were regarded as more important than expenditure.

<i>Classification of Account</i>	<i>Materiality Base</i>	<i>Materiality As Percentage</i>
Very Sensitive	Gross Receipts/ Expenditure	½ %
Sensitive	Gross Receipts/ Expenditure	½% to 2%
Not Sensitive	Gross Receipts/ Expenditure	2%

This is illustrated in the following example.

<i>Example</i>
The gross expenditure of a Government entity in a year is Rs 100 crore. The accounts are considered as sensitive in view of the interest expressed by Parliament and members of the general public. Considering the sensitivity, materiality threshold at 1%, i.e., Rs 1 crore was fixed for financial audit (as the overall threshold for errors).

For Accounts prepared on Accruals basis

2.43 The materiality level is usually set at a percentage of the materiality base, depending upon the sensitivity of the account. Different bases are available, as indicated in the following table.

<i>Base Figure for Materiality</i>	<i>Sensitivity of Account</i>		
	<i>Very Sensitive</i>	<i>Sensitive</i>	<i>Not Sensitive</i>
Normal net surplus	5%	5 – 10%	10%
Gross income / expenditure	1½%	½ - 2%	2%
Turnover (Sales)	1½%	½ - 2%	2%
Total assets	1½%	½ - 1%	1%
Net assets	1%	1 – 2%	2%

Example

A public sector corporation engages mainly in trading activities. The turnover of the corporation in a year is Rs 500 crore. The accounts are not considered as there is no recent interest expressed by Parliament and members of the general public, there is no proposal for disinvestment of Government's shareholding and there are no shareholders other than Government. Considering the accounts as non-sensitive, materiality threshold at 2%, i.e., Rs 10 crore was fixed for financial (attest) audit (as the overall threshold for errors).

2.44 It may not be necessary to set separate materiality levels for different financial statements like the Balance Sheet and Income and Expenditure Account. Each statement should be audited as part of an integrated set of financial statements recognizing that assurance from auditing one area of an account gives some assurance in others. For example, audit work in the income account area should normally provide assurance of the debtor balance.

Factors other than value in deciding materiality

2.45 While the use of a percentage as a numerical threshold, such as 1% of gross expenditure may provide the basis for a preliminary assessment of materiality, it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. In the Government Perspective, materiality is also based on the "context and nature" of an item and includes, for example, sensitivity as well as value.

Materiality by nature

2.46 The question asked here is ***"Does the error affect a figure in the accounts which users expect to be stated with a high degree of accuracy or which is likely to be of great interest to them?"*** This recognises that in any set of accounts some are more material than others. These will include specific disclosure requirements of the auditee entity and matters which the auditors know Parliament will be interested in to the extent that a higher degree of accuracy is required for those particular figures that there is for the account as a whole. Examples of items material by nature include the budgetary excesses, misclassification between voted and charged expenditure, chief executive's salary, the cash balance, Auditor's remuneration and details of special payments, write-offs and losses.

2.47 The following are some of the considerations that may render material a quantitatively small misstatement in a financial statement:

- whether the misstatement arises from an item capable of precise measurement or where the users expect it to be precisely stated (for example, surpluses and balances to be surrendered in Appropriation Accounts);
- whether the misstatement affects compliance with disclosure requirements of Accounting Standards or Rules (for example, items which need to be shown separately because of their exceptional nature).

Materiality by context

2.48 The question being addressed here is "Is the error material because of its implication for other aspects of the accounts?" For example, if , due to a misstatement, the financial statements indicate that a department has savings when it has, in fact, exceeded its budget, it will become material by context.

Materiality with regard to planning

2.49 "Planning materiality" is primarily concerned with materiality by value. Audit calculates the highest level of "tolerable error" for the estimated accounts as a whole, that is the highest amount which would not distort the overall view of the accounts given to the addressee of the audit report. Since Audit can rarely examine all transactions or balances, allowance is made within this "tolerable error" leaving only a fraction for the incidence of errors identified during the audit. Then Audit assesses the risk of this level of error in the balances and transactions and focuses the audit work accordingly.

2.45 The materiality of errors by nature and by context is a matter to be considered specifically at the end of the audit. At the planning stage, the possibility of such errors occurring should be recognised by ensuring that audit programmes include year-end procedures to detect them.

Reporting materiality

2.46 Reporting materiality applies at the end of the audit when all errors are evaluated and viewed in relation to their known effects on the financial statements. At this stage, the Auditor has to consider the audit findings by value, by nature and by context, and errors or omissions may be considered material which otherwise by value would not.

2.47 As a matter of abundant caution, planning materiality may be taken at a lower figure than reporting materiality.

Types of error

2.48 The types of error, which might be present in accounts, are those which the general audit objectives seek to identify.

Example

Items omitted from the accounts would be revealed by tests designed to meet the completeness objective. Included items not relevant to the period of the account would be identified against the occurrence objective. The measurement objective seeks out any misstated figures. The regularity objective would seek out if expenditure was not in accordance with the intention of governing legislation. Tests against the disclosure objective would be aimed at showing up items which had not been properly disclosed.

Most Likely Error and Precision

Most Likely Error (MLE)

2.49 Most likely error is a term used in planning and evaluating the results of audit. In planning it is more properly known as anticipated most likely error (AMLE) and is the error the auditors predict they will find as a result of audit testing based on the errors found in the previous year's audit. The level of AMLE set is a matter of judgement; if it is felt that the level of error found in the previous year was not typical for the account it may be adjusted to produce the AMLE. At evaluation stage MLE represents the level of error found and extrapolated.

Precision

2.50 'Precision' represents the degree of uncertainty in the auditor's estimate of error (the MLE). It is a range of error that auditors could accept in the account between MLE and materiality, it helps to ensure that if there is more error than anticipated it either remains below materiality or will be found through audit testing. As auditors cannot be sure that the errors predicted and found in testing are the only errors in the account, the sample chosen should ensure that the auditors can be 95% sure that they have found any error.

2.51 Precision forms the basis of the calculation used to determine the sample size which should be tested by auditors to gain audit assurance. If auditors base their sample sizes on materiality and AMLE alone, this would allow no room for the unexpected errors the auditors could find. Auditors, therefore, set a level for precision between 80% and 90% of the possible range between AMLE and materiality.

2.52 The auditors should ensure that the level of error predicted in the account is a genuine estimate. If there is an over-estimation of the level of error anticipated in the account, a smaller precision increases sample sizes and this usually leads to too much work being done. If the auditors anticipate very low levels of error and find more errors than planned for, this may cause problems in extrapolation.

Calculating Precision

2.53 Precision is calculated by the following formula:

$(\text{Materiality} - \text{Anticipated Most Likely Error}) \times \text{Range of error possible but with no room for unexpected error}$

The range is normally taken as 80 to 90%. The percentage to be chosen depends upon the nature of population and the expected chance of unexpected error. If the chance is more, a lower percentage (say 80%) can be chosen which will give more margin for error.

Example	
Population value	Rs.8,00,00,000
Materiality	Rs.8,00,000
Anticipated error	Rs.3,00,000
Percentage (from range of error) taken for calculating precision	80%
Planning Precision	$\text{Rs.}(8,00,000 - 3,00,000) * 80\%$ $= \text{Rs.}4,00,000$

2.54 Precision is used in the calculation of the size of statistical sample drawn and the evaluation of the results of testing the sample. For any account the reasons for the level of planning precision and AMLE should be explained and recorded.

Risk-based Audit Approach

2.55 It is the policy of CAG of India to adopt a risk based approach that focuses audit efforts on areas of greatest risk to the proper presentation of financial statements of government entities, while respecting all areas of his audit mandate.

2.56 Risk in auditing means that Audit accepts some level of uncertainty in performing the audit. In other words, Audit accepts the risk that the audit conclusion may be wrong and that Audit may have allowed material error to remain undetected in the account. Only a very small degree of audit risk would be acceptable as otherwise the audit process may lose its purpose. Hence, a very high level of assurance (or confidence) is required when expressing the audit opinion. This is one of the most important steps in the planning phase in ensuring that the auditor will gather competent, relevant and reasonable audit evidence at minimum cost.

2.57 Normally, a level of 95% assurance is considered appropriate in which the audit risk would be 5%. The instructions issued by the Office of the CAG of India regarding the level of assurance and acceptable level of audit risk should be complied with by all field offices.

2.58 The amount of assurance the auditor needs from the audit tests (i.e., the

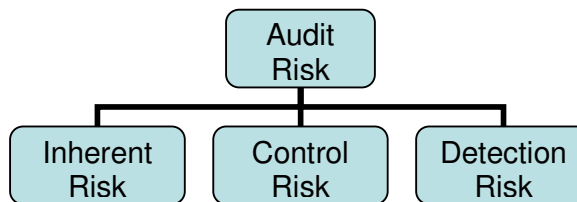
amount of risk the auditor is prepared to accept) and the materiality level set by the auditor are inter-related factors in determining the number of transactions and items which the auditor needs to examine.

2.59 There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. Audit should take note of the inverse relationship between materiality and audit risk when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, Audit determines that the acceptable materiality level is lower, audit risk is increased.

2.60 The risk model enables the auditor to calculate the level of assurance (or confidence) needed from substantive audit tests. The level of assurance required then determines the size of the sample to be tested.

Risk Model

2.61 According to the risk model, audit risk (AR) has three components: inherent risk, control risk and detection risk.



“Inherent Risk” (IR) is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

“Control Risk” (CR) is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

“Detection Risk” (DR) is the risk that an auditor’s substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.

2.62 The risk that audit procedures fail to detect material error (DR) is therefore influenced by the amount of inherent risk (IR) and control risk (CR). For example, the lower the risk of material error occurring in the first place (IR) and of internal

controls failing to prevent or detect it (CR), the less audit work is necessary in relation to the detection risk (DR). In other words, the more assurance Audit feels able to take from assessments of IR and CR, the less assurance Audit needs from substantive testing and thus the smaller the sample Audit requires to reasonably examine.

2.63 The risk model can be expressed by the equation:

$$\text{AR} = \text{IR} \times \text{CR} \times \text{DR}$$

Example

Assume that the level of assurance required is 95%; the audit risk accepted (AR) is 5%. Inherent risk (IR) was assessed at a level of 40%, i.e., it was felt that 60% assurance could be taken. From the testing of controls, it was felt that 50% assurance could be taken, i.e., control risk (CR) is 50%.

$$\text{Then Detection Risk (DR)} = \frac{0.05}{0.4 \times 0.5} = 25\%$$

A detection risk of 25 % would mean that assurance of (a confidence level of) 75% would be required from substantive audit tests.

2.64 Use of the overall audit risk model enables the auditor to assess risk in order to plan and perform the audit to reduce overall audit risk to an acceptably low level.

2.65 Though it is possible to give weightage to various risk parameters and arrive at a quantitative assessment of risk, in practice, Audit need not make precise assessment of each risk component or to carry out complicated calculations to arrive at the assurance needed from substantive testing. Instead, the principles explained above can be built into an assurance guide. Moreover, risk is generally assessed as 'high', 'medium' or 'low' rather than being quantified in percentages.

2.66 Audit has to assess whether to take high, medium or low assurance (or indeed any assurance at all) from the 'accounting environment'. *In this context, the term 'accounting environment' means anything which has an influence on whether or not an error is likely to occur in the first place.* Audit is concerned with material error and inherent risk assessment may be applied to an account area or to the account as a whole.

2.67 The following are some of the illustrative factors used for assessing inherent risk.

- the characteristics of the account or account area (like for example, errors are more likely to occur where the governing conditions and calculations are complex)

- the personnel doing the accounting (for example, their competence and also whether the likelihood of errors might have been increased by other factors, such as time pressures)
- the history of error in the account or account area
- whether there is any motive for management to manipulate the figures (for example, for presentational reasons, perhaps to avoid showing a deficit)
- volume and size of transactions
- previous history of non-production of records to audit

Audit evidence

2.68 The concept of evidence is fundamental to auditing. All audit techniques and procedures are derived from this concept. Auditing is considered as a form of judgement concerned with verification and examination of quantifiable information. In this process, an auditor collects and evaluates evidential matter to establish facts and to draw conclusions and inferences.

2.69 As per the Auditing Standards, the auditor should obtain competent, relevant and reasonable evidence to support his judgement and conclusions.

2.70 In regularity audit, evidential matter primarily consists of underlying accounting data and all corroborating information available to the auditor. The evidence should be collected with reference to the general and any special objectives of audit. For example, the auditor seeks evidence to confirm that items have not been omitted from the accounts, and that no items in the accounts have been included wrongly or have been misstated, and that all items have been properly disclosed. In relation to assets and liabilities, the auditor has to obtain evidence as to the existence of assets and liabilities and that they have been recorded at reasonable values. With the application of various audit techniques, an auditor collects different types of evidence.

2.71 The principal source of evidence for audit conclusions will be the records of the auditee. It is the primary duty of Audit to ensure that the audit conclusions drawn about the organisation and various projects and programmes, activities, transactions, etc. subjected to audit are based on sufficient, competent and relevant evidence. Evidence must be planned, gathered and analysed before any conclusion can be reached. Evidence may be gathered by:

- physical observation, including joint inspection by the auditors and the executive, the resultant observations being signed by both as confirmation of performance or achievements;
- reperformance of accounting routines (e.g., checking computations);

- analysis of financial statements and interrelationships or comparison between elements of relevant information;
- vouching, i.e., checking of documents in support of transactions;
- critical scrutiny of documents (e.g., reviewing data to identify unusual items);
- confirmation and enquiry;
- evaluation of the quality of internal control mechanisms;
- interviews with executives; and
- computer assisted audit techniques (CAATs).

2.72 The concept of audit evidence was dealt with in more detail in Chapter 4.

Commonly Used Audit Procedures

2.73 The following audit procedures are commonly used to obtain audit assurance.

- (i) Analytical Procedures (APs)
- (ii) Systems Based Audit (SBA)
- (iii) Direct Substantive Testing (DST)

Analytical Procedures

2.74 Analytical Procedures consist of the evaluation of financial information in audit, made by a study of plausible relationships among both financial and non-financial data. It involves analysis of significant ratios and trends including the fluctuations that are inconsistent with other relevant data or which deviate from expectations. "Expectations", in this context, refer to the auditor's expectations of what a figure in the accounts being audited should approximately be as worked out from other relevant financial and non-financial information. Their use is based on the assumption that there are relationships between items in the accounts and that these relationships may be expected to continue.

Examples
The reasonableness of the figure of expenditure on salaries can be verified by multiplying the average number of the employees in each grade with the average salary for the grade.
The reasonableness of the interest on General Provident Fund balance can be verified by multiplying the average balance in the General Provident Fund with the prescribed rate of interest.

Some of the commonly used analytical review procedures are:

- comparisons involving a single component;
- comparison across components;
- system analysis;
- predictive analysis;
- regression analysis; and
- business analysis

Comparisons involving a single component

2.75 There are two types of comparisons. The first type involves comparison of the recorded value of a component with its budgeted value. The second, called trend analysis, involves a comparison of a component's current value with its value in previous years. This procedure may be used at both the planning and execution stages of audit. It is commonly used to analyse income statement accounts. In trend analysis, it is preferable to compare figures of a few previous years than just the immediately preceding year in order to factor out any anomalies or aberrations specific to a given year.

Comparison across components

2.76 This involves analysis of the relationship between more than one financial statement component. This procedure is also referred to as ratio analysis. Some examples are accounts receivable to turnover ratio, inventory-turnover ratio, gross-margin ratio, etc. This procedure may be used at both the planning and execution stages of audit. It is crucial that the definition of the ratios used is consistent with that used for prior years or with that of similar entities, as the case may be. This procedure is generally more effective than single component comparisons because it considers the inter-relationships among different components. Moreover, this procedure can provide assurance simultaneously for more than one component.

System analysis

2.77 This involves the identification of anomalous items within an account balance rather than a macro level analysis of the balance itself. The approach would be to scan or analyse individual entries in transaction listings so as to locate unusual entries or abnormalities. This procedure may be fruitfully used during the execution stage. However, since it may involve scrutiny of numerous transactions, it may be time consuming if performed manually. If the data is computerized, use of appropriate auditing software could significantly aid the adoption- of this procedure.

Predictive analysis

2.78 This involves the creation of an expectation using not just financial data but also operating or external data, independent of the accounting system. The key word is “independent”; predictive testing can be used only where sufficient information independent of the accounting system is available. Therefore, it is also referred to as an “independent test of reasonableness”. For example, volume of imports and import duty rate may be used to predict import duty revenue. This is generally used in the execution stage. It often requires more time than simpler analytical procedures, especially since it involves collection of reliable data from outside the accounting system.

Regression analysis

2.79 This is a statistical technique that creates an equation to reveal how one variable is related to one or more other variables. It is similar in principle to predictive analysis but has added mathematical rigor and objectivity. It is generally used in the execution stage. It requires understanding of the statistics of complex variables and is therefore not “user-friendly” to the general auditor. It also requires much time for application and testing and is therefore not in frequent use.

Business analysis

2.80 This is a high (macro) level analysis of financial statements involving critical ratios related to profitability, liquidity, financial stability, debt, etc. It is a useful technique for identification of risk areas during planning and audit completion stages and also for a better understanding of the entity and its operations. However, it provides no audit assurance and is not used in the execution stage. It requires detailed knowledge of general business relationships and trends; consequently, it is likely to prove a useful tool for the more experienced members of the audit team who can apply their cumulative knowledge of the particular entity being audited.

Steps involved in analytical review

2.81 The steps involved in analytical review are as follows:

- (i) Develop an expectation: The basic premise of analytical review is the expectation that there are relationships between different types of data and that these relationships will continue to exist unless conditions to the contrary arise, which may then have to be investigated. For example, based on the quantity of cotton imported and its import price, Audit may develop an expectation that the annual value of cotton imports could be of the order of magnitude of Rs 1,000 crore.
- (ii) Define significant differences: Only very rarely will the actual recorded amount equal our expectation. It will perhaps not be worthwhile to investigate all cases of differences between recorded amounts and expectations. Instead, only

those that are significant will need to be investigated. For example, Audit may, based on professional judgment, decide in the example given in (i) above that variations of up to Rs 50 crore from expectations are acceptable.

(iii) Compare the actuals with the expectation: Continuing with the above example, let us assume that Audit discovers that actual value of the annual cotton imports is Rs 910 crore. In this situation, the difference between the expectation of Rs 1,000 crore developed at (i) above and the actuals is Rs 90 crore, which is significant because the auditor has decided [(ii) above] that variations above Rs 50 crore between expectations and actuals are significant.

(iv) Investigate any significant differences between actuals and expectation: As the difference of Rs 90 crore is more than Rs 50 crore considered as being significant, Audit will have to investigate the reasons for this significant difference.

(v) Document the first four steps and make an audit conclusion as to whether assurance can be drawn: Assuming that the investigation referred to at (iv) above has revealed that, of the difference of Rs 90 crore, a sum of Rs 25 crore is attributable to the misclassification of cotton imports as textile imports, an amount of Rs 65 crore will still remain unexplained. This amount being greater than the significant difference of Rs 50 crore defined at (ii) above, Audit can derive very little or no assurance from the analytical review procedure adopted in this case.

2.82 Analytical procedures can be used for different purposes at different stages of audit, viz.,

- in planning the audit, to assist Audit by pointing areas requiring examination
- as substantive tests, in areas where analytical procedures can be used to obtain evidential matter regarding the accuracy of figures
- in reporting stage, to assist in the final stage of the audit in assessing the conclusions Audit has reached and in evaluation of the overall financial statement presentation by identifying odd or unusual figures in the final accounts.

2.83 The decision about whether to use analytical procedures as substantive procedures and the nature, timing and extent of their use is based on the auditor's judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions.

Basic Audit Approaches

2.84 The Systems based audit (SBA) and direct substantive testing (DST) constitute the basic audit approaches.

Systems Based Approach (SBA)

2.85 Government Departments will normally establish systems of control designed to assure the accuracy and completeness of financial statements, the legality and regularity of underlying transactions and the economy, efficiency and effectiveness of operations. Generally speaking, if the auditor is satisfied about the adequacy of these controls, substantive checking of financial statements, transactions or the performance of the organisation can be reduced accordingly. The approach whereby the auditor relies upon the entity's system of internal control is known as the Systems Based Approach (SBA).

2.86 Various steps involved in SBA are as follows:-

- the identification and in-depth evaluation of relevant key controls, and assessment of the extent, if any, to which the auditor can rely upon these controls provided that they are found to be operating effectively;
- the testing of the operation of those key controls to establish whether they have operated effectively throughout the period under examination;
- the evaluation of the results of the tests of control to establish whether the degree of reliance foreseen can be taken from the examination of the controls;
- substantive testing of a number of transactions, account balances, etc. to determine (as relevant to the audit objectives) whether, irrespective of the entity's system of controls, the financial statements of the entity are properly presented, free from material misstatements and the underlying transactions were regular.

Example
In auditing the Customs Department, one of the sub-systems could be 'Assessment of Duty'. The control objective for this sub-system could be that the tariff applied for the purpose is an approved one in accordance with the Customs Act. One of the controls for achieving this objective could be that the staff engaged in assessment work should be imparted refresher training at least once in three years. Audit may decide that this is not a key control and instead identify the stipulation that the Assessment Supervisor should test check at least 20 <i>per cent</i> of the assessments made by the assessment staff as a key control.

2.87 In addition, evidence gathering techniques like review of documents, review of performance, physical observation or interviews will be used to test check whether the key control function as envisaged has been achieved. Based on the results of the test check, the auditor will arrive at a conclusion whether the controls are reliable and the extent of their reliability. If necessary, the auditor may also indicate loopholes in the internal control systems and suggest what additional controls could be introduced to remove such loopholes.

Direct Substantive Testing (DST) approach

2.88 When the audit objectives can be achieved without relying on the systems in place in the auditee, and thus without undertaking tests of control, it is known

as the Direct Substantive Testing approach (DST). Direct substantive tests are those tests of transactions and balances which seek to provide evidence as to the completeness, accuracy and validity of information in the accounting or financial statement. The testing involves examination of samples of transactions or account balances and is a form of inductive reasoning where the reasonableness of the aggregate results is inferred from the evidence of reliability of the individual details that have been tested.

Example

If the auditor wants to test whether purchases have been made by following the established procedures and have been accounted for correctly in the records, the auditor may test check some purchase transactions. If the transactions tested conform to procedures and have been correctly accounted for, the auditor can infer that purchase procedures have been adhered to.

2.89 Various steps involved in performing direct substantive testing are as follows:

- i. Identification of the sub-system to be tested. For example, while auditing the Transport Department, one of the sub-systems could be purchases.
- ii. Identification of the sub-audit objective to be tested for the selected sub-system. For example, the sub-audit objectives could be to check whether 'the transactions are accurately reflected in the accounts' or 'all purchases are completely accounted for in the records'.
- iii. Identification of the technique for gathering evidence. Continuing with the earlier example, to test the sub-audit objective of whether the transactions are accurately reflected, the auditor may re-perform the calculations in the purchase vouchers. However, in order to test whether all the purchase transactions have been accounted for, the auditor may reconcile the purchase book with the invoices received from the suppliers or with the suppliers' ledger.
- iv. Determination of the sample size and performance of a test check using the identified technique for evidence gathering.
- v. Formulation of conclusions on the fulfilment or otherwise of the sub-audit objective for the selected sub-system.

Audit Sampling

2.90 While Audit is not required to examine all the transactions and vouchers, nonetheless, it has to obtain sufficient evidence to reach an appropriate conclusion. This requirement is met through careful selection and sampling of the transactions or items.

2.91 The audit procedures like inspection, observation, enquiry and confirmation, computation and analysis are applied to transactions and account

balances. Audit can apply such techniques to an entire set of data (100% testing) or may choose to draw conclusions about the entire set of data (the population) by testing a representative sample of items selected from it. This latter procedure is audit sampling.

2.92 Audit Sampling is the testing of less than 100% of the items within a population to enable Audit to form certain conclusions about the population. The population can be a class of transactions (like grants-in-aid) or an account balance (like loans).

2.93 The transactions making up an account are usually examined by areas *where the transactions are of the same type and have the same risk of being misstated*. Account balances (for example, loans) are made up of individual items. All the transactions of an account area are known as its accounting population. Similarly, all the items making up an account balance comprise an accounting population. The documents which the auditor needs to examine for particular tests can also be regarded as population, for example, all the salary bills or running account bills.

2.94 Generally, a population should be divided (or stratified) into at least three segments:

- high value items;
- key items; and
- the remainder.

2.95 The high-value and key items are separately examined 100% and Audit would examine a sample of the remainder.

2.96 The following methods cannot be expected to produce representative samples and are not generally considered as acceptable.

Block selection: Using this selection method the auditor selects all items of a specified type processed on a particular day, week, or month. For example, the auditor might examine all transactions of a selected month (usually March). The problem with this selection method is that the sampling unit is a period of time rather than an individual transaction and a valid sample size would normally be impractically large. However, if the auditor desires to lay special emphasis on the transactions for a selected month (say March) due to reasons like substantial expenditure or irregularities noticed in previous years, the auditor should treat it as a separate segment within the population and apply sampling procedures separately.

Judgemental selection: Using this selection method, the auditor selects large or unusual items from the population or uses some other judgmental criterion for selection. This selection method cannot be considered a representative selection method.

2.97 One of the main kinds of sampling called 'Attribute Sampling' is generally

used for testing of controls.

2.98 Monetary Unit Sampling (MUS) is an important sampling method, which is mainly used in Substantive test of details in financial audits. This helps in the projection of findings, based on test results, in Rupee terms to the population tested.

Principles of Sampling Techniques

2.99 When designing the size and structure of any audit sample, the auditor should always:-

- identify the specific objectives to be addressed;
- ascertain the nature of the population; and
- determine the sampling and selection methods which are most appropriate and cost effective for the objectives given the nature of the population.

Sampling uncertainty

2.100 Where the auditor decided to use sampling, it should be recognised that results obtained from the sample will be different from those which would have been found if 100 per cent testing was carried out. Because of this sampling uncertainty, there is a risk that the auditor may either fail to detect material error, or may conclude that there is material error where this is not the case. However, the margin of uncertainty can be reduced to acceptable levels by increasing the sample size or by finding a more efficient sampling method, if available.

Statistical sampling

2.101 A major objection to the use of subjective selection of the individual transactions to be tested is the possibility that such a sample may, despite the auditor's best intentions, be biased, that is, tend to lead to an estimate of total population values which is systematically either too large or too small. A further difficulty is that there is no objective method for calculating the uncertainty in the estimate produced.

2.102 If, on the other hand, statistical sampling methods are used, the auditors can generally find a way of producing unbiased, or almost unbiased, estimates of population values and of calculating objective measures of uncertainty in the estimates. Provided that the use of statistical sampling is feasible and cost-effective, it should generally be used in preference to non-statistical methods.

2.103 While using statistical sampling, a random mechanism is applied to choose the transactions to be tested. For example, in simple random sampling each transaction has the same chance of being included in the sample. However, modifications of simple random sampling are more widely used in audit.

2.104 A pre-condition for any statistical sampling is the availability of a sampling frame, in effect, a listing of all the transactions which make up the account or

account area. Where accounting records are computerised, this listing may be readily accessible. The use of computer assisted audit techniques (CAATs), in particular IDEA, is likely to provide a cost-effective means of sample selection in such cases.

Non-statistical sampling

2.105 In most cases, 100 per cent testing of an account area is impracticable on cost grounds. However, in some instances, the auditors may be able to identify a relatively small group of transactions which are sufficiently important that an error in any one of them would have serious implications for the account area. This might apply, for example, to any transaction whose value was in excess of the planning materiality.

2.106 The auditors may also wish to carry out 100 per cent testing when the results of the first phase of testing suggest that unexpected errors may be present in a precisely defined group of transactions, such as those authorised by a particular individual between specified dates. The 100 per cent testing would be applied only to the identified group of suspect transactions.

2.107 The auditors can also use 100 per cent testing to audit a group of transactions within an account area which they believe have either a particular sensitivity, or a particular risk.

2.108 Where the auditors apply 100 per cent testing to a group of transactions, they will know the monetary value of error for that group. For the remaining account areas, where the auditors have tested a sample of transactions, they can only estimate the error. Where the auditors have selected the sample statistically, there is a firmer basis for calculating the estimate.

Specific statistical sampling techniques for tests of detail

2.109 The most commonly used sampling methods in connection with tests of detail are:-

- simple random sampling;
- stratified random sampling;
- monetary unit sampling (MUS); and
- Multi stage sampling

Simple random sampling

2.110 The main characteristics of simple random sampling is that all transactions have the same chance of being included in the sample. A high value transaction is no more likely to be selected than one of low value, one with low risk of error has the same chance of inclusion as a high risk transaction. While the method is more straightforward to apply than stratified sampling and MUS, its application to sampling for tests of detail is generally restricted to situations where both the values and the risks associated with the transactions making up the account area are believed to be fairly homogeneous.

2.111 The extrapolation of results from simple random sampling does not in general lead to significantly biased estimates of total population error. On the other hand, results can be subject to considerable variation, depending, for example, on how many high value transactions are sampled. Where either monetary values or assessed risks of error vary widely between transactions, alternative sampling methods are usually preferable.

Stratified random sampling

2.112 Stratified random sampling is an extension of simple random sampling, in which the population is first divided into discrete bands, or strata, each being fairly homogeneous with respect to value and risk. Sampling, usually simple random sampling, is then carried out separately in each stratum, but more intensively in some strata than in others. The use of 100 per cent testing in one or more strata is not precluded.

2.113 The decision on where to draw the stratum boundaries is a matter for audit judgement. The auditor may, for example, wish to consider whether any identifiable types of transaction have a particularly high risk of error.

Monetary Unit Sampling (MUS)

2.114 Monetary Unit Sampling (MUS), as its name implies, is a statistical sampling method in which a high value transaction is more likely to appear in the sample than one of lower value. It is a particular case of the statistical technique of probability proportional to size (PPS) sampling. Where the strata in stratified sampling are based on book values, and appropriate sampling fractions are used in each stratum, stratified sampling can produce results which are broadly similar to those obtained from MUS.

2.115 Many variants of MUS are used in audit. It is more widely used than simple random sampling because it is usually more efficient, in the sense that the margins of uncertainty in the estimates of error are generally narrower with MUS than those based on a simple random sample of the same size. However, the calculations needed as a preliminary to carrying out MUS are liable to be cumbersome, unless they can be computerised.

2.116 In most audit applications of MUS, a 100 per cent probability of selection is attached to transactions in excess of the Average Sampling Interval (ASI), which is defined as the ratio of the total book value in the account area to the sample size.

Multi stage sampling

2.117 Multi stage sampling approach is required if transactions are processed or accounting records are held at a number of locations in such a way that we cannot directly extract a sample from across the entire population. In most cases, the locations are too numerous for it to be practicable to visit them all. In such a situation, a practical way of drawing a sample would be:-

- select the locations to be visited; then
- select the items to be tested at each location.

2.118 When selecting the locations to be visited a stratified sampling approach can be adopted, but MUS and simple random sampling may also be used. The strata may be based on number and value of transactions passing through each location, or on the levels of risk attached to them.

The evaluation of the test results will consider:-

- the error found at each sampled location;
- the combination of the test results from all locations.

2.119 The Statistical Advisor at Headquarters Office may be consulted when a multi-location sampling approach is planned, and in connection with the extrapolation of sample results.

Right of Access to Information

2.120 In the course of scrutiny of accounts and transactions of Government, Audit is entitled to make such queries and observations and to call for all records, statements, returns and explanations as it may consider relevant and necessary in the interest of proper discharge of its duties. All such queries and observations shall be couched in courteous and impersonal language.

2.121 Under Sub-section (2) of Section 18 of the Act, it is the statutory obligation of the person in-charge of the office or the department, the accounts of which are to be inspected/audited by the functionaries of the CAG, to afford all facilities for the inspection/audit and comply with requests for information in as complete a form as possible and with all reasonable expedition. In the eventuality of non-production of vital records, the audit should be called off and the matter should be reported by the Accountant General to the Chief Secretary in the State or to the Secretary to the Government of India in the Centre, or the chief executive of the auditee entity, as the case may be.

2.122 In case the problem is not resolved even after this is brought to the notice of the Chief executive concerned, an omnibus draft paragraph on all such problems that arise during the year should be considered for inclusion in the Audit Report for bringing to the notice of the Legislature through the Public Accounts Committee or the Committee on Public Undertakings the failure of the executives to discharge their statutory obligation. In addition, in the Audit Certificates on Accounts, appropriate qualification / disclaimer on account of 'limitation in scope' caused by the non-production of records should be considered.

Overview of the financial (attest) audit process

2.123 The numerous steps in the financial audit process can be broadly grouped in three phases:

- | | |
|-------|-----------|
| (i) | Planning |
| (ii) | Executing |
| (iii) | Reporting |

2.124 The financial audit process can be illustrated by means of the diagram in the next page. The process is summarised below. The various steps involved are elaborated further in subsequent Chapters of this Manual.

Planning

2.125 A timely, well-thought-out and well-executed planning effort is essential to the performance of an effective and efficient financial audit. In the initial planning stage, Audit should obtain or, in the case of a recurring audit, update understanding of the auditee, its activities, operations and control environment. This results in an overall audit plan. The planning phase covers various steps/activities indicated in a diagram in next page.

Understanding the entity

2.126 The understanding of the auditee entity is normally a documented compilation which serves as a framework or reference to the Audit when planning, executing, completing the audit as well as reporting the results of audit. The description must comply with guidelines in the relevant Auditing Standards and audit instructions.

Establishing Audit Objectives and Scope

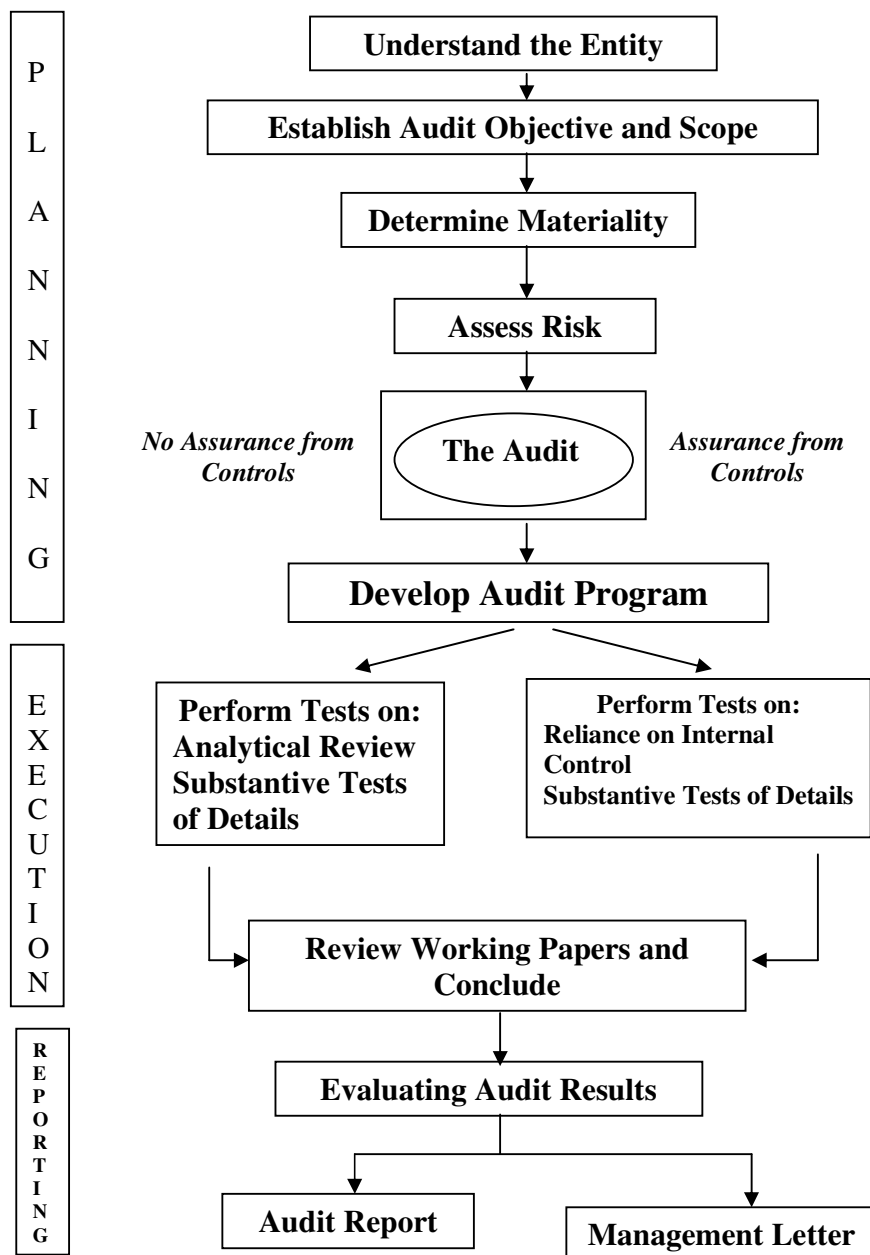
2.127 The objective of a financial audit is primarily to provide opinion on a set of financial statements and the audit process has to be designed to enable the certificate to be given. Modern auditing is more of an analytical exercise which involves evaluating the effectiveness of internal control procedures, examining scientifically selected samples of transactions in depth and applying analytical procedures.

2.128 For the purpose of expressing an opinion on the financial statements, Audit collects evidence. To be relevant, audit evidence must relate to the general audit objectives (also called 'assertions') which were already explained earlier.

Determining Materiality

2.129 The concept of materiality was already explained in earlier paragraphs. The CAG of India can give an unqualified certificate on the financial statements under audit as long as the level of error is not judged to be material. The accepted level of error for any particular account is determined in accordance with guidelines for materiality laid down by the CAG of India. Auditing standards require auditors to consider materiality in determining the nature, timing and extent of auditing procedures and in evaluating the results of those procedures.

OVERVIEW OF THE AUDIT PROCESS



Assessing Risk

2.130 The concept of Audit Risk was already explained in earlier paragraphs. In a nutshell, Risk in auditing means that Audit accepts some level of uncertainty in performing the audit work. In other words, Audit accepts the risk that the audit opinion given might be wrong. Only a very small degree of audit risk would be acceptable as otherwise the audit process may lose its purpose. Hence, a very high level of assurance (or confidence) is required when expressing the audit opinion. This is one of the most important steps in the planning phase in ensuring that the audit team will gather competent, relevant and reasonable audit evidence at minimum cost.

Preparing Audit Plan

2.131 The audit plan would contain details of the areas to be audited, the starting date and ending date for the audit, the manpower and other resources needed for a financial audit. Audit planning is explained in detail in a separate Chapter.

Preparing Detailed Audit Programmes

2.132 For each and every area identified for audit, it is necessary to specify in detail the manner in which the audit will be carried out. An audit programme would contain the objective of audit for that area, the audit procedure to be followed, the source for audit and description of what constitutes error.

Execution

2.133 This phase covers the following steps to carry out the audit.

Sampling

2.134 While the CAG of India is not required to examine all the transactions and vouchers, nonetheless, the auditor has to obtain sufficient evidence to reach an appropriate conclusion. This requirement is met through careful selection and sampling of the transactions or items.

Sampling for Testing of Controls:

2.135 Generally, the auditor tests controls using 'Attribute Sampling', one of the main kinds of sampling.

Performing Controls Testing Procedures:

2.136 If Audit, based on preliminary evaluation, decides that controls instituted in the organisation are effective and some assurance can be drawn from them, procedures to test controls are performed. Where the internal controls are effective, Audit can perform reduced substantive testing as more assurance can be derived from controls. On the other hand, where the internal controls are weak or ineffective, Audit has to perform more substantive testing as little or no assurance can be derived from controls.

Performing Analytical Review

2.137 Using this technique, Audit would analyse ratios and trends and analyse fluctuations from expectations.

Sampling for Substantive Test of Details

2.138 Monetary Unit Sampling (MUS) is another important sampling method, which is mainly used in Substantive test of details. MUS enables Audit to project findings, based on test results, in monetary terms (such as Rupees, etc.) to the population tested.

Performing Substantive Test of Details

2.139 Substantive test of details are performed for checking monetary misstatements in individual transactions.

Review of Working Papers

2.140 At each stage in the execution phase, the auditor is required to prepare adequate documentation of his work. These working papers prepared by the audit personnel would have to be reviewed by higher-level supervisory officers to see whether they are correct and contain reliable, adequate evidence to support findings.

Reporting

2.141 The reporting phase generally covers evaluation of audit results and preparation of audit reports.

Deriving Conclusions and Evaluate Audit Findings

2.142 The impact of the errors found out during the execution stage would be assessed to determine whether they would have material effect on the financial statements audited. For this purpose, the errors found in samples are required to be suitably projected to the population.

Reporting

2.143 This is the last activity in the audit process and involves preparation of audit report (certificate) which contains the audit opinion on the financial statements.

2.144 A management letter may also be issued to the management of the auditee indicating the weaknesses in internal controls.

Cash vs accrual based accounts

2.145 Depending upon the basis adopted for their preparation, sometimes,

accounts are categorised into:

- **cash accounts** - which include only the transactions which actually take place within the period covered by the accounts; and
- **accrual accounts** - which reflect all the transactions relating to the period of the accounts without regard to the actual date of payment or receipt.

2.146 The Union and State Governments presently follow cash based accounting. The Corporations and autonomous bodies mainly follow accrual based accounting. The Government Companies invariably follow accrual based accounting as it is mandatory under the provisions of the Companies Act, 1956. They are also required to follow the Accounting Standards of the Institute of Chartered Accountants of India. The Externally aided projects follow the method of accounting adopted by the implementing agency.

Audit Certificates

2.147 The auditor's certificate is made up of two parts, given in separate paragraphs:

- **Scope:** The auditor has to provide information about the audit carried out
- **Opinion:** The auditor has to give opinion on the financial statements audited.

2.148 An audit opinion is normally given in a standard format, relating to the financial statements as a whole, thus avoiding the need to state at length what lies behind it but conveying by its nature a general understanding among readers as to its meaning. The nature of these words will be influenced by the legal framework for the audit, but the content of the opinion will need to indicate unambiguously whether it is unqualified or qualified and, if the latter, whether it is qualified in certain respects or is adverse or a disclaimer of opinion.

The audit opinion and basis of accounting

2.149 It has already been explained in the beginning that the words used in an unqualified opinion are intended to convey a meaning which allows for the existence of some (but not material) error in the accounts. The following paragraphs describe the wording of the opinion for different types of accounts audited.

2.150 The words used in the audit opinion depend on the basis of accounting employed. The circumstances in which each form of words is used are as follows:

- **properly presents** - used when the financial statements have been prepared on a cash basis, for example, Finance Accounts of Governments in India or receipts and payments accounts. This form of words is relatively precise,

reflecting the very low level of judgement required in preparing financial statements on a cash basis.

- **presents fairly** - used when the financial statements have been prepared on a partial accruals basis and are not intended to give a true and fair view. This form of words reflects the fact that though some element of judgement has been used in preparing the financial statements, the audit opinion is distinct one on accounts which give a true and fair view.
- **true and fair view** - used when the financial statements have been prepared on a full accruals basis and intended to give a true and fair view. Such financial statements will substantially comply with the commercial accounting requirements and with applicable accounting standards (for example, financial statements of Companies prepared in accordance with the requirements of the Companies Act, 1956).

2.151 Detailed guidance about reporting is given in Chapter 7.

Chapter 3

Audit Planning

Audit Plan for the entire Office

3.1 In order to improve the quality of audit, detailed and well-defined planning is essential. Every year, each office should frame a formal detailed Audit Plan in accordance with the instructions prescribed by the concerned functional wings of Headquarters Office. A single plan will integrate and include Central audit of vouchers and other records, routine inspections (phase audit), financial (attest) audits and performance audits.

3.2 Early in January each year, every field office will prepare the detailed annual programme for financial (attest) audits of various auditee entities (including the Union / State / Union Territory Government concerned) to be undertaken during the ensuing financial year. This programme should be in accordance with the annual plan and approved by the Accountant General (Audit). In addition to the units selected for audit, copies of this programme should also be sent to the Administrative Departments, Heads of the Departments and chief executives of the auditee entities concerned.

3.3 In case of shortage of audit resources, the financial (attest) audits which are mandatory to be carried out in compliance with the provisions of the Constitution, Legislation (including Rules or Orders prescribed thereunder) and entrustment to CAG should receive priority over other non-mandatory audits. If required, audit resources may be diverted from other non-mandatory audits for carrying mandatory financial (attest) audits.

Audit Plan for individual financial (attest) audits

3.4 The subsequent paragraphs contain the CAG's policies and guidance on planning of individual financial (attest) audits. They lay down the steps necessary for the development of an efficient and effective audit approach. In these paragraphs, the term 'audit plan' is used to denote the plan for carrying out audit of financial statements of specific entities (State Government, Union Government, autonomous body, etc.) for a particular year and not the overall annual plan of the entire audit office.

Purpose of Planning

3.5 Planning for financial (attest) audits helps to develop an audit approach which will ensure that sufficient appropriate evidence is gathered to support the audit opinion in the most cost-effective manner.

3.6 The Auditing Standards of CAG require that the audit should be planned in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way and in a timely manner.

3.7 The Audit Plan should be documented and kept as a part of audit working papers.

3.8 The planning process encompasses several steps and it should be carefully noted that the steps are all inter-related and not considered as ends in themselves.

3.9 The audit planning process should be founded on a thorough understanding of the auditee entity and its operations. This understanding is used for:

- determining the materiality for the audit, i.e., to determine the magnitude of misstatements which might reasonably influence the users of the C&AG's certificate on the financial statements;
- identifying those factors which lead to an increased risk of material misstatement or irregularity. First of all, the risks are identified at the entity level and then to pinpoint them in terms of their effect on particular account areas and audit objectives;
- preparing an audit approach which focuses testing on the specific risk factors while providing an acceptable level of assurance across the financial statements as a whole.

Planning process

3.10 The process of audit planning for financial audit is summarized in the following Exhibit.

Planning Process

Steps	Purpose
<p><i>Understanding the entity</i></p> <ul style="list-style-type: none"> • operations and organisation • financial reporting requirements • regularity and legal framework • parliamentary and legislative interest • public interest • accounting processes and formations {(including Drawing and Disbursing Offices (DDOs), Pay and Accounts Officers (PAOs), Treasuries, Works & Forest Divisions in case of Government Accounts} • computer involvement • control environment • analytical review • account areas 	To obtain sufficient understanding to inform determination of materiality, risk and audit approach
↓	
<p><i>Materiality</i></p> <ul style="list-style-type: none"> • materiality by value • materiality by nature • concerns of users of audit certificate 	To determine the tolerable level of error or irregularity
↓	
<p><i>Risk Assessment</i></p> <ul style="list-style-type: none"> • entity risks • account area risks • mitigating controls including controls in IT systems 	To identify those factors which lead to an increased risk of misstatement or irregularity and controls which mitigate those risks
↓	
<p><i>Plan Finalisation</i></p> <ul style="list-style-type: none"> • audit approach to specific risk areas and specific risk factors • audit approach to other areas 	To prepare an approach which focuses on specific risk factors while providing an acceptable level of assurance across the financial statements as a whole

Understanding the entity and its operations

3.11 A thorough understanding of the auditee entity and its operations helps in designing an efficient and effective audit approach so that audit resources are focussed on the areas of greatest risk and audit methods which meet audit objectives at minimum costs are adopted in obtaining competent, relevant and reasonable evidence to support the audit judgement and conclusions.

3.12 Though the Government Departments / Entities share certain common characteristics, it should be recognised that each one is unique.

3.13 The audit team should

- i. familiarise itself with:
 - a. the operations and organisation of the auditee entity
 - b. the financial statements
 - c. the regularity framework
 - d. the general legal framework governing the entity's operations;
- ii. identify Parliamentary and legislative interest and public interest in the entity and its financial statements;
- iii. understand the accounting processes and the degree of computer involvement;
- iv. assess the overall control environment and in particular the controls to prevent irregularity, illegality and fraud;
- v. perform preliminary analytical procedures;
- vi. analyse the financial statements into account areas.

Interim Visit

3.14 For the purposes of carrying the above steps as a part of the planning process, the audit team should make interim visits to the auditee entity during a financial year, without waiting for the year end.

Entity Operations and Organisation

3.15 This will normally include considering matters such as:

- what are the products manufactured / services delivered?
- what is the statutory basis for these operations?
- how are they funded?
- what is its relationship with other entities / government organisations?
- is the entity stable or are major changes took place / planned? (like re-organisation of a department/ wing)
- who are the recipients of its products / services?
- how does it deliver its products / services?
- who is the Accounting Officer?
- who are likely to be the main contacts of Audit in the organisation?

- who are the key members of the entity's management team and what are their responsibilities?
- is there an audit committee and what is its scope?
- what is the organisational structure of the entity? Is it centralised or decentralised?
- what are the principal geographical locations and how are the operations distributed between them?

3.16 Information can be obtained from

- previous years' accounts;
- past audit experience and observations on previous years' accounts (including transaction audit observations);
- from the audited entity by discussion with management and internal audit personnel;
- from documents such as statutes, policy and procedural manuals, internal audit reports, annual reports, budgets, minutes of management meetings;
- interim accounts, if any;
- observation of the entity's activities and operations.

Financial Reporting Requirements

3.17 The financial statements are the focus of Audit. The audit team should familiarise with the formats of financial statements (in the case of Government Accounts, the formats of the various Statements in Finance and Appropriation Accounts and any supporting schedules).

3.18 The following points merit special attention.

- Any changes in accounting standards, accounting rules or accounting policies since the last audit;
- Any new heads of account introduced since the last audit;
- Any changes in the formats of Accounts since the last audit.
- Whether any items require exercising of judgement or estimation.

Legal and Regularity Framework

3.19 The audit team should familiarise with the legal and regularity framework within which the entity operates. This will include:

- primary and secondary legislation (like any Governing Legislation, Appropriation Act, Financial Rules, Fiscal Responsibility and Budget Management Acts and Rules) and any changes since the last year ;

- regulations or instructions issued by Finance Ministry or controlling Department and any changes since the last audit.

Parliamentary and public interest

3.20 The audit team should identify the extent of Parliamentary or Legislative interest and public interest in the entity's activities and financial statements. The factors which might indicate such an interest include:

- high level of comment in media (like newspapers, television channels);
- significant number of Parliamentary or Assembly questions;
- Parliamentary or Legislative debates on the entity and its activities

3.21 Audit should also consider whether the level of interest is likely to increase during the course of the audit, for example due to any proposed or forthcoming change in status, organisation, activities or review of activities.

Understanding the accounting process

3.22 Audit should obtain an understanding of the accounting process, its key feeder systems and the management information systems.

3.23 In the context of Government Accounts in India, the key feeder systems include:

- Treasuries and Sub-Treasuries
- Pay and Accounts Offices
- Principal Accounts Offices in Ministries of Union Government
- Public Works Divisions
- Forest Divisions
- Inter-Governmental Transactions / Adjustments
- Reserve Bank of India
- State Bank of India or any other public sector bank transacting Government Business on behalf of Reserve Bank of India
- Office of the Accountant General (A&E) including branch offices, if any, compiling the Accounts of the State Government

3.24 Audit should also understand the nature and accounting treatment of different streams of transactions like:

- Income
- Tax Revenue
- Non-Tax Revenue
- Grants in Aid
- Capital Receipts
- Revenue Expenditure
- Fixed Assets / Capital Expenditure
- Revenue Receipts

- Loans and Advances
- Public Debt
- Public Account
- Investments
- Current Assets
- Current Liabilities

3.25 The audit team should understand the records and procedures used to identify, record, process, summarise and report material classes of transactions and to maintain accountability for assets. Audit should also distinguish between those material classes of transactions which are processed systematically and those that are not.

Understanding the degree of computer involvement

3.26 Computer based systems often form an integral part of the financial control and reporting systems used by all sizes of auditee entities. The audit team should review the information technology systems used in the preparation of financial statements, classify the degree of computer involvement and assess the complexity of the computer based financial systems.

3.27 Guidance on carrying out a review of the IT systems for financial audit is given in Appendix .

3.28 In the context of Government Accounts, the review should inter alia cover the IT systems used in:

- The Office of the Accountant General (A&E)
- Treasuries
- Pay and Accounts Offices
- Principal Pay and Accounts Offices
- Public Works and Forest Divisions
- Organisation of the Controller General of Accounts

3.29 In cases where the Treasuries and Pay and Accounts Offices are inspected by the Office of the Accountant General (A&E), the inspection should include carrying out a review of the IT systems used by the Treasuries and Pay and Accounts Offices and copies of the inspection reports should be sent to the Office of the Accountant General (Civil Audit) responsible for the certification of Finance and Appropriation Accounts.

3.30 In cases where a detailed review of the IT systems is required, IT Audit trained personnel within the Audit Office should be associated, particularly where:

- there are developing systems;

- the use of IT is extensive; or
- the entity's computer systems are assessed as being very important or technologically complex.

3.31 External IT experts (not employed in the Indian Audit and Accounts Department) may be associated only with the prior approval of Headquarters Office.

3.32 The IT Audit Wing of SAI India has developed a Criticality Assessment Tool for assessing the degree of complexity of IT Systems. This may be employed while reviewing IT systems.

Understanding the Control Environment

3.33 The control environment comprises the conditions under which the entity's accounting process and internal controls are designed, implemented and function. Based on the understanding, the audit team should seek to arrive at a conclusion as to whether the control environment is generally conducive to reliable accounting systems and effective internal control and determines if specific components increase or decrease the effectiveness of some or all application systems and controls. If, based on understanding of the control environment, the audit team has fundamental doubt about the effectiveness of the accounting system or controls, this should be reported to the entity and kept in mind while carrying financial audit.

3.34 To obtain an understanding of the control environment, Audit needs to consider:

- management's characteristics, philosophy, operating style and commitment to accurate financial reporting;
- the operating environment and culture;
- management's commitment to designing and maintaining reliable accounting systems;
- the ability of management to control the operations:
 - the organisational structure of the entity;
 - methods of assigning authority and responsibility;
 - supervision and monitoring;
 - senior management control methods.

Controls against irregularity, illegality and fraud

3.35 Audit should understand the control procedures established by the entity to:

- ensure regularity;
- ensure compliance with the legal and regulatory framework within which the entity conducts its operations;
- prevent and detect fraud by management, employees or third parties.
- It is the responsibility of the Accounting Officers or their equivalent in the Executive Government and entities to ensure that:
 - proper financial procedures are followed;
 - public funds are properly and well managed and safeguarded;
 - assets are similarly controlled and safeguarded;
 - funds are applied only to the extent and for the purposes authorised by Parliament or Legislature;
 - effective controls are developed and maintained to prevent fraud and to ensure that, when it does occur, it is detected promptly.

3.36 Audit should document the particular control procedures established in order to ensure regularity, legality and prevention and detection of fraud. Audit should assess whether these procedures are effective and if they are not, should consider the impact on the planning for financial audit. A lack of effective control procedures usually indicates increased risk of material misstatement or irregularity.

Preliminary Analytical Procedures

3.37 Analytical procedures can:

- serve as part of the risk assessment
- identify non-routine and unusual transactions and balances
- confirm and also improve on our understanding of the business
- be used as a starting point for substantive assurance

3.38 The audit team should perform preliminary analytical procedures to assist understanding of the entity, its operations and identify areas of potential risk.

3.39 The main purpose of performing planning analytical procedures is to identify and thereby enable the audit team to direct audit resources to, areas of the financial statements where the recorded values may vary from the values the audit team would expect. Analytical procedures may therefore identify specific risk factors at the entity level.

3.40 Planning of the audit should take place well in advance before the annual financial statements are available. Hence, it will usually be necessary to base the analytical procedures on:

- interim financial statements
- budgets or estimates
- prior period's financial statements
- any other Management Information

3.41 Use of computer interrogation software will often be useful at this stage as well as during the audit fieldwork. Interrogations can be run on interim data as well as the full year data. The use of the technique will depend on availability of computer data in an appropriate format.

3.42 One of the popular tools used for computer interrogation is IDEA.

3.43 Generally, at the planning stage, the analytical procedures likely to be used consist of simple comparisons and ratio calculations like, for example, comparing information for the latest period or budget with previous year accounts and budget. There may also be scope to consider non-financial data and its relationship with figures in the financial statements. Unexpected variations should be investigated and evaluated in the light of other information identified during preliminary planning.

Account Areas

3.44 The audit team should analyse the financial statements into account areas. *Account areas are classes of assets, liabilities, income and expenditure which have similar underlying characteristics and transaction streams.* While analysing the financial statements, the audit team should keep in view the basis of accounting underlying the financial statements. If the accounts are prepared on accrual basis, the underlying characteristics of assets and liabilities would be different from those prepared on cash basis. This is because the accrual accounting recognises incomes and expenditures which have accrued, though not actually received or paid.

3.45 Although the objective of financial audit is to express an overall opinion on the financial statements, it is necessary to analyse the financial statements into account areas to facilitate an effective audit. This helps Audit to plan audit work around transaction streams and balances which have similar characteristics, are processed in a like manner, and are subject to the same type of controls.

3.46 The definition of account areas is a matter for the judgement of the Accountant General in charge of audit. However, the guiding factors include:

- the significant transaction types;
- the accounting and financial reporting process;
- an assessment of the risk and propensity to error of different transaction types;
- the control systems operated by the entity; and
- the control systems operated in the accounting offices.

3.47 The audit team should aim to establish a linkage between the account areas and Departments and Grants (with reference to Budget), wherever

possible, in the case of Government accounts. Normally, such a linkage is easier to establish in case of items of receipts and expenditure items.

3.48 The understanding of each account area should be sufficient to inform risk assessment and detailed audit planning. This will require, inter alia, a clear understanding of:

- the key components and transaction types included in the area;
- the underlying accounting processes and controls; and
- the sensitivity of the area.

Significant versus Non-Significant audit areas

3.49 Significant audit areas are those account areas that impact significantly upon an entity's financial statements and, as a result, are audit areas for which we must obtain sufficient, relevant and reliable audit evidence for us to certify that the financial statements are true and fair.

3.50 If the audit teams focus on audit areas that do not have a significant impact on the financial statements (i.e. non significant audit areas) it would result in over auditing and inefficient utilisation of audit resources. Hence, identification of non significant audit areas is a vital part of the audit planning to ensure that audit is both effective and efficient.

3.51 Therefore:

- All audit areas should be assessed for significance and non significance to the financial statements
- This analysis should be based upon materiality by value and materiality by nature and context
- The results of auditor's Understanding the operations (business) of the entity should also inform this assessment

3.52 Identification of non significant audit areas is usually dependent upon analysing audit areas into their smaller constituent parts. The auditors can make use of accounts, trial balance, print out of ledger accounts, etc. when doing this.

3.53 The auditors should be careful to consider the aggregate value of all non-significant audit areas in relation to materiality.

3.54 In all cases it is absolutely essential that the audit file contains lead schedules which clearly demonstrate that the amounts being audited can be directly agreed to the financial statements. The provisions of Chapter 6 of this Manual dealing with Documentation should be read in this connection.

Planning Materiality

3.55 The audit team should determine planning materiality. The reasons and bases on which the planning materiality is calculated should be documented.

3.56 The concept of materiality and various types of materiality (by value, by nature and by context) were explained in Chapter 2. Materiality affects both the way in which Audit plans and designs audit work and how it evaluates and reports the results of audit work.

3.57 At the planning stage, the audit team is concerned primarily with materiality by value.

3.58 The Accountant General shall determine an appropriate materiality base and planning materiality in accordance with the instructions issued from the Office of the Comptroller and Auditor General of India.

3.59 For financial statements prepared on a cash basis, the base will usually be gross expenditure or income. This is of special relevance in the context of financial audit of Finance and Appropriation Accounts of Governments which are presently prepared on cash basis.

3.60 Planning materiality may be set at a lower level than reporting materiality. For instance, if the reporting materiality is set at 1% of gross expenditure, planning materiality may be set at 0.5% , which will facilitate greater extent of checking by selecting a bigger sample size. The Accountant General and Group Officers should use their professional judgment in deciding about planning materiality.

3.61 It is easier to plan for errors material by nature. These will include specific disclosure requirements of the **entity** and matters which **the auditors** know Parliament **or Legislature** will be interested in to the extent that a higher degree of accuracy is required for those particular figures that there is for the account as a whole. Examples of items material by nature include **excesses over budget**, the Chief Executive's salary, cash balance, **auditor's remuneration** and details of special payments, write-offs and losses.

3.62 Materiality by context is harder to assess at the planning stage, but **the auditors** should still be aware of the possibility so that **they** can quickly assess the impact of any errors **they** find on these considerations. An example of materiality by context is **misclassification of revenue expenditure resulting in a saving in a grant (when in fact there has been an excess)**. **The auditors** need to be particularly aware of the contexts when performance measures may or may not be met, for example where misclassification of expenditure has resulted in higher performance payments being made to **employees**.

3.63 Clearly defining examples of errors that will be material and communicating them to the audit team will help the team to spot material error at an early stage.

3.64 Audit should consider materiality at both the financial statement level and in relation to individual account balances, classes of transaction or disclosures. For items where users expect a higher degree of accuracy, the auditors should not reduce the overall materiality but increase the audit procedures.

Risk Assessment

3.65 The concept of 'Risk' was explained in Chapter 2. The audit team should use understanding of the entity and its operations to identify specific risk factors taking into account factors relevant at both the entity level and to specific areas and audit objectives.

3.66 The audit approach of CAG seeks to reduce to an acceptable level the risk that audit work will not detect material error or irregularity. Decisions on the nature, extent and direction of audit tests depend upon assessment of the risk of material error or irregularity occurring (inherent risk); and the risk that the entity's controls will not detect such errors or irregularities in a timely manner (control risk).

3.67 Regarding the factors affecting the risk, While it may not be possible to give across the board guidelines for entities in view of the fact that there are variety of Govt. companies, e.g., oil sector, power sector, aviation, tourism, etc., having sector / entity specific assessment of risk, applicable accounting standards, etc., some of the risk indicators (illustrative) are indicated in the following table.

<i>Some risk indicators (illustrative)</i>	
(i)	Previous Audit Observations (accounts audit as well as transaction audit) with amounts involved not yet settled
(ii)	Number and amount of accounting adjustments made in last 3 years
(iii)	Nature of transactions--their mix and size
(iv)	Number and location of field formations/branch offices, etc.
(v)	Any formation of new offices, branches, locations, etc. during the period under audit
(vi)	Any new activities undertaken during the period under audit
(vii)	Any re-organisation of the office / department during the period under audit
(viii)	Any financial problems facing the entity like shortage of funds, liquidity crunch, huge debts, default in repayment of borrowings/payments to suppliers, etc.
(ix)	Effectiveness of internal controls and management's response to any weaknesses in internal controls
(x)	Complexity of accounting principles and calculations
(xi)	Complexity of operations and underlying regulations/ regulatory environment
(xii)	Susceptibility of assets to material fraud/misappropriation
(xiii)	Staffing of Accounts personnel--number and competence
(xiv)	Whether any judgment is involved in accounting process
(xv)	The entity's track record in production of records to audit
(xvi)	Changes in key management and accounts personnel in last 3 years, with

	reasons for change
(xvii)	Public visibility of operations
(xviii)	Any complaints about the audited entity
(xix)	Any newspaper/other media information about the audited entity in last one year
(xx)	Dependence on few suppliers/contractors, etc.
(xxi)	The degree to which the financial circumstances of the audited entity may motivate the entity's management to misstate the accounts / records
(xxii)	Use of special purpose vehicles for financing arrangements
(xxiii)	Any changes in IT Systems (hardware and software) / computerisation during the period under audit
(xxiv)	Any changes in account heads, accounting policies, accounting standards, etc.
(xxv)	Pending litigation and contingent liabilities
(xxvi)	Other Risk Indicators like: <ul style="list-style-type: none">• Expenditure trends• Persistent and unexplained excess draws.• Unadjusted account bills.• Transfers to Personal Ledger Accounts.• Large purchases.• Delivery under programmes not being susceptible to verification.• Political or managerial sensitivity of activities.

3.68 When planning financial (attest) audits, auditors should also assess the risk that fraud may cause the financial statements to contain material misstatements or record material irregular transactions. Based on risk assessment, audit should design audit procedures so as to have a reasonable expectation of detecting and evaluating material misstatements and irregularities arising from fraud. A separate Standing Order on the position of Audit in relation to fraud and corruption was issued by the Headquarters Office in August 2006, which should be complied with.

Assessment of Inherent Risk

3.69 Inherent risk is defined as the susceptibility of an account balance to material misstatement, irrespective of related internal controls.

3.70 The following three levels of inherent risk can be recognised in audit.

- High risk
- Medium risk
- Low risk

3.71 The audit team should recognise that within each Government, the Departments are different and similarly, within each Department, the account areas can be different. Hence, it is not necessary to apply the same approach, or test in the same depth across all audit areas and objectives. The process of risk

assessment reflects this, as Audit does not take a general view of risk across the Government. The audit team should identify:

- specific risk factors, document the nature of the risks and reasons for the assessment of the degree of risk (as high, medium or low);
- the account areas and audit objectives affected; and
- controls that management may have in place to mitigate the risk.

Risk Identification

3.72 The process of identifying risks should be a continuous one which takes place throughout the planning period. Generally, the following two levels of risk are identified.

- **Entity risks:** the risks identified from top down review of entities and which may affect a number of different account areas
- **Account area risks:** the risks identified from more detailed review of each account area and that may arise as a result of particular characteristics of the associated transaction streams.

Entity Risks

3.73 The audit team should identify risks at the entity level from its preliminary work on understanding the entity. While it is not possible to produce an exhaustive list of risk factors, the following are some of the illustrative factors which can be taken for the purpose of risk identification.

- **the overall control environment:** in particular management commitment to internal financial control and accurate financial reporting;
- **external pressures on the entity:** where the entity is under heavy external pressure from Parliament, Legislature, lenders or public to achieve particular results, risk will generally be higher than in those cases where there is little external interest in the entity;
- **experience and competence of staff:** risk is normally lower where staff are experienced, properly trained and well supervised. High turnover, lack of commitment to training and poor supervision will increase risk;
- **reliability of accounting systems:** transactions processed systematically by tried and tested systems will normally carry low risk. New systems, systems requiring a significant level of manual intervention or systems that have been modified, added to or extended in some way tend to be more risky;
- **stability of the entity:** stable entities performing the same function in the same way over a number of years tend to be of low risk. Major changes through

the addition or removal of functions, organisational restructuring or geographical dispersal or restriction of operations tend to increase risk.

3.74 The audit team should seek to relate risks identified at the entity level to specific account areas and audit objectives. For example, if management of the entity is under pressure to meet particular performance targets, specific risk factors may be present in those account areas which are important to the target and which may be susceptible to manipulation.

Example
If a State Government has a specific target of reducing revenue deficit, there may be a possibility of misclassifying some portion of revenue expenditure as capital expenditure and, consequently, show a reduction in revenue deficit.

Account Area Risks

3.75 A more detailed review of each account area should be carried out to identify risks that may be peculiar to the transaction streams or balances contained in it. While it is not possible to provide a complete list of the characteristics that might suggest a higher than normal risk, some illustrative categories are indicated below.

- **Transactions governed by complex regulations.** The more complex the regulations governing a transaction, the greater the risk of error. This may occur either through a misunderstanding or a misinterpretation of the regulation or through simple error in application. It should be noted that the audit team is concerned with the risk of material error.
- **Services and programmes delivered through third parties.** Some Departments operate at a distance from the final user / beneficiary and work through contractors or other implementing agencies. Where this happens, they may lose a degree of direct, day to day control.
- **Payments and receipts made on the basis of claims or declarations rather than in exchange for goods and services.** Verification of the receipt of goods or services will generally be easier than verification that, for example, a claimant meets the criteria specified for receipt of a grant.
- **Transactions not in the normal course of business or operations.** Such transactions are by definition generally few in number but may be relatively large in value and therefore often have a material effect. They are prone to misstatement because they are usually processed on an exception basis, frequently by staff unfamiliar with their nature.
- **Transactions recording estimates.** There will invariably be specific risk factors associated with accounting estimates. The evidence available to support

an estimate will rarely be conclusive; the judgements involved will be subjective with scope for conflicting views.

- **Multiple sources of funds.** One of the factors which affect the risk of financial misstatement especially in the government accounts is the fact that there could be more than one source of funds from where expenditures are met. In such a scenario, the risk of financial misstatement and misclassification increases considerably e.g. in railways there are a number of funds from where expenditures of capital nature are met. Some of these are funded by railways own resources, some are funded through central government and funds for some are collected by levying surcharge on passengers. In such a scenario a misstatement from one source to another may show a wrong financial position.

3.76 As reconciliation is an internal crosscheck to ensure that the financial transactions were properly accounted for, non-reconciliation should be viewed as a major risk factor. Norms for reconciliation should be fixed by the respective organization based on their nature of transaction. For example, in a transport corporation the preprinted ticket reconciliation is a vital one. Non-reconciliation of preprinted ticket stock with tickets actually sold would result in revenue drain by way of counterfeit notes being mingled by the unscrupulous and unfaithful group of employees. Similarly in respect of electricity boards, the reconciliation of power purchased/generated with power sold would show power unaccounted or revenue loss due to theft of power. Therefore audit should emphasis on the auditee to develop relevant manuals exhibiting the various intricate problems faced by the organization, its method of handling financial transactions, standard formats for reporting.

Mitigating Controls

3.77 After identifying specific risk factors, the next step is to identify controls which effectively mitigate those risk factors.

3.78 The audit work at the entity and account area level will identify specific risk factors which increase the risk of material misstatement; and will relate them to account areas and objectives. For each of these specific risk factors, it should be considered whether management have mitigating controls in place.

3.79 The following are some examples of mitigating controls.

- in the area of complex regulations, management may ensure that the regulations are translated into clear desk instructions for all staff concerned;
- for services delivered by third parties, management may require independent verification by external or internal inspectors or auditors;
- for payments on the basis of claims, management may draw evidence on claimants' circumstances from other sources, or exercise rights of investigation;
- for unusual transactions, management may require internal checking at a higher level than in normal circumstances.

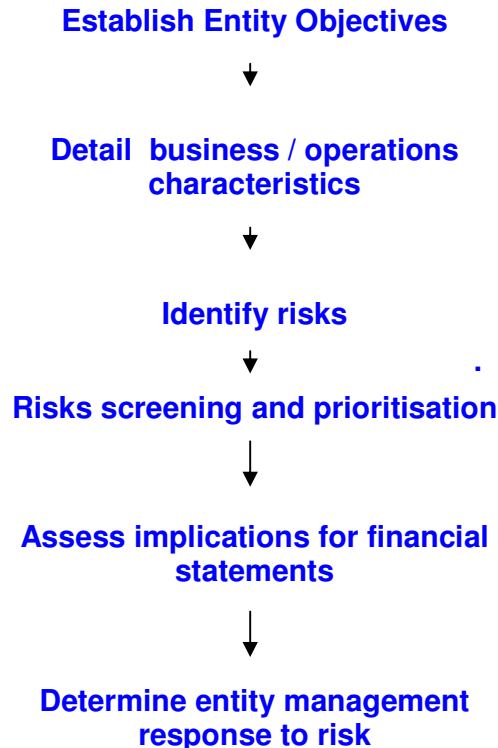
3.80 All the cases where the audit team identifies specific risk factors without corresponding mitigating controls should be specially kept in view in deciding the audit approach. Such cases should also be brought to the notice of the entity's management for possible introduction of mitigating controls.

Risk Screening and Prioritisation

3.81 Once all the inherent risks of misstatement have been identified, it is important to review them to focus on those that will have the greatest impact on the accounts and therefore on our audit approach.

3.82 This process can also form part of control risk assessment as we would expect management to have a different response to individual risks depending on their likely impact on their business operations.

3.83 The process for identifying material risk factors has six key stages.

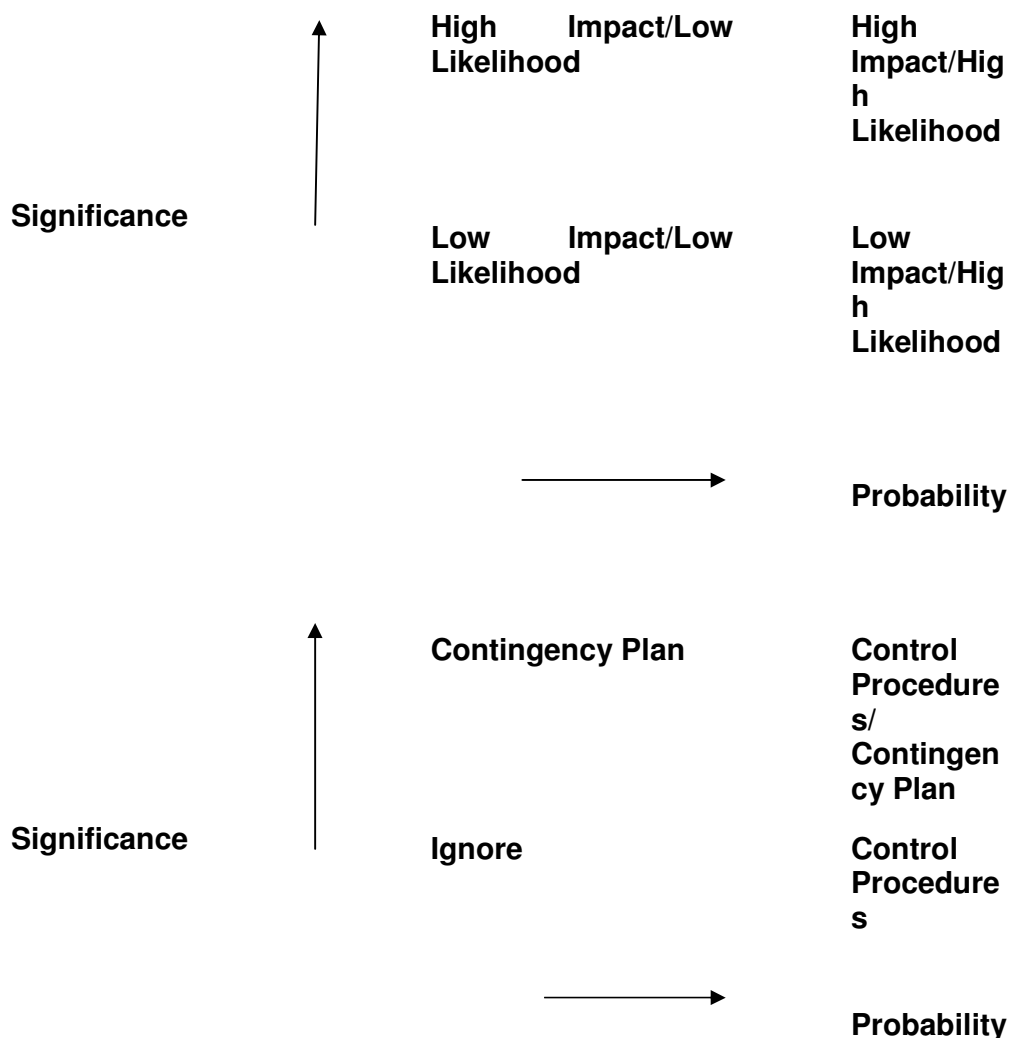


3.84 The first three stages are those that are covered by the assessment of External Factors and Overall Control Environment factors as part of the Understanding the Operations (Business). The second part of the Understanding the Operations (Business) process is to prioritise the risks and, by assessing the implications for the financial statements, assign them to audit areas.

3.85 The priority the audit approach should give to individual risks depends on the likelihood of that risk maturing and the impact on the financial statements if it matures. Categorising risks as high or low impact is a matter of judgement, but it can be helpful to keep planning materiality in mind when doing so.

3.86 In the plan document, the auditors may initially consider materiality by value and based on the outcome of preliminary or mid-term analysis of the financial statements, the auditors may consider the particular type(s) of materiality to be taken for detailed analysis.

3.87 The audit approach to the different levels of risk should be as shown in the following matrix:



High Impact/Low Likelihood

Keep the risk in view and reassess the likelihood of the risk maturing in light of any new information, but there is no need to develop specific audit procedures.

High Impact/High Likelihood

The audit approach should specifically address the risk.

Low Impact/Low Likelihood

There is no need for the audit approach to address this level of risk.

Low Impact/High Likelihood

The audit approach does not need to specifically address this level of risk. However, it is necessary to be aware of the potential cumulative effect of a number of risks at this level on the same audit area. In addition, the

management response to this level of risk may provide evidence for work on the Statement of Internal Control and for reporting to auditee entities.

Using a simple matrix for inherent risk indicators

3.88 The auditors should ask themselves two questions:

- is this an indicator of potential inherent risk
- if so, which audit area(s) does it affect?

Assessing the Financial Statement Implications

3.89 Although a risk may potentially impact on the entire account, it is likely to have a significant effect on only one or two audit areas. By identifying those areas as early as possible in the planning process in a simple matrix form, it is possible to avoid unnecessary work and develop an efficient audit approach.

Indicator of potential inherent risk	Audit Areas													Is overall inherent risk assessment high? (yes/no)	Rationale for not assessing inherent risk as high

Note: More rows / columns may be added, as required.

3.90 This is a simple matrix, which allows the audit team to cross reference inherent risks to audit areas.

3.91 Even if the team feels that an indicator of inherent risk should be assigned to all audit areas, it is possible to class some or more of those audit areas as having a low overall inherent risk profile. It might be appropriate to do this where a risk will have a high impact on some audit areas and a low impact on others.

3.92 Each indicator of potential inherent risk should be cross referenced to the Audit Areas identified during audit planning, all of which should be populated on the form.

3.93 The auditors should exercise judgement in assessing the impact of various combinations of indicators of potential inherent risk applicable to each Audit Area, and arrive at an Overall Inherent Risk Assessment for that Audit Area; i.e. is Inherent Risk assessed as 'high' or not. This will not necessarily be a case of simply aggregating or considering the incidence of indicators of potential inherent risk affecting a particular Audit Area and the auditors will need to consider the significance of the relevant indicators.

3.94 No single risk assessment methodology can be expected to be appropriate in all situations. Conditions affecting audits may change over time. Periodically, the auditor should re-evaluate the appropriateness of the chosen risk assessment methodologies.

3.95 The auditor should document the risk assessment technique or methodology used for a specific audit. The documentation should include a description of the risk assessment methodology used, the identification of significant exposures and the corresponding risks, the risks and exposures the audit is intended to address and the audit evidence used to support the auditor's assessment of risk.

Planning: Considering the need for sampling techniques

3.96 An introduction to sampling techniques was given in chapter 2. In preparing the audit plan, the auditor should consider sampling as one of a range of available techniques for obtaining the audit evidence which will provide the assurance sought in relation to the account.

3.97 For each objective in each account area, the auditor should select one or more methods by which audit evidence is to be obtained. No single method is likely to be effective in meeting all requirements. For example, sampling is generally not an effective technique for testing the completeness of either income or expenditure. For this purpose, careful application of analytical procedures in combination with other audit procedures can provide a better result.

3.98 In many cases, the auditor should choose between a number of methods capable of providing the desired evidence. Overall, the auditor needs to use audit judgement and experience to decide which combination of techniques is likely to provide the total required assurance in the most cost-effective way.

3.99 There is, therefore, no presumption in favour of any one method. For the majority of audits, it is likely that sampling will be used not in isolation but in combination with other audit techniques to provide the planned assurance.

3.100 In certain circumstances, when the auditor has decided that it is appropriate to carry out tests of detail, it may be desirable to carry out 100 per cent testing, rather than to sample. For example, if the auditor is

seeking to gain assurance about a specific risk factor which applied to the relatively small number of items in a particular stratum of a population, the auditor may test every item in that stratum.

Applying audit knowledge, experience and judgement

3.101 The sampling efficiency can be improved by applying knowledge, experience and judgement. Specifically, the knowledge of the entity should be applied to identify transactions which may carry higher levels of risk or sensitivity. It is also important that a preliminary data analysis on the audit population should be carried out and audit judgement applied to the result of this analysis to guide the auditor toward the best sampling approach.

3.102 By using such knowledge, experience and judgement at the planning stage of the audit, a more efficient sampling approach can be developed.

Use of VLC data in audit planning in case of State Government Accounts

3.103 In case of financial (attest) audit of State Government Accounts, the VLC data containing Drawing and Disbursing Officer (DDO)-wise information on various parameters like monthly expenditure pattern, expenditure on contingencies, AC bills pending, position of PD accounts etc., would help in risk assessment and selection of DDOs for audit. Reports could be generated to give information on erratic expenditure, rush of expenditure, erratic purchases, heavy purchases, quality and quantity of purchases, rates paid, supplier information, etc. Auditee-wise information on sanctions, contracts etc. would also be an important input for audit planning. This information would, in addition to assisting audit planning, also be as important input for developing thrust and focal areas for audit prior to commencement of audit.

Decision regarding the Audit Approach to be adopted

3.104 The auditors should carefully note that the assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for auditors to perform any substantive procedures for material account balances and transaction classes.

3.105 This is a summary of the questions the auditors should ask themselves in order to determine the most appropriate audit approach for different balances/transaction streams. The auditors should consider:

- If a risk exists
- If controls can be relied on
- If auditors can use an analytical procedure
- If auditors need to use other substantive procedures

3.106 The key to the risk based approach is to apply this decision tree to each of the financial statement assertions in turn listed below.

<i>Assertions pertaining to Assets and Liabilities</i>	<i>Assertions pertaining to Income and Expenditure</i>
Completeness	Completeness
Existence	Occurrence
Valuation	Measurement
Ownership	Regularity
Disclosure	Disclosure

3.107 The decision criteria should also be applied in turn to audit area populations that display similar characteristics. This focuses audit approach to a particular audit area based on the risky elements of a population.

3.108 It is the policy of the CAG to seek to adopt a cost-effective audit approach that will reduce audit risk to an acceptable level and provide a high degree of assurance.

3.109 The audit approach chosen will:

- reflect understanding of the auditee entity and its business;
- take account of audit judgement on planning materiality; and
- respond to the specific risk factors identified in the course of risk assessment.

3.110 A cost-effective audit approach is one that achieves this and an optimum mix of the following objectives:

- i. minimising sampling risk - the risk that audit procedures will fail to detect material misstatement or irregularity due to drawing a non-representative sample;
- ii. minimising audit cost - by achieving the most efficient deployment of audit resources taking account the overall timetable and minimising potential disruption to the normal functioning of the auditee;
- iii. maximising assurance on the audit objectives.

3.111 The risk assessment and audit procedures should provide a high degree of audit assurance in accordance with the instructions issued by the CAG.

3.112 The audit team members need to have a thorough understanding of the different types of audit procedure that may be undertaken for the purpose of adopting a cost-effective audit approach. These procedures are covered in the other Chapters. In brief, the possible procedures include:

- testing of control by the audit team;
- using the work of internal audit;
- substantive procedures:
- direct tests based on statistical or non-statistical samples;
- 100% testing;
- predictive analytical procedures;
- using the work of other auditors;
- using the work of third party experts.

3.113 Computer assisted audit techniques (CAATs) can be used for both tests of control and substantive procedures. The availability of appropriate techniques will inform the audit judgement on the most cost-effective mix of tests of control and substantive procedures.

Levels of substantive procedures to be performed

3.114 The substantive procedures can be performed at one of three levels, depending on the amount of assurance required. In decreasing order of assurance, they are:

- focused
- standard
- minimum.

3.115 In general, the lower the level of assurance required, the lesser will be the extent of audit procedures. The level of the procedures to adopt depends on whether any specific risk factors were identified and whether any reliance is proposed to be placed on controls. These procedures are explained in the following table.

Type of Substantive Procedure	Circumstances in which performed	Audit Procedures generally Included
Focussed Substantive Procedures	Performed if the audit team identifies a risk that could lead to potential material misstatement and where no reliance can be placed on mitigating controls to address the risk	Substantive Procedures: <ul style="list-style-type: none">• Testing high value and key items• Sample testing of representative transactions• Confirmation from third parties• Reliance on internal audit work

		Analytical Procedures are unlikely to be used
Standard Substantive Procedures	Performed if the audit team has not identified risks that could lead to material misstatement and no reliance is planned to be placed on controls.	<ul style="list-style-type: none"> • Modelling / Comparative Type Analytical Procedures • Other Substantive Procedures
Minimum Substantive Procedures	Performed if the audit team plans to take assurance from mitigating controls (where there are risks of material misstatement) or from other controls (where there are no risks of material misstatements).	<ul style="list-style-type: none"> • Comparison Type Analytical Procedures or • Other Substantive Procedures

Designing audit approach

3.116 For each audit objective where specific risk factors were identified, the audit team should either:

- rely on mitigating controls and perform a minimum level of substantive procedures ; or
- perform focused substantive procedures

3.117 Where effective mitigating controls are identified, the audit team may plan to rely on them and reduce the extent of substantive procedures. It can be more efficient to identify and test relevant mitigating controls than to perform focused substantive procedures. Sometimes, focused substantive procedures are more efficient than a combination of tests of control and minimum substantive procedures. This is particularly true in cases where the effects of specific identified risk factors can be accurately identified and appropriate focused procedures are designed.

Example

If the audit team identify a specific risk factor affecting a particular grant, it may be able to isolate the risk as affecting only the expenditure incurred at a particular location (say Treasury / Sub Treasury of a State Government). For that location the audit team might perform focused substantive procedures but, for other locations, the audit team can restrict substantive procedures to the standard level.

3.118 For audit objectives where no specific risk factors were identified, the audit team should either:

- confirm the reliability of the relevant accounting systems and controls and perform a minimum level of substantive procedures; or
- perform focused substantive procedures

Weaknesses in Controls

3.119 In gaining an understanding of the control environment, the audit team may have identified significant weaknesses that may cause the team to believe that some or all of the internal controls are likely to be ineffective. In such a situation, the audit team should not plan to rely on controls; but should, instead, plan to obtain all assurance from substantive procedures.

Performing the audit procedures at interim date

3.120 Where reporting deadlines are tight, or if there are constraints on audit resources at the time of main audit visit, the audit team should normally perform some of the substantive procedures at an interim date. Where the team audits income or expenditure (or receipts and payments) figures at an interim date, it can adopt one of two approaches to the remainder of the accounting period at the time of final audit:

- place reliance on controls, together with a minimum level of substantive procedures; or
- perform a standard level of substantive procedures.

Number of Locations

3.121 The number of operating locations of the auditee affects the audit plan. The larger the size of the auditee, the more likely it is that reliance on controls will be an efficient approach. Also, if the number of operating locations is large, it may be practical to visit only certain locations in a given year and to rotate audit visits. It may also be necessary to involve internal audit or other sub-auditors belonging to the Indian Audit and Accounts Department in the field work.

Role of Internal Auditors

3.122 The work of internal auditors may influence audit decision on whether to rely on controls. For example, if internal auditors perform tests of controls that contribute to the reliability of accounting systems and if audit team can test a portion of their work, it will generally be more efficient to adopt a strategy to rely upon controls for audit objectives for which no specific risk factors were identified.

Classification of Computer Use

3.123 In cases where the computer environment of the auditee was assessed as complex, a controls-reliance approach should normally be adopted and the reliability of accounting systems for audit objectives for which no specific risk factors were identified should be confirmed. If a wholly substantive testing approach is adopted, still the need remains to confirm the reliability of accounting systems. This is important if evidence used by audit team in performing substantive procedures is processed or generated by computers, as is often the case when the computer environment is complex. Further guidance is given in Appendix II.

3.124 IT Audit trained personnel should be involved in auditing in a complex computer environment. They may also be involved in cases where there are one or two complex sub systems.

3.125 The IT Audit trained personnel can assist in:

- obtaining and evaluating the information used to understand the accounting process;
- identifying and testing controls that contribute to the reliability of accounting systems.

3.126 The IT Audit trained personnel can also assist in developing the audit plan. Responsibility for the audit plan remains with the Accountant General who should ensure that there is adequate review of the work of the IT Audit trained personnel.

Using services of outside experts

3.127 Audit planning should also recognise the necessity of professional/technical assistance in complex areas of investigation. Therefore, provision may also be made in the plan for procurement of services of outside experts in the relevant fields, where necessary.

Preparation of audit planning memorandum

3.128 The overall audit plan should be summarised in a memorandum containing a summary of the scope of the audit and of the planned audit approach. The audit planning memorandum should present an analysis of the main audit areas and a summary of the key planning decisions.

3.129 The audit planning memorandum provides a basis for regular monitoring of progress by audit management. It helps audit team members to understand what is required of them. It facilitates redistribution of audit work in the event of changes in the composition of audit team.

3.130 While the contents of an audit planning memorandum depend on the specific circumstances attending a particular audit, it is possible to indicate some illustrative list of contents. The audit planning memorandum should include:

- a brief outline of the auditee's activities and financial circumstances, cross referenced to more detailed information if appropriate;
- the effect of the regularity framework on the audit; cross-referenced to a summary of primary and secondary legislation;
- details of any significant facts, events or changes which have taken, or may take place; their likely effect on the auditee's operations or environment and on the audit;
- a description of the scope of the audit and the authority under which it is conducted, the type of account, the form of opinion required and any other reporting requirements. This should highlight any additional work required;
- the accounting principles / framework under which the financial statements are prepared and their acceptability (for example government accounting rules; accounting standards);
- sources of funding, financial targets and a brief assessment of the auditee's financial situation;
- planning materiality, cross referenced to documentation setting out the reasons and basis on which it was calculated;
- a summary of specific risks identified, any major problems likely to be met and other items in the financial statements which are likely to require specific attention.

This should be cross referenced to:

- the account areas/audit objectives affected;
 - more detailed information where appropriate;
 - relevant audit programmes;
-
- a brief assessment of the general control environment and mitigating controls, and whether they are to be relied on. This should be cross referenced to more detailed information where appropriate;
 - a brief overview of the audit approach to be adopted, that is to say the degree of compliance and substantive procedures (including analytical procedures);
 - comment on the auditee's ability to continue as a going concern;
 - audit proposals for dealing with multi-locations;
 - details of the nature and extent of use to be made of the work to be carried out by internal audit, other auditors and specialists. This should include names, contact addresses, timing and nature of work;
 - a summary of the key team members and the total planned days / hours and costs, if required under the extant instructions.
 - Respective responsibilities of the auditor and the auditee entity
 - Liaison schedule with auditee entity

Preparation of detailed audit programmes

3.131 After determining audit approach and preparing audit planning memorandum, detailed audit programmes explaining the procedures to be followed by the audit team in order to implement the chosen audit approach should be prepared. The audit programmes instruct audit team members on the performance of chosen audit procedures. The past experience with the auditee entity should be kept in mind while preparing the programmes.

Good communications with auditee entity

3.132 Good communications with the auditee entity at the planning stage of any audit are vital. Discussions with the auditee entity are also essential to agree the administrative arrangements which are needed for the smooth running of the audit.

3.133 The audit reports should be produced promptly. The timetable for drafting, agreeing and issuing the report should be agreed with the auditee entity when the audit plan is finalized.

Creation of Data Bank

3.134 Availability of adequate information/data is a vital prerequisite factor for preparation of the Audit Plan. A formal data bank of the auditee entities should be created covering the type of activities the entity is carrying out, the details of new activities undertaken in the recent years, the environment in which the entity functions, the kind of autonomy the entity enjoys, risk assessed in the previous years, the accounting standard applicable for the entity, changes made, if any, in the accounting standard applicable to the entity, etc. The data should be maintained in a systematic manner which can be easily retrieved as and when they are required. The data should be kept in electronic format, as much as possible, to facilitate easy retrieval.

Planning in the case of State Government Accounts

3.135 In the case of State Government Accounts, the planning should cover the central audit, local audit and information technology audit functions. Where the Accounts of the Works and Forest Divisions and/or State Receipts are audited by a Sub-Auditor, i.e., the Office of the Accountant General (Commercial, Works and Revenue Audit), that Office should plan its work for financial audit, in consultation with the Principal Auditor (i.e., the Principal Accountant General (Civil Audit) or the Accountant General (Civil Audit).

3.136 The Office of the Accountant General (A&E) shall also make a plan for inspection of Treasuries and State Pay and Accounts Offices, complying *inter alia* with the provisions of the present Manual.

Planning in the case of Union Government Accounts

3.137 In the case of Union Government Accounts, the three Offices of Director General Audit (Central Revenues), Principal Director of Audit (Economic and Service Ministries) and Principal Director of Audit (Scientific Departments) should prepare Audit Plans in respect of financial audit of the Departments covered by their respective offices in accordance with the provisions of this Manual.

3.138 Where other Sub Auditors carry out the financial audit of some Departments and provide an audit certificate to the Principal Auditor (as in the case of Railways, Posts and Defence), the respective Sub Auditors should prepare their Audit Plans inter alia complying with the provisions of this Manual.

3.139 The Office of the Director General Audit (Central Revenues) may require other Sub Auditors and the Offices of the State Accountants General to carry out test audit of the transactions of field offices of the Union Government Ministries / Departments covered under their audit jurisdiction and communicate to them the method of sampling and materiality level to be adopted, for the purpose of obtaining assurance regarding the portion of the Accounts pertaining to their audit jurisdiction.

Planning in the case of other auditee entities

3.140 Similar procedures will apply when the auditee entity falls under the audit jurisdiction of more than one audit office. The audit planning should be carried out in close co-ordination between the primary auditor and sub auditors including the method of sampling, materiality level and audit approach to be adopted, for the purpose of obtaining assurance regarding the portion of the Accounts pertaining to their respective audit jurisdiction.

3.141 Moreover, in the case of supplementary audit of Government Companies, based on the planning process as detailed in this Chapter, the concerned Accountant General may revise/ update auditee specific sub-directions to be issued to the statutory auditors.

Chapter 4

Fieldwork

Introduction

4.1 This Chapter provides the Comptroller and Auditor General of India's policies and guidance on fieldwork. It explains the nature of evidence to be gathered when implementing the financial (attest) audit plan.

4.2 The audit plan indicates how the Accountant General proposes to obtain evidence to support the audit opinion. This will normally comprise a mix of control and substantive procedures.

Letter of Understanding / Audit Engagement Letter

4.3 The communication with the entity is a continuous process. The Accountant General and the audit team will be required to be in communication with the entity at different levels throughout the audit process. Though normally the financial audits are of recurring nature every year, it would be desirable if the Accountants General sends a letter to the secretary / chief executive of the entity, communicating the launch of the audit along with the entity units tentatively selected for audit, respective responsibilities of Audit and the entity management, the time-frame for audit and request him/her to issue necessary directions to the functional officers and field units to provide documents and information to the audit team. The letter may be termed letter of understanding (for statutory financial (attest) audit) and engagement letter (for non-statutory audit).

Entry conference

4.4 Entry conference at the commencement of each field audit serves more than one objective. It affords an opportunity for introduction of the audit team members with the chief of the entity and heads of various divisions. The entry conference affords an opportunity for the audit officer to explain the audit plan as applicable to the entity consisting of the audit objectives, approach and time frame besides apprising the entity of the information and documents that will be required by the audit team. The working procedures for audit may also be established in this meeting. The audit officer may also utilise this occasion to request the chief of the entity to provide assistance to the team by way of office accommodation, access to office equipment, etc. It is useful to make a request for the entry

conference in the letter of understanding / audit engagement letter itself to enable the chief of the entity to set aside appropriate time on the very first day of the audit and inform his division heads in time. The entry conference should be followed by a brief minutes of the proceedings.

Nature of evidence

4.5 The Auditing Standards of Comptroller and Auditor General of India require that the auditor should obtain competent, relevant and reasonable evidence to support his judgement and conclusions.

Competent evidence

4.6 Competent evidence is information that is quantitatively sufficient and appropriate to achieve the auditing results and is qualitatively impartial such as to inspire confidence and reliability.

Sufficient evidence

4.7 Sufficient audit evidence will be obtained if the extent of tests (both compliance and substantive tests, as may be relevant) is adequate.

4.8 Although sufficient evidence means primarily not too little evidence, it also means not too much evidence as audit resources should not be wasted. The question how much is enough is a matter of professional audit judgement, guided by the policy of Comptroller and Auditor General of India and generally accepted auditing principles.

Reliable evidence

4.9 Reliable audit evidence is evidence that is impartial. The reliability of audit evidence is dependent upon its nature, its source and the method used to obtain it.

4.10 Some times, alternative forms of evidence, sources and methods are available and the following guidelines may be noted regarding their relative reliability and the audit team should seek to ensure that the most reliable sources and methods are employed within the time and cost constraints imposed upon the audit.

- Documentary evidence is more reliable than oral evidence.
- Evidence, of which the auditor has direct personal knowledge, is the most reliable evidence.
- Independent evidence obtained from external sources is more reliable than internal evidence (obtained from the audited entity) if that evidence is truly independent and complete.
- Visual evidence is highly reliable for confirming the existence of assets, but not their ownership or value.
- Drawing conclusions solely through examining relationships between figures in the account (analytical review) is less reliable evidence.
- Oral evidence must be considered as the least reliable. Whenever feasible, auditors should attempt to obtain documentary confirmation of oral evidence (e.g., agreed written records of interviews or meetings).
- The reliability of information generated within the auditee entity is a function of the reliability of internal control systems within the entity.
- Photocopies are less reliable than the originals. The source of photocopies should be identified by noting the source and, as far as possible, the photocopies should be certified.
- Evidence, which is accepted by the auditee entity, is always reliable.
- The auditor may gain increased assurance when audit evidence obtained from different sources is consistent.

Relevant evidence

4.11 Relevant audit evidence is information that is pertinent to the audit objectives. The auditor's purpose in obtaining substantive evidence is to express an opinion on the financial statements under audit. Evidence is relevant only if it can be used for this purpose. The general audit objectives are designed to ensure that the auditor obtains evidence to support all aspects of the opinion he is required to give on an account. To be relevant, audit evidence must relate to the general audit objectives (also called 'assertions'), which were already explained in Chapter 2.

Reasonable evidence

4.12 Reasonable audit evidence is information that is economical in that the cost of gathering it is commensurate with the result that the auditor is trying to achieve.

4.13 Generally, audit evidence is persuasive rather than conclusive and, for this reason, the auditor should seek evidence from different sources or of a different nature to support the same audit objective.

Obtaining audit evidence

4.14 During the course of fieldwork, the audit team may obtain audit evidence from a number of sources and in a number of ways in support of both testing of controls and substantive testing procedures.

4.15 The principal ways in which audit evidence is obtained can be categorised as:

- **inspection:** examination of records, documents or tangible assets. Generally, an audit team place considerable reliance on this for both tests of control and substantive tests;
- **observation:** watching a process as it takes place. This is unlikely to provide substantive evidence but may be useful in testing controls that leave no audit trail. However, its reliability is limited because the presence of the audit team may influence the way in which the process is undertaken;
- **enquiry and confirmation:** obtaining information from knowledgeable people inside or outside the auditee entity. This may be used for both testing of controls and substantive testing. Confirmation is a response to an enquiry which corroborates information contained in the accounting records;
- **computation:** checking the arithmetical accuracy of source documents and accounting records. This is a central feature of substantive testing and as the evidence is created by the audit team itself, it is very reliable;
- **analytical procedures:** the analysis of the relationship between items of financial data or between items of both financial and non-financial data. Its reliability as a source of evidence depends crucially on the plausibility of the relationship examined and the controls operated over the data used.
- **Surveys:** by using carefully designed questionnaires. Independent consultancy firms may be outsourced for conducting surveys in accordance with the instructions issued by Headquarters Office.
- **Interviews:** with concerned officers.

Use of interviews for gathering evidence

4.16 Interview technique can be gainfully used in a structured or unstructured manner to elicit information from the entity both in the planning as well as execution phase. Auditors can use interview to obtain both qualitative and quantitative information.

4.17 Use of interview technique requires careful preparation. The questionnaire should be reliable and valid. The information collected can be analysed for risk assessment. Once all interviews have been completed, the auditor should read all of the interview documentation memos, looking for themes and patterns. If the interview results indicate a lack of internal controls, overrides of internal controls, potential fraudulent activities, or other specific risks of material misstatement due to fraud, the auditor should expand procedures in the identified areas.

4.18 Audit should ensure that evidence obtained from deliberations or interviews with executives is documented and signed by both the participating audit personnel and executives.

4.19 Interview does not substitute a direct audit procedure. The evidence gathered should be cross-checked through verification of records.

4.20 In auditing government accounts, evidence may not be obtained by making independent enquiries from private individuals or members of the general public. However, evidence may be gathered by enquiry from third parties through a reputed agency only when Audit is of the view that the evidence gathered directly from the auditee organisation is insufficient to arrive at proper conclusions.

Audit Testing

4.21 The audit plan will set out the mix of tests of control, substantive analytical procedures and tests of detail which, in the opinion of the Accountant General, will, subject to satisfactory results, provide competent, relevant and reasonable evidence to support the C&AG's opinion. The plan will be supported by detailed audit programmes specifying the tests required.

4.22 A summary of audit approach to the main forms of audit testing is indicated in the subsequent paragraphs.

Tests of controls

4.23 Before seeking to place reliance on controls, the audit team should perform tests to confirm that they have been operating *effectively and consistently throughout the period under audit*.

4.24 If the audit tests confirm that controls are effective, the audit team should perform a minimum level of substantive procedures.

4.25 If the audit tests do not confirm that controls are effective, the audit team should not place reliance on them and the Accountant General should revise the audit plan.

4.26 There are two controls testing approaches that can be adopted and the rationale for each is explained in the previous Chapter on Planning.

- **Tests of mitigating controls** - where the audit team tests the operation of a single control, which seeks to mitigate a specific risk.
- **Controls reliance strategy** - where the audit team tests and relies on the overall system of controls for one or more audit objectives.

4.27 Before the audit team can adopt a controls reliance strategy, it should perform a systems control evaluation in order to identify the key controls. It is these key controls, which should be tested for compliance. Many of the auditees

of Comptroller and Auditor General of India are increasingly using computer based systems and it becomes essential to evaluate the IT control procedures if audit team intends to adopt a controls reliance strategy.

4.28 To confirm that controls have operated effectively and consistently throughout the period, the audit team can adopt one of several testing methods. These methods include:

- **enquiry and confirmation.** This would normally entail oral enquiry of the members of management responsible for the control. Confirmation could range from a simple walk-through test to a reperformance of the control to ensure that it has operated properly;
- **observation.** This may be used to test controls which leave no audit trail. *It is important that where a control is sought to be tested by observation, the testing should take place in the financial period under audit and not later.* Hence, observation tests should normally be performed during planning or interim visits;
- **sampling** - testing the operation of the controls on a sample of transactions in the period (compliance testing).

4.29 Where the control operates on only a few transactions in a period, audit should test all such transactions.

4.30 In adopting a sampling method, sample sizes should be generally bigger for tests of mitigating controls where there is less tolerance of error. This reflects the higher level of assurance required from a test of a mitigating control than from tests forming part of a controls reliance strategy.

4.31 The results of tests of control can be evaluated as under:

- If the audit team adopts enquiry and confirmation or observation to test controls, then the tests will either succeed or fail.
- If the audit team adopts a sampling method and if the error found in the sample is less than the maximum acceptable level, then the audit team can take its planned level of assurance and perform the minimum level of substantive testing procedures.
- If, on the other hand, the error found in the sample exceeds the maximum acceptable level, then it becomes necessary to reappraise the audit plan. This will generally mean obtaining all the requisite assurance from substantive testing procedures.
- Where the audit team identifies any control failures, it should investigate the causes and consider whether there may also be risks of regularity and propriety with potential for audit paragraphs in C&AG's report.

- The failures of key controls should also be reported to management through management letter.

Substantive Analytical procedures

4.32 The substantive analytical procedures should compare recorded amounts with an expectation thereof developed from relevant financial or non-financial data in order to conclude whether the recorded amounts are free from material misstatement.

4.33 If the substantive analytical procedures predict an error, which is greater than the tolerable difference calculated by the audit team, the audit team should not take assurance from them and should revise the audit plan.

4.34 The advantage of employing substantive analytical procedures is that they test an entire population, eliminating sampling risk. They consist of developing an expectation from plausibly related data and comparing that expectation to actual recorded amounts. If the difference exceeds the acceptable level, and the model cannot be refined, the audit team cannot take its planned assurance from substantive analytical procedures and must perform tests of details instead. However, the audit team should always try to follow up the causes of the difference to ensure that the risk assessment remains valid.

4.35 In order to take assurance from substantive analytical procedures, the audit team should corroborate the data from which the expectation was developed. The extent of corroboration is a matter for the judgment of the Accountant General. It will depend on the assessment of the reliability of the financial systems from which the data is derived. Data obtained from outside the auditee will often need less corroboration than data produced by the auditee.

Tests of detail

4.36 Very rarely, an audit team will be able to obtain competent, relevant and reasonable evidence in respect of each audit objective through tests of control and analytical procedures alone.

4.37 Tests of detail involve obtaining evidence about all, or a sample of, transactions in a population. For example, if the focused substantive procedures have pinpointed a specific risk to a small population, the audit team may test all such transactions. The audit team may also test all transactions where, even without specific identified risks, the total population is small. Where it is not feasible or cost-effective to test all transactions in a population, the audit team can adopt a sampling approach.

4.38 Where the audit team plans to test an audit objective using tests of detail, it should identify the relevant population and:

- apply an appropriate sampling technique to select items from the population and examine supporting evidence for those items; or

- examine supporting evidence for the entire population.

4.39 If the tests of detail, including tests of accounting estimates, identify errors, the audit team should evaluate the impact of those errors to determine whether there is material misstatement in the financial statements or material irregularity in the financial transactions included in them.

4.40 If the tests of detail have been applied to a sample of items, the audit team should estimate the expected error in the population from which the sample was drawn.

Sampling techniques for tests of detail

Determining the sampling frame for tests of detail

4.41 **Before undertaking any form of sampling for tests of detail the auditors should, as part of planning, establish a listing of population items for each financial statement assertion in each account area. This listing will form the sampling frame from which the auditors will normally extract transactions samples for tests of detail.**

4.42 **This listing will normally be derived from the entity's accounting system, usually a transaction history file. However, as part of the planning process the auditors should also have a good understanding of the entity's other business information systems, in particular where these are independent of the accounting system. This is because these systems could provide a suitable listing of population items from which to sample against certain specific risks, or to test the completeness assertion. As an example, the auditors could use the entity's fixed assets register or a company's inventory control system to test completeness of balance sheet assets at the year end.**

Preliminary work required before sampling for tests of detail

4.43 Before sampling any transactions the auditors should carry out a preliminary review of the listing of population items. This preliminary review, which should include the application of planning analytical procedures, is intended to:-

- establish that the sampling frame the auditors intend to sample from does, in fact, match the planning expectations (for example, in terms of completeness);
- contribute to auditors' judgement as to where the main sensitivities or risks are in the population;
- provide an analysis of the population, as a basis for grouping the population by transaction type or value;
- allow auditors to determine our sampling methodology; and

- enable auditors to decide which sampling unit should be tested

4.44 The auditors should document these judgements and completion of this preliminary review in the working papers.

Specific statistical sampling techniques for tests of detail

4.45 The most commonly used sampling methods in connection with tests of detail are:-

- simple random sampling;
- stratified random sampling;
- monetary unit sampling (MUS); and
- two stage sampling

4.46 For all tests of detail, it is necessary to clearly state:

- i. the objective of the test;
- ii. what constitutes an error;
- iii. the population to be covered.

4.47 Where the audit team is testing a sample of transactions, it is necessary to also state:

- i. the source from which the sample is selected and the procedures for reconciling this to the financial statements;
- ii. the method of selection adopted.

Evaluating the results of sampling for tests of detail

4.48 The auditors should, wherever possible, examine the sample data from time to time during the process of testing so that they have early warning if any of the planning assumptions were seriously in error. This examination should normally include a preliminary estimation of the total error in the account or account area, on the basis of the sample of transactions tested to date.

4.49 When all the planned testing has been completed, the auditors should analyse any errors detected in the sample and draw inferences for the population as a whole. As part of this process, the auditors need to consider whether:

- the extent of error identified is consistent with planning assumptions and the decisions which led to determination of the scope of the audit;
- the auditors have gathered sufficient, appropriate audit evidence from sampling for tests of detail and other substantive procedures; and
- at this stage, the results from tests of detail suggest that the financial statements contain material error.

4.50 The discovery of errors which are larger or more numerous than originally expected normally implies that the auditors need to carry out more work than

originally planned before the auditors can draw a reliable conclusion on the truth and fairness or proper presentation of the financial statements.

4.51 In case the audit team identifies errors in a sample of transactions, it should consider the nature and circumstances of the error to determine whether it is a systematic error or random error.

- A *systematic error* is one which will only occur in defined circumstances and hence affects only a proportion of the population
- A *random error* is one which could have also occurred in any of the transactions that were not selected for testing.

4.52 The audit team should then extrapolate the error across:

- either *the defined subset of the population for systematic errors*; or
- *the entire population for random errors*.

4.53 For any clarifications regarding sampling and extrapolation, the guidance of the Statistical Advisor at the Office of the Comptroller and Auditor General should be obtained.

4.54 After evaluating the results of individual tests, the results should be combined:

- i. at each account area level across all audit objectives; and
- ii. at the financial statements level across all account areas.

4.55 After combining the results, the Accountant General will assess whether or not the results of testing enable him to conclude that there is no material misstatement or irregularity in the financial statements.

4.56 After combining the results of all audit tests, the Accountant General may find that the aggregated extrapolated errors indicate possible material misstatement or irregularity. In such a circumstance, it becomes necessary to perform additional work either to:

- reduce the level of extrapolated error by testing a larger sample in one or more populations and narrowing the upper and lower limits of possible error; or
- accurately quantify the level of error in each population.

4.57 If the Accountant General concludes that the tests of detail do not indicate material misstatement or irregularity in any account area, then he may take the planned level of substantive assurance.

4.58 If the Accountant General concludes that there is material misstatement in the financial statements, then he should request the auditee entity to make

appropriate disclosures in or adjustments to the financial statements. Where they do not agree, then the Accountant General should propose a qualified opinion.

4.59 If the Accountant General concludes that there is material irregularity then he should propose a qualified opinion, if the irregularity is not capable of correction by management.

4.60 Sometimes, the Accountant General may conclude that material misstatement or irregularity might be present, but he is unable to quantify it. This would usually occur due to a limitation on the scope of work. In such a situation, he may propose a disclaimer of opinion.

4.61 Detailed guidance about Reporting is given in separate Chapter 7.

4.62 Collection of information for recommendations / inclusion in the Report should not be left to the end of the audit. Every member of the audit team who identifies a matter ought to record the point on a separate collection sheet and in a style which is suitable for inclusion in final letter.

Accounting estimates

4.63 Accounting estimates are approximations of the amount of an item in financial statements in the absence of a precise means of measurement.

4.64 The accounting estimates are usually associated with the preparation of accounts on an accruals or partial accruals basis. They may also be found in cash accounts, for example, when it is required to disclose estimates of contingent liabilities.

4.65 The substantive audit procedures should provide competent, relevant and reasonable audit evidence in respect of accounting estimates. In particular, the audit team should obtain evidence as to whether an accounting estimate:

- i. is reasonable in the circumstances; and
- ii. is appropriately disclosed.

4.66 In auditing accounting estimates, the audit team can adopt one or more of the following approaches:

- *review and test the processes* used by management to develop the estimate;
- *use an independent estimate* for comparison with that prepared by management;
- *review subsequent events.*

4.67 These approaches reflect the three general audit approaches explained earlier in this chapter, namely, to test controls, perform analytical procedures or to perform tests of detail.

Reviewing and testing the processes used by management

4.68 The steps normally involved in the review and testing of the processes used by management are:

- i. evaluation of the data and consideration of the assumptions on which the estimate is based;
- ii. testing of the calculations involved in the estimate;
- iii. comparison, wherever possible, of estimates made for prior periods with actual results of those periods; and
- iv. consideration of management's review and approval procedures.

Using an independent estimate

4.69 The audit team may make or obtain an independent estimate and compare it with the accounting estimate prepared by management. When using an independent estimate, the audit team should evaluate the data, consider the assumptions and test the calculation procedures used in its development. It may also be appropriate to compare independent estimates made for prior periods with actual results of those periods.

Reviewing subsequent events

4.70 Transactions and events which occur after the period end may provide audit evidence regarding an accounting estimate made by management. Audit review of such transactions and events may reduce, or even remove, the need to review and test the process used to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

4.71 The audit team should use professional judgment to evaluate the results of these procedures. The work will often arrive at a difference between the estimate of the amount best supported by the available evidence and the estimated amount included in the financial statements. The audit team should determine whether such a difference requires adjustment. However, as with substantive analytical procedures, the audit team should consider a difference reasonable if the amount in the financial statements falls within a pre-determined range of acceptable results.

Investigating Errors and Control Failures

4.72 The audit team should investigate the nature and causes occurrence of any errors or control failures it discovers.

4.73 *All errors or control failures are of audit interest. The audit team should note that it will never be enough to merely treat them as immaterial or include them within overall evaluation without first understanding how and why they occurred. Without this understanding, it will not be possible to fully consider the implications for audit. Only a full investigation will allow an audit team to judge*

whether the error or failure should cause reconsidering the risk assessment or the reliability of management representations.

4.74 It is important that the audit team pursues the errors and control failures at the time of discovery so that management can take any remedial action promptly and the audit team has sufficient time to change audit procedures if this becomes necessary.

4.75 At that time any corrective action taken by the auditee rectifying the defects pointed out by the audit should be deleted by the authorized person after due verification and certification that omission or mistake is rectified This will help

Auditors' right of access to information

4.76 In the course of scrutiny of accounts and transactions of Government, Audit is entitled to make such queries and observations and to call for all records, statements, returns and explanations as it may consider relevant and necessary in the interest of proper discharge of its duties. All such queries and observations shall be couched in courteous and impersonal language.

4.77 Under Sub-section (2) of Section 18 of the Act, it is the statutory obligation of the person in-charge of the office or the department, the accounts of which are to be inspected/audited by the functionaries of the Comptroller and Auditor General, to afford all facilities for the inspection/audit and comply with requests for information in as complete a form as possible and with all reasonable expedition. In the eventuality of non-production of vital records, the audit should be called off and the matter should be reported by the Accountant General to the Chief Secretary in the State or to the Secretary to the Government of India in the Centre, or the chief executive of the auditee entity, as the case may be.

4.78 In case the problem is not resolved even after this is brought to the notice of the Chief executive concerned, an omnibus draft paragraph on all such problems that arise during the year should be considered for inclusion in the Audit Report for bringing to the notice of the Legislature through the Public Accounts Committee or the Committee on Public Undertakings the failure of the executives to discharge their statutory obligation. In addition, in the Audit Certificates on Accounts, appropriate qualification / disclaimer on account of 'limitation in scope' caused by the non-production of records should be considered.

Exit conference

4.79 In audit of all units, the audit team should conclude the audits with an exit conference/ meeting with the chief officer of that unit. The Head of the Audit Party, or the Group supervisory officer or the Accountant General should lead the

team from the audit side in the exit conference depending upon the size and level of the field entity. All audit observations should preferably be issued to the entity at least one or two days before the scheduled exit conference. The exit conference is an opportunity for the entity to discuss the audit findings with the audit representatives. This also affords opportunity to the audit officer/group supervisory officer to clarify any points of doubt that the entity may like to raise. The minutes of exit conference should be recorded and endorsed to the entity.

Updating the Audit Plan

4.80 The audit plan is based on the evidence available and assumptions made at a particular point in time. As such, it is only valid for as long as those assumptions hold and should not be followed blindly if circumstances change.

4.81 The audit team should be alert throughout the fieldwork to any matters, which may come to attention either as a result of audit procedures or from other sources which may necessitate a revision in the planning assumptions and audit procedures.

4.82 The audit plan is based on an assumed level of error or control failure. There is a need to revise the audit procedures if the results of audit testing reveal higher than expected levels of error or control failure. These are only illustrative of the circumstances in which the audit team should consider revising the audit plan. Each member of the audit team has a responsibility for considering the implications of the following kinds of information on the audit plan.

i. information obtained from the auditee which although not directly obtained from the audit procedures may indicate risks that are not identified at the planning stage. This may, for example, come from discussion with the auditee staff, documenting evidence obtained which was not directly related to the item being tested or just from observing the auditee's operations at their premises;

ii. information obtained directly from third parties or from press or Parliamentary or State Legislature comments. The Office of the Accountant General may receive letters from members of the public directly or through the Office of the CAG drawing attention to alleged irregularity and impropriety; such matters may also be raised in questions in Parliament or State Legislature. The audit team should always consider the implications of these for audit.

4.83 The audit plan should be flexible. At each stage of the audit, the audit team should consider whether the planned approach remains appropriate and monitor any major events which may require a change in the plan such as a change in the operations or services provided by the auditee entity or the volume and nature of the expenditure or income.

Documentation of Fieldwork

4.84 The audit working papers should document the audit procedures undertaken, the conclusions drawn and the implications for the audit opinion. They should record the reasoning on all significant matters where the members of the audit teams have exercised judgment.

4.85 The audit working papers help individual audit team members ensure that they have completed all the work necessary; they provide the evidence to back up the opinion reached and allow review of the audit work to be carried out.

4.86 The audit working papers recording the fieldwork should *inter alia* show:

- i. that all the audit procedures in the plan have been completed or that justification has been given and approval obtained for any departures;
- ii. the results of the audit procedures, drawing out clearly any errors or control weaknesses identified;
- iii. that all errors or control weaknesses have been investigated and discussed with the management of the auditee, as necessary;
- iv. any matters that are unresolved or that should be informed in writing to the auditee;
- v. the conclusions the audit team members have drawn from the fieldwork, the judgments made in reaching these conclusions and the reasoning underlying them.

4.87 All correspondence with the auditee should be retained, together with minutes of meetings. Wherever possible, the latter should be agreed with the auditee.

4.88 *The acid test for good documentation is that an experienced auditor with no previous connection with the audit should be able, without difficulty, to ascertain the evidence gathered and understand and support the conclusions reached.*

Quality Assurance in Fieldwork

4.89 Quality in fieldwork is assured through the following:

- Adherence to the Field Standards and policy of Comptroller and Auditor General of India regarding fieldwork;
- Ensuring staffing of audit teams with persons possessing appropriate knowledge and skills;
- Supervision, monitoring and review;
- Holding of Workshops of audit teams engaged in similar audits;
- Documentation of the fieldwork; and
- Peer review.

4.90 Most of the above measures have been explained in the relevant paragraphs in this Manual. Peer review refers to the review of the procedures and practices by a professional, who has not been associated with the specific audit with a view to ensuring that the best practices and standards have been followed. Peer review is carried out in accordance with the practice established within Comptroller and Auditor General of India.

Chapter 5

Audit Completion

Introduction

- 5.1 This chapter provides the policies and guidance on completion of the audit. The objective of the completion procedures is to ensure that the financial statements comply with all disclosure requirements; competent, relevant and reasonable audit evidence was obtained to form an opinion on the appropriate form of audit certificate; and audit evidence is adequately documented.

Overall review of financial statements

- 5.2 In the completion phase of audit, the audit team should perform an overall review of the financial statements. The review will consider whether:
- i. the financial statements comply with requirements of applicable statutes, rules and instructions, if any;
 - ii. accounting policies conform to the relevant Accounting Standards, Rules and instructions and have been properly disclosed, consistently applied and are appropriate to the auditee;
 - iii. the financial statements as a whole are consistent with the audit team's knowledge of the auditee and the results of audit procedures;
 - iv. the manner of disclosure within the financial statements is fair / proper.
- 5.3 The overall review of financial statements serves the following purposes:
- i. It ensures that the disclosures and information in the financial statements are adequate for expressing audit opinion on the proper presentation (in case of cash-based accounts) or true and fair view (in case of accrual-based accounts) to be given and that the financial statements are prepared in accordance with the requirement of legislation, Accounting Rules and applicable instructions;
 - ii. to look critically at the information presented in the financial statements and ensure that it is consistent with the audit team's knowledge of the auditee and the results of audit procedures.
- 5.4 The accounting policies of the auditee would already have been considered at the planning stage of audit. This consideration should be updated at the completion stage in the light of the results of audit procedures.
- 5.5 Audit considerations while carrying out the analytical review at the completion phase are:

- i. whether the financial statements adequately reflect the information and explanations previously obtained and conclusions previously reached during the course of audit;
 - ii. whether the review reveals any new factors which may affect the presentation of, or disclosures in, the financial statements;
 - iii. whether comparing the information in the financial statements with other relevant data produces results which assist in arriving at overall conclusion as to whether the financial statements as a whole are consistent with audit team's knowledge of the auditee's business (i.e., activities and operations);
 - iv. whether the presentation adopted in the financial statements may have been unduly influenced by the management's desire to present matters in a favourable or unfavourable light; and
 - v. the potential impact on the financial statements of the aggregate of uncorrected misstatements (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if any.
- 5.6 Before commencing analytical review of the financial statements, the audit team should agree and cross reference them to the lead schedules in the audit working papers. These lead schedules should themselves be agreed to the balances in the auditee's accounts. These checks ensure that the financial statements are properly prepared from the accounting records. If the audit team receives further drafts of the financial statements, it should agree them to the cross referenced draft and ensure that all adjustments are properly documented, audited and reflected in working papers. Where significant adjustments and amendments are processed, the audit team should update the review of the financial statements.

Review of subsequent events

- 5.7 The audit team should consider the effect of subsequent events on the financial statements between the period end and the date of the audit certificate. For this purpose, subsequent events are those relevant events (favourable or unfavourable) which occur and those facts which are discovered after the close of the period covered by the financial statements under audit and before the date of the audit certificate.
- 5.8 The audit team should perform audit procedures to obtain assurance that all material subsequent events up to the date of the audit certificate have been identified and that appropriate adjustments or disclosures have been made in the financial statements.

- 5.9 An examination of subsequent events is often an integral part of audit testing of account areas, particularly while auditing accounting estimates. For example, an accrued liability may be verified *inter alia* by reviewing invoices received after the period end.
- 5.10 The audit team should perform specific procedures to identify subsequent events, which may require adjustment or disclosure in the financial statements. These procedures are performed during main audit visit and updated to the date of signing the audit certificate. Some of these procedures are:
- making enquiries of management to ascertain their procedures for identifying subsequent events;
 - reading minutes of management meetings and board meetings;
 - reviewing the latest available financial information, for example post period accounts, budgets and management information;
 - obtaining written representations from management;
 - considering Parliamentary or State Legislature proceedings occurring after the period end which might have an impact on the auditee. In particular, the implications of any Parliamentary decisions, reports or new legislation, which might require adjustment of, or disclosure in, the financial statements should be considered.
- 5.11 The extent to which the audit team needs to update its audit procedures to the date of signing the audit certificate depends on the length of time since the main audit visit. The minutes of management meetings or board meetings since that visit should be always reviewed. Where a substantial period has elapsed since the main audit visit, the audit team should also consider the current status of items involving subjective judgement and whether there have been any developments regarding risk areas and contingencies. Where audit certificate is issued soon after completing the main audit visit, the audit team may normally restrict the audit procedures to a review of minutes of the management or board, making enquiries of management and receipt of written management representations.

Going concern

- 5.12 At the completion stage of audit, the audit team should ensure that it has considered the auditee's ability to continue as a going concern in the foreseeable future. It should update the review of matters that may affect the going concern basis to the date of signing the audit certificate
- 5.13 The audit work at the completion stage includes a review of cashflow forecasts and budgets in order to ascertain whether the auditee has sufficient resources and facilities to continue operations for a period of at least one year from the date of approval of the financial statements. Audit should also consider whether there is any evidence of uncertainty over the

auditee's future or whether decisions have been made to significantly curtail the auditee's operations.

- 5.14 Normally, in the context of auditing the accounts of Governments, all the Government Departments can be considered as going concerns. The present guidance regarding 'Going Concern' is of relevance to the audit of accounts of auditees other than Government Departments or Governments.

Management representations

- 5.15 Audit team should obtain written representations from the Accounting Officer or Chief Executive on matters material to the financial statements when those representations are critical to obtaining competent/relevant and reasonable audit evidence. Audit should also seek to obtain a written representation acknowledging the Accounting Officer's or Chief Executive's responsibility for the regularity of transactions.
- 5.16 Management representations are usually sought for the following reasons:
- where knowledge of the facts pertaining to a matter is confined to management alone;
 - to acknowledge management's responsibility for the regularity of expenditure;
 - to acknowledge management's responsibility for the preparation of the financial statements.
- 5.17 Evidence about the last point is usually obtained by receiving a signed copy of the financial statements which incorporate a statement of responsibility.
- 5.18 Management representations cannot be a substitute for other audit evidence that would be normally expected to be available. However, they are sometimes the only form of evidence available, for example, where the matter is principally one of judgment or opinion.
- 5.19 In the context of certification of Government Accounts of State Governments, the Comptroller and Auditor General of India has initiated a process to make the Executive own up responsibility regarding the accounts. The instructions issued by the Headquarters Office should be followed in this regard.

Summarising the audit

- 5.20 After completing the audit procedures, the audit team should prepare an executive summary of audit findings. This summary explains the key audit issues, their resolution, agreed adjustments and concludes on the appropriate form of audit certificate. The summary is reviewed and signed

by the Audit Officer, Group Officer (supervising the audit) and Accountant General.

5.21 The executive summary is a high level summary, which explains audit findings. While it is a concise document, it should contain sufficient information to stand alone as a summary of the evidence which supports audit team's conclusion on the appropriate form of audit certificate. It should include:

- i. a summary of the auditee's operations and purpose;
- ii. a summary of the regularity framework within which the auditee operates;
- iii. an explanation of the audit approach and the balance between tests of controls and substantive procedures;
- iv. a summary of the key risks identified;
- v. a commentary on the expenditure and income of the auditee;
- vi. a commentary on key balances;
- vii. a commentary on the accounting policies in significant account areas;
- viii. a summary of the results of audit procedures;
- ix. details of areas where difficult questions of principle or judgement were involved;
- x. a summary of audit issues and their resolution;
- xi. commentary on unadjusted errors which are significant, but not material;
- xii. a summary of other important matters for attention;
- xiii. outstanding matters, for example, outstanding re-appropriation orders or letters authorising agreed amendments to the financial statements;
- xiv. a summary of matters carried forward to the next year's audit;
- xv. a conclusion on the appropriate form of audit certificate.

5.22 Where the proposed audit certificate will be other than unqualified, the full rationale should be given in the executive summary. Further guidance on audit reporting is given in a separate Guide on Audit Certificates.

Chapter 6

Documentation

6.1 According to the Auditing Standards, Auditors should adequately document the audit evidence in working papers, including the basis and extent of the planning, work performed and the findings of the audit. Working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant findings and conclusions.

Importance of adequate documentation

6.2 According to the Auditing Standards, adequate documentation is important for several reasons. It will:

- (a) confirm and support the auditor's opinions and reports;
- (b) increase the efficiency and effectiveness of the audit;
- (c) serve as a source of information for preparing reports or answering any enquiries from the audited entity or from any other party;
- (d) serve as evidence of the auditor's compliance with Auditing Standards;
- (e) facilitate planning and supervision;
- (f) help the auditor's professional development;
- (g) help to ensure that delegated work has been satisfactorily performed; and
- (h) provide evidence of work done for future reference.

6.3 The Standards further state that the auditor should bear in mind that the content and arrangement of the working papers reflect the degree of the auditor's proficiency, experience and knowledge. Working papers should be sufficiently complete and detailed to enable an experienced auditor having no previous connection with the audit to subsequently ascertain from them what work was performed to support the conclusions.

6.4 The audit opinion given on an account should be based on competent, relevant and reasonable evidence. The audit should be planned to achieve this. The evidence is gathered by the audit party and conclusions are drawn from the tests carried out. The review of the audit by senior officers has to assess the adequacy of the evidence and the reasonableness of the conclusion reached. The Officers responsible for the audit work should ensure that all this has been carried out properly. Good documentation is, therefore, vital to show the quality of the audit attained.

6.5 Every matter relevant to the audit should be recorded in a clear and concise way. The referencing of documents is especially important to show the way through the papers. The aim should be to make it easy for anybody not previously involved with the audit (for example, another auditor who for some reason has to take over the audit), and for senior officers reviewing the documentation, to see exactly what has been done and the conclusions reached. The auditor knows exactly what he has done and what views he has formed; the documentation must make sure that other people examining the documentation are put in the same position. *The acid test for good documentation is that an experienced auditor with no previous connection with the audit should be able, without difficulty, to ascertain the evidence gathered and understand and agree with the conclusions reached.*

Document files

6.6 A standard method of filing documents is essential. The filing method should recognise that documents fall into two categories:

- those relevant to the audit of the entity (Government, Department etc. under audit) generally
- those relevant only to the audit of the entity (Government, Department etc. under audit) for a particular year of account

6.7 The documents to which the auditor needs to refer each year should be placed in a Standing File. This file should contain current information about the organisation itself, such as:

- the authority for the audit
- governing legislation
- organisation chart and key personnel
- descriptions of accounting systems
- manuals
- systems evaluations

6.8 The documents relevant to the audit of a particular year of account should be filed in a manner which brings together related working papers in a series of folders (or in separate sections within folders). An indication of how working papers might be grouped into Working Paper Folders (current file) is given in Annexe-1.

6.9 The working paper folders should include documentation which shows:

- the names of audit personnel who carried out the audit work;
- the dates when the audit work was carried out by the respective audit personnel;
- the sources of the information / evidence obtained;
- the nature and purpose of the audit tests carried out and the results obtained.

6.10 It is important to note that any judgements made, and each audit conclusion reached, on account areas and balances should be recorded clearly. Lead schedules

covering each account area should summarise the audit work carried out and the results of the audit. Each lead schedule should provide cross-referencing between the figures in the financial statements and the audit done to confirm or verify them. An example of a lead schedule is given at Annex-2.

Submission of audit documentation for review and accounts for certification

6.11 As described earlier, the review of the audit is in two stages. The team leader responsible for the supervision of the audit should, therefore submit to the first stage reviewer the working paper folders containing all the audit documentation. If there are outstanding matters to be resolved before the accounts can be certified, the team leader should bring them to the attention of the first stage reviewer (the Group Officer or Senior /Audit Officer in charge of the audit of financial statements) on a summary sheet (see example at Annexe-3).

6.12 Separate folders should be opened for submission of:

- the results of the audit (the examination folder); and
- the signed accounts for certification (the certification folder).

6.13 The team leader's submission to the first stage reviewer in the examination folder should include the Executive Summary and its supporting documents. The team leader should also state formally:

- that the audit has been completed; and
- his opinion as to whether a clear certificate can be given and, if not, his reasons for any proposed qualification.

6.14 The certification folder should contain:

- the signed accounts appropriately ticked to indicate that they have been audited
- the letter which accompanied the signed accounts when they were sent for certification; and any further letters from the signatory to the accounts (or some authority empowered to act for him) authorising amendments to the accounts
- any superseded pages of the accounts (which should be clearly cancelled) a copy of the list of items awaiting clearance before the accounts can be certified.

6.15 In the accompanying submission the team leader should clearly indicate:

- the place where the results of the examination of the accounts are recorded (the reference number of the examination folder)
- the certificate he proposes
- whether any separate report on the accounts is under consideration.

6.16 In proposing the certificate, the team leader is required to follow the approved form of certificate appropriate to the type of account audited (see the Guide on Audit Certificates).

6.17 Working papers also serve as a connecting link between the fieldwork and the audit report. These should, therefore, be complete and appropriately detailed to provide a clear trail of the audit. The confidentiality of the working papers should be maintained and they should be retained for a period sufficient to meet the professional, legislative and legal requirements.

Broad characteristics of working papers

6.18 Some of the broad characteristic that working papers should have are set out below:

Completeness and accuracy:	and	Provide support to audit conclusions and recommendations.
Clarity and conciseness:	and	Self contained in the sense that anyone using them should be able to understand the entire audit process without need for any supplementary examination.
Ease of preparation:		While the audit teams will be called upon to collect large volumes of working papers, to the extent they can use the entity prepared documents and reports, pre-printed standard audit stationery and automatically generated standard working paper formats, the time and effort may be optimised.
Legibility and neatness:	and	Applies particularly to photocopies.
Relevance:		Working papers should be restricted to matters, which are important, pertinent and useful for the purpose.
Ease of review:		The working papers should contain cross references to the audit memoranda, discussion papers, audit observation, field audit report and performance audit report, as the case may be, to enable the Accountants General and Headquarters Office management to link the working papers to audit conclusion.
Organisation and ease of reference:		The working papers may contain an omnibus, easy to follow, index with proper narration for all volumes in an audit summary file and an index for each of the working paper files

6.19 The audit officer and group supervisory officer will be responsible individually and jointly for the documents as per the above standards.

Use of electronic documentation

6.20 Use of electronic documentation software like TeamMate will improve the quality of documentation. Electronic documentation software should be used in accordance with the instructions issued by the Headquarters Office.

Quality Assurance

6.21 Quality in audit completion stage is assured through the following:

- Adherence to the Field Standards and policy of Comptroller and Auditor General of India regarding audit completion;
- Supervision, monitoring and review;
- Documentation of the fieldwork; and
- Peer review.

6.22 The Comptroller and Auditor General of India may prescribe detailed specific audit completion procedures for each type of financial audit carried out.

Layout of Working Papers

Working papers should be filed in such a way that different aspects of the audit are separated. A standardised layout such as that suggested below has the advantage that the location of papers can be easily identified.

Working Paper Folders (current file)

	Working paper Folders	Contents that should be in the Working Paper folder
A	Audit Plan	<ol style="list-style-type: none"> 1. <u>Audit Planning Memorandum</u> which should cover: <ul style="list-style-type: none"> <input type="checkbox"/> Background <input type="checkbox"/> Materiality <input type="checkbox"/> Risk Assessment <input type="checkbox"/> Audit objectives <input type="checkbox"/> Audit approach for each account area <input type="checkbox"/> Resources and timing <input type="checkbox"/> Key contacts at the entity 2. <u>Understanding the entity -</u> consider and document: <ul style="list-style-type: none"> <input type="checkbox"/> External Environment; <input type="checkbox"/> Legislation to which the entity is subject 3. <u>Materiality calculation</u> 4. <u>Calculation of estimated error and precision</u> 5. <u>Review of Information systems (if applicable) -</u> consider and document: <ul style="list-style-type: none"> <input type="checkbox"/> Physical controls (location of computer, back-up, etc; <input type="checkbox"/> and application controls. 6. <u>Risk assessment</u> – consider and document: <ul style="list-style-type: none"> <input type="checkbox"/> Inherent Risk for each account area <input type="checkbox"/> Control environment questionnaire and overall assessment <input type="checkbox"/> Control procedures questionnaire (if applicable)

		<ul style="list-style-type: none"> ❑ Control Risk Assessment for each account area ❑ Specific Risks for the entity ❑ Specific Risks in respect of each account area <p>7. <u>Assessment of key controls on each of the account areas.</u></p> <p>8. <u>Audit Approach for each account area:</u> Including calculation of sample sizes required, and where applicable any use to be made of analytical procedures or tests of control.</p> <p>9. <u>Approval of audit planning memorandum by Director and/or Counsellor</u></p>
B	Draft Account	<p>1. <u>Transaction listings</u></p> <p>2. <u>Trial Balance;</u></p> <p>3. <u>Draft Account and amendments;</u></p> <p>4. <u>Cross reference from Draft Account to individual WPFs.</u></p>
C	<p>Profit and Loss Account Areas.</p> <p>For each account area, for example income, salaries, operating expenditure, etc.</p>	<p>1. <u>Issues from last year;</u></p> <p>2. <u>Audit planning document from the audit plan;</u></p> <p>3. <u>Audit Programme;</u></p> <p>4. <u>Samples tested;</u></p> <p>5. <u>Errors found and evaluation of errors</u></p> <p>6. <u>Overall lead schedule to show the amount audited for each account area;</u></p> <p>7. <u>Summary of matters for attention;</u></p> <p>8. <u>Issues to carry forward into next year.</u></p>
D	<p>Balance Sheet Areas</p> <p>For each account area, for example fixed assets, cash, debtors, creditors etc.</p>	<p>1. <u>Issues from last year;</u></p> <p>2. <u>Audit planning document from the audit plan;</u></p> <p>3. <u>Audit Programme;</u></p> <p>4. <u>Samples tested;</u></p> <p>5. <u>Errors found and evaluation of errors</u></p> <p>6. <u>Overall lead schedule to show the amount audited for each account area;</u></p> <p>7. <u>Summary of matters for attention;</u></p> <p>8. <u>Issues to carry forward into next year</u></p>
E	Losses	<p>1. <u>Details of losses;</u></p> <p>2. <u>Summary of matters for attention.</u></p>

F	Internal Audit	1. <u>Evaluation of Internal Audit;</u> 2. <u>Summary of matters for attention.</u>
G	Liaison	1. <u>Copies of correspondence with entities;</u> 2. <u>Summary of matters for attention.</u>

Account Area Lead Schedule

Name of Audited Entity (Government, etc. under audit):

Account:

Year:

	Name	Designation	Date	Signature
Prepared by				
Reviewed by (1 st stage) *				
Approved by (2 nd stage) **				

(*) Group Officer or Senior/Audit Officer in charge of certification of financial statements

(**) Accountant General

SECTION A : COMPOSITION OF ACCOUNT AREA

Account Head	Current Year Actuals (a)	Current Year Budget (b)	Previous Year Actuals (c)	Variation (a)/ b	Variation (a)/ c	Reference to supporting schedules /working papers	Reference to Final Accounts figures
Total							

SECTION B : ACCOUNT FIGURE WORK

		Working paper Reference
Brief explanation of significant variations from estimate and/or previous year:		

SECTION C : AUDIT WORK CARRIED OUT

Did the audit approach follow the approved plan? In particular: a) as a result of your audit can the planning assessment of inherent risk be confirmed b) where an SBA approach was adopted, was the compliance test programme completed satisfactorily, providing the planned assurance; c) has substantive testing been completed satisfactorily, providing the planned assurance; d) where quantified reliance was to be placed on analytical review, were results consistent with those from other substantive testing, providing the planned assurance; and e) does the clearance certificate from, or review of the work carried out by, other auditors / specialists provide adequate assurance as planned?	Yes/No/NA	WP Reference
Briefly note any major changes to the plan and/or problems arising:		

SECTION D: OVERALL CONCLUSION ON ACCOUNT AREA

Notes:

1. The lead schedule for an account area should provide:

- i. a cross-referenced reconciliation from the account area to the financial statements;
- ii. cross-references to the supporting schedules and working papers and to the financial statements;
- iii. a brief explanation of any significant variations in actual figures;
- iv. confirmation that the audit approach was the same as approved in the audit plan;
- v. a brief summary of the audit work carried out and the results; and
- vi. an overall conclusion of the audit findings

2. In the example of a lead schedule given above, Section A provides for the auditor's analysis of the items on the financial statements which are in the account area. This analysis should be cross-referenced to supporting working papers and to the final account. It should also record variations from estimates and previous year's figures. A brief summary of the explanations for these variations should be provided in Section B.

3. Section C provides for the auditor to give a summary of the audit work carried out. This is helped by the use of a checklist. All actions should be cross-referenced to working papers.

4. The overall audit conclusion on the account area should be recorded in Section D.

Annexe-3

Summary of Matters for Attention

Account:

Class:

Year:

Sheet Page No.....of

Ref eren ce	Examining Official	Senior/ Officer	Audit	Group Officer	Accountant General

Signature

Signature

Signature

Signature

Chapter 7

Reporting

Introduction

7.1 This chapter contains the policies and guidance in respect of the reports on financial statements on completion of financial audit. These policies seek to ensure clear and informative reporting to the users of financial statements.

7.2 In the context of Accounts of Governments, the term "financial statements" comprises the Finance and Appropriation Accounts of the Government. It includes any notes and other explanatory material thereon included in the respective statements of Finance and Appropriation Accounts. In the context of other entities, the term will refer to the financial statements under audit like income and expenditure account (or other form of profit and loss or receipts and payments or revenue account), the Balance Sheet, Cash Flow Statement and those notes and other explanatory material, identified as within the scope of the audit opinion.

Auditors should be careful to:

- Ensure facts presented are correct
- Recommendations are realistic and cost-effective

Opinion and basis of accounting

7.3 It was already explained in Chapter 2 that the words used in the audit opinion depend on the basis of accounting employed. The circumstances in which each form of words is used are briefly indicated below.

properly presents - used when the financial statements have been prepared on a cash basis, reflecting the very low level of judgement required in preparing financial statements on a cash basis.

presents fairly - used when the financial statements have been prepared on a partial accruals basis and are not intended to give a true and fair view. This form of words reflects the fact that though some element of judgement has been used in preparing the financial statements, the audit opinion is distinct one on accounts which give a true and fair view.

true and fair view - used when the financial statements have been prepared on a full accruals basis and intended to give a true and fair view.

Format of certificate

7.4 Normally, the audit reports on completion of financial audit will be in the form of audit certificates. However, in appropriate cases, a detailed report can be annexed to the audit certificate. In case the format of audit certificate is prescribed under the provisions of any law or engagement, such prescribed format shall be used.

7.5 The reporting standards require that the form and content of all audit opinions and reports are founded on the following general principles:

(a) **Title.** The opinion or report should be preceded by a suitable title or heading, helping the reader to distinguish it from statements and information issued by others.

(b) **Signature and date.** The opinion or report should be properly signed. The inclusion of a date informs the reader that consideration has been given to the effect of events or transactions about which the auditor became aware up to that date (which, in the case of regularity (financial) audits, may be beyond the period of the financial statements).

(c) **Objectives and scope.** The opinion or report should include reference to the objectives and scope of the audit. This information establishes the purpose and boundaries of the audit.

(d) **Completeness.** Opinions should be appended to and published with the financial statements to which they relate, but performance reports may be free standing. The auditor's opinions and reports should be presented as prepared by the auditor. In exercising its independence CAG may acquire information from time to time, which in the national interest cannot be freely disclosed. This can affect the completeness of the audit report. In this situation the auditor should consider the need to make a report, possibly including confidential or sensitive material in a separate, unpublished report.

(e) **Addressee.** The opinion or report should identify those to whom it is addressed, as required by the circumstances of the audit engagement and local regulations or practice. This is unnecessary where formal procedures exist for its delivery.

(f) **Identification of subject matter.** The opinion or report should identify the financial statements to which it relates. This includes information such as the name of the auditee entity and the date and period covered by the financial statements.

(g) **Legal basis.** Audit opinions and reports should identify the legislation or other authority providing for the audit.

(h) **Compliance with standards.** Audit opinions and reports should indicate the auditing standards or practices followed in conducting the audit, thus providing the reader with an assurance that the audit has been carried out in accordance with generally accepted procedures.

(i) **Timeliness.** The audit opinion or report should be available promptly to be of greatest use to readers and users, particularly those who have to take necessary action.

7.6 The audit opinion will also contain separate sections dealing with:

- respective responsibilities of the executive and auditors
- the basis of the opinion expressed
- the opinion on the financial statements.

Statements of responsibility

7.7 The audit opinion should make a clear distinction between the responsibilities of the management of the entity and the SAI carrying audit.

7.8 Some financial statements (like those of Companies) may include statements of Directors' responsibilities. In case of Government Departments, the Secretary of the Department and any equivalent designation can be considered as the management. The titles will vary depending upon the nature of the auditee.

7.9 In several States, the Finance and Appropriation Accounts are compiled by the Accountant General - Accounts and Entitlements {(AG (A&E))} who belongs to the Indian Audit and Accounts Department under the SAI India. The AG (A&E) compiles the accounts in accordance with the requirements of the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 from the initial and subsidiary accounts rendered by the treasuries, offices or departments responsible for the keeping of such accounts functioning under the control of the State Government and the statements received from the Reserve Bank of India. It is very important to note that the treasuries, offices or departments functioning under the control of the State Government (and not SAI India) are primarily responsible for the correctness of the initial and subsidiary accounts as well as ensuring the regularity of financial transactions in accordance with the applicable laws, standards, rules and regulations concerning such accounts and transactions. This position should be clearly brought about in the C&AG's certificate.

7.10 It is also desirable to obtain a Certificate from the Secretary (or equivalent Officer in the Executive) of the Government to the effect that the initial and subsidiary accounts relating to the year under audit rendered by the treasuries, offices or departments functioning under the control of the Government are correct and in accordance with the applicable laws, standards, rules and regulations.

7.11 The following paragraphs provide basic guidance on the language of audit certificates and should be read in conjunction with the illustrations of unqualified and qualified certificates given in the separate Guide on Formats of Certificates.

Opinion

7.12 An audit opinion is normally in a standard format, relating to the financial statements as a whole, thus avoiding the need to state at length what lies behind it but conveying by its nature a general understanding among readers as to its meaning. The nature of these words will be influenced by the legal framework for the audit, but the content of the opinion will need to indicate unambiguously whether it is unqualified or qualified and, if the latter, whether it is qualified in certain respects or is adverse or a disclaimer of opinion.

Basis of Opinion

7.13 The audit certificate should include a statement expressly setting out the basis of the audit opinion. This will include:

- i. a statement certifying that the C&AG has performed his examination in accordance with relevant legislative authority - where there is a legal requirement for him to certify;
- ii. a statement as to compliance or otherwise with Auditing Standards, together with the reasons for any departure therefrom;
- iii. a statement that the audit process includes examining, on a test basis, evidence relevant to the amounts, disclosures and regularity of transactions included in the financial statements; and
- iv. a statement that the audit is planned and performed so as to obtain reasonable assurance that the financial statements are free from material misstatement.

7.14 These statements are suitably modified where there a limitation of audit scope.

Expression of opinion

7.15 The audit certificates should contain a clear expression of opinion on both the truth and fairness/proper presentation/fair presentation (as appropriate) and the regularity of the transactions recorded in the financial statements. The form of words used is governed by the basis of accounting used in the preparation of the statements.

7.16 Audit procedures are also carried out to form an opinion as to whether or not:

- i. proper accounting records have been kept by the entity and proper returns adequate for the audit have been received from branches not visited;
- ii. the financial statements are in agreement with the accounting records and returns;

- iii. other information published with the financial statements is consistent with those statements.

7.17 If any of these requirements have not been met, it should be stated in the audit certificate. The certificate should also state whether or not all the information and explanations required for the purposes of audit were obtained or not.

Unqualified opinions

Presentation of financial statements

7.18 An unqualified opinion is given when, in the judgement of the Accountant General, the financial statements properly present receipts and payments or give a true and fair view and have been prepared in accordance with relevant accounting requirements. In forming this judgement, the Accountant General must be satisfied that in all material respects:

- i. the financial statements have been prepared in accordance with relevant legislation, regulations, instructions of Finance Department, Government Accounting and applicable accounting standards (and that any departures are justified and adequately explained in the financial statements);
- ii. there is adequate disclosure of all information relevant to a proper understanding of the financial statements;
- iii. appropriate accounting policies have been consistently applied in the preparation of financial statements.
- iv. the financial statements are free from material irregularity and therefore that the transactions recorded in them conform with the authority which governs them.

7.19 In forming the judgement about absence of material irregularity, the Accountant General must be satisfied that in all material respects:

- i. transactions comply with the legislation (both primary and secondary) governing them;
- ii. transactions comply with any regulations relating to them issued by a body with the power to do so under the governing legislation;
- iii. approval of Finance Department or any sponsoring Department has been sought and obtained as required;
- iv. the financial transactions fall within the ambit of the Vote of the Parliament or Legislature.

7.20 If the Accountant General has reservations on any of the above matters, an unqualified opinion should not be expressed. It is essential that the wording of kmmman

opinion is precise, brief and without reference to anything which may be contained in other sections of the audit certificate. The "opinion" section of the audit certificate should not highlight specific information contained in the financial statements, as such reference might be interpreted as a qualification in the mind of the reader when none is intended.

Inherent uncertainty

7.21 The Accountant General should consider whether the view given by the financial statements could be affected by "inherent uncertainties" and whether, irrespective of the opinion being given, such uncertainties have been adequately disclosed in the financial statements.

7.22 Financial statements sometimes reflect the working assumptions of the management as to the outcome of future events. It may be impossible for management to remove any uncertainty surrounding these outcomes by obtaining more information at the date the financial statements are approved. Where this uncertainty is material, then the statements should describe the reasons and their potential financial effect. SAI India's audit will include an assessment of whether there is sufficient evidence to support management's view. This will involve consideration of:

- the appropriateness of accounting policies dealing with uncertainties;
- the reasonableness of the estimates made regarding these uncertainties;
- the adequacy of the disclosure of the uncertainty.

7.23 *It is important to distinguish between an inherent uncertainty and a limitation in the scope of the audit.* In all cases of apparent uncertainty, the audit team should ensure that the "uncertainty" relates to a future event and that management have done everything in their power to resolve it. If a case fails either of these tests then it is likely that a scope limitation exists.

7.24 In some circumstances, the degree of uncertainty and its potential impact on the view given by the statements may mean that it is regarded as fundamental. In determining whether an inherent uncertainty is fundamental, the Accountant General should consider:

- the risk that estimates included in the statements may be subject to change;
- the range of possible outcomes of the uncertainty;
- the consequences of those outcomes on the financial statements.

7.25 In the corporate sector, fundamental uncertainties generally relate to matters which call into question going concern issues and are therefore unlikely to exist in the case of government departments. However, where an Accountant General concludes that a fundamental uncertainty exists, but has been

adequately disclosed in the financial statements, this should be drawn to the readers' attention by way of an explanatory paragraph, but without qualifying the opinion. The explanatory paragraph should have a separate heading and be inserted after the "basis of opinion" section.

7.26 Where an Accountant General concludes that an estimate of the outcome of an inherent uncertainty, disclosed in the financial statements, is materially misstated or that disclosure of the uncertainty is inadequate, he should propose a qualified opinion on the grounds of disagreement. Where the Accountant General is, for some reason, prevented from assessing the adequacy of the accounting treatment or disclosure of an inherent uncertainty, then he may use a disclaimer of opinion.

Qualified opinions

To make an audit opinion, an estimate is to be made of the most likely error present in the financial statements. This needs to be compared with the materiality to determine the impact it has on audit opinion.

7.27 The audit opinion should be qualified where the Accountant General is unable to satisfy himself that the financial statements are free from material misstatement whether caused by fraud, error or other irregularity. For Appropriation Accounts a qualified opinion is also given on all Excess votes.

7.28 Three types of opinion other than unqualified can be issued - "except for", adverse and disclaimer of opinion. These are used in the following circumstances.

7.29 The point at which 'some' error (acceptable) in the accounts becomes 'too much' error (unacceptable) is the point when qualification becomes necessary. The critical question to be answered is: would this level of error distort the overall view given by the accounts? If the error in the financial statements were thought likely to have such a serious effect, it would be regarded as 'material'. It is not just the value of the error which must be considered. The materiality of error must also be judged in relation to the nature of the error and to the context in which it occurs.

7.30 The reasons for qualification fall into two groups:

- the audit may have caused the Accountant General to be uncertain as to whether material error does, or does not, exist in the accounts
- the Accountant General may disagree with the way something has been dealt with in the accounts.

7.31 Uncertainty can arise in either of the following circumstances:

- the Accountant General is unable to obtain all the information and explanations he considers necessary to complete his audit (resulting in a limitation on the scope of his audit); the absence of proper accounting records might be the cause, or the

Accountant General might be prevented from carrying out a necessary audit procedure so that a material figure in the account cannot be confirmed.

- the Accountant General cannot reach an objective conclusion as to the outcome of a situation due to the circumstances themselves; for example, there may be doubts about the obligations under a guarantee given which would have material financial consequences for the auditee entity.

7.32 Disagreement qualifications arise where the Accountant General disagrees with something the auditee entity has included in, or omitted from, the accounts. There are various circumstances in which disagreement may occur, such as:

- the auditee entity may present figures in the accounts which are not in accordance with the applicable accounting rules or not based on appropriate accounting policies or principles;
- the Accountant General may disagree with facts or amounts in the accounts (disagreement needs to be distinguished from uncertainty in this regard);
- the Accountant General may disagree with the way the auditee entity has disclosed facts or amounts in the financial statements;
- the auditee entity may fail to comply with legislation or regulations; the Accountant General might then need to disagree on the grounds that there were regularity errors in the accounts, or the accounts were not in the required form.

7.33 The manner in which the Accountant General qualifies his opinion depends on two things:

- which of the groups the qualification falls into: uncertainty or disagreement;
- the strength of the qualification.

7.34 The strength of the qualification can be determined by asking a basic question: Is the matter fundamental to an understanding of the financial statements, so that in the Accountant General's opinion, a person reading the financial statements would be totally misled as a result of the error in them? The manner of dealing with cases of fundamental uncertainty or disagreement, which are not common, is given in the later paragraphs. Consideration is given first to how the Accountant General qualifies his opinion in the more usual circumstances encountered, when the matter is material but not fundamental.

7.35 A qualification on grounds of material uncertainty which arose from limitation on the scope of the audit would be reflected in both paragraphs of the certificate. The scope paragraph would indicate the limitation by reference to the Accountant General's report which should give the reasons for the Accountant General being unable to carry out his examination fully. The normal opinion would then be given 'subject to' the limitation on the scope of his examination.

7.36 In other cases of material uncertainty, the scope paragraph is not affected. The uncertainty does not arise because the Accountant General's examination has been restricted, but because the outcome of a matter, which in the Accountant General's opinion would have material effect on the financial position of the auditee entity is not known. If the Accountant General considered that something caused material uncertainty, he would qualify his normal opinion that the accounts 'properly present' / 'give a true and fair view' by saying 'subject to.. (this uncertainty)' and he would report separately on the circumstances.

7.37 The circumstances described above need to be distinguished from those where the Accountant General experiences normal difficulties in agreeing figures in the accounts which are necessarily estimates (for example, a provision for bad debts). The Accountant General would be expected in these circumstances to form a view based on his audit tests and professional judgement. As a result, he might, however, disagree with the auditee entity's figure.

7.38 With regard to the second group of qualifications, material disagreement is reflected in the opinion by stating 'subject to ..(the irregular expenditure or the failure to)' followed by the normal opinion. The Accountant General's report should provide the details of the disagreement.

7.39 In the circumstances described in paragraph 7.35:

- fundamental uncertainty would be reflected in the certificate by the Accountant General stating that he was unable to give an opinion on the accounts
- fundamental disagreement would result in the Accountant General giving an adverse opinion stating that the accounts did not 'properly present' / 'give a true and fair view'.

7.40 Qualifications of the audit opinion therefore fall into the following categories.

<i>Nature of Circumstances</i>	<i>Material but not fundamental</i>	<i>Fundamental</i>
Uncertainty	"Subject to" opinion	Disclaimer of opinion
Disagreement	"Except for" opinion	Adverse opinion

7.41 Before issuing a qualified opinion or a disclaimer of opinion, the matter should be discussed with the management of the auditee entity in full regarding the circumstances giving rise to the qualification and the auditee management should be given the opportunity to make corrections to the financial statements or provide further information in support of the figures contained in them.

7.42 The audit certificate should describe the reasons for the opinion being other than unqualified and should quantify the effects on the financial statements whenever this is practicable. The opinion section should also be clearly headed to advise the reader that the opinion is qualified, for example by indicating

"Adverse Opinion", or "Qualified opinion arising from disagreement about accounting treatment".

7.43 Where a note to the financial statements explains the problem in detail, the explanatory material in the "opinion" section may include a reference to the note in order to minimise repetition. However, reference to the note is not a substitute for sufficient description of the circumstances such that a reader appreciates the principal points at issue and their implications for an understanding of the financial statements.

7.44 The wording of the audit certificate is a matter for the C&AG and does not have to be agreed with the Accounting Officer or management of the auditee entity. However, it should be discussed with the management of the entity to ensure that it is a true reflection of the facts.

7.45 An example about qualified opinion, due to likely aggregate error crossing the materiality threshold is given in Annexe.

The procedure to be adopted in case of non-cooperation from auditee/non-production of records by the auditee may be considered for incorporation in the manual.

Corresponding amounts from preceding periods

7.4546 Where the C&AG qualified his opinion in a preceding period and there remains doubt in the current period regarding the possible misstatement of the corresponding amounts, it is necessary to assess the impact on the opinion for the current period. Where corresponding amounts are required by law or by any instruction of the Government, and the amount is material, the financial statements for the current period will normally be qualified on the grounds of a scope limitation. This will involve inserting the following paragraph at the start of the opinion format.

"Except for any adjustments to corresponding amounts for the year ended..... that might have been found to be necessary had I been able to obtain sufficient evidence concerning.....[relevant event]".

Signing and dating

7.4647 The Accountant General should not sign the certification journal until the financial statements and all other financial information contained in a report of which the audited financial statements form a part have been approved by the accounting officer, board, or equivalent persons. The date of a certificate on financial statements is the date on which the C&AG, or his delegate, signs his report expressing his opinion on those statements.

7.4748 The C&AG will personally sign certificates on financial statements with the exception of those where he has delegated the responsibility of signing to another Officer.

7.4849 The audit opinion should not be expressed until financial statements have been approved by the Accounting Officer or equivalent persons, and Accountant General has considered all necessary available evidence. Where there is a gap between the approval of the financial statements and the completion of audit, including review of audit papers, the Accountant General should take steps to:

- obtain confirmation that the Accounting Officer or equivalent persons would still approve the financial statements at that date;
- ensure their review of events after the accounting reference date covers the period up to their signing.

Place for the Certificate while printing

7.49 50 The Accountant General should consider, in the light of circumstances applying to the auditee entity, the most appropriate place for the audit certificate. Normally, the audit certificate should be positioned immediately before the financial statements and immediately after the statement of executive's (directors' or management's) responsibilities.

Management Letters

7.501 The outcome of financial audit is not only to express an opinion on the financial statements of the auditee organisation, but also value addition in improving their financial management and controls. The recommendations to the auditee towards improvement in their financial management and controls would be auditor's value addition in the overall financial management. On the conclusion of financial (attest) audit of an entity for a year, the Accountant General may issue a Management Letter to the top management of the entity include audit findings other than those which have been considered material enough to be taken to the Audit Certificate. In developing findings, it is important to focus on underlying causes of problems rather than simply to report the problems and their results. Management Letter could also be used to give recommendations regarding improvement in management controls.

7.512 The Management Letter is distinct from and does not replace the inspection reports issued after the completion of transaction audit.

7.523 It should be ensured that the facts presented are correct and the recommendations are realistic and cost-effective.

We should also use audit work to provide clients with constructive advice which will help them improve financial management, control and accountability for public funds. We should also use audit work to provide clients with constructive advice which will help them improve financial management, control and accountability for public funds.

All our reports should be produced promptly. The timetable for drafting, agreeing and issuing the report should be agreed with the client when the audit plan is finalized.

In developing comments, it is important to focus on underlying causes of problems rather than simply to report the problems and their results.

7.534 Audit must ensure that nothing communicated to the auditee entity it says to a client is inconsistent with the audit opinion.

7.545 If audit considers that the audit certificate should be qualified or should include an explanatory paragraph, a report to management cannot be regarded as a substitute. Omitting a significant comment on the basis of contemplated corrective action is not acceptable.

Auditors should be careful to:

- Ensure facts presented are correct
- Recommendations are realistic and cost-effective

Confidentiality of communication

7.556 All communications between audit and the client are confidential. Audit should not reveal the contents of any communication to a third party without the client's permission, subject to the provisions of any law in force (like the Right to Information Act)..

The outcome of financial audit is not only to express an opinion on the financial statements of the auditee organisation, but also value addition in improving their financial management and controls. The recommendations to the auditee towards improvement in their financial management and controls would be auditor's value addition in the overall financial management.

While Section 2.20.28 (page 387) talks about three types of qualified opinion, Section 2.20.40 (page 390) talks about four types of qualified opinions. This may be reviewed, if necessary. Further, it will be better to re-organise the various types of qualified opinions under separate captions and describe them separately for better comprehensibility.

Management Letters

The concept of Management Letter can be introduced which will list out audit findings other than those which have been considered material enough to be taken to the Audit Certificate. Management Letter could also be used to give recommendations regarding improvement in management controls.

Whether the IR is to be done away with or whether in addition to IRs, MLs are also to be issued is not clarified.

Right of Access to Information

2.90 In the course of scrutiny of accounts and transactions of Government, Audit is entitled to make such queries and observations and to call for all records, statements, returns and explanations as it may consider relevant and necessary in the interest of proper discharge of its duties. All such queries and observations shall be couched in courteous and impersonal language.

2.91 Under Sub-section (2) of Section 18 of the Act, it is the statutory obligation of the person in-charge of the office or the department, the accounts of which are to be inspected/audited by the functionaries of the Comptroller and Auditor General, to afford all facilities for the inspection/audit and comply with requests for information in as complete a form as possible and with all reasonable expedition. In the eventuality of non-production of vital records, the audit should be called off and the matter should be

reported by the Accountant General to the Chief Secretary in the State or to the Secretary to the Government of India in the Centre, or the chief executive of the auditee entity, as the case may be.

2.92 In case the problem is not resolved even after this is brought to the notice of the Chief executive concerned, an omnibus draft paragraph on all such problems that arise during the year should be considered for inclusion in the Audit Report for bringing to the notice of the Legislature through the Public Accounts Committee or the Committee on Public Undertakings the failure of the executives to discharge their statutory obligation. In addition, in the Audit Certificates on Accounts, appropriate qualification / disclaimer on account of 'limitation in scope' caused by the non-production of records should be considered.

Submission of Audit Reports

7.567 1.24 Article 151 of the Constitution requires the CAG to submit reports relating to the accounts of the Union and of a State to the President or the Governor of the State as the case may be for being placed before Parliament/Legislature of a State. Similar provision exists in Section 49 of the Government of Union Territories Act, 1963, for submission of the reports of the CAG in relation to the accounts of a Union Territory having a Legislative Assembly to the Administrator of the Union Territory for being laid before Legislature. These reports relate to the totality of the accounts of the Union, a State or a Union Territory, as the case may be, and cover not only its expenditure but its receipts as well.

Delegation of powers of the CAG

1.357.578 Section 21 of the CAG's (Duties, Powers and Conditions of Service) Act, 1971 authorises the CAG to delegate any power exercisable by the CAG under the provisions of the Act, or any other law, to any officer of his department, by general or special order. However, except during his absence on leave or otherwise, no officer shall be authorized to submit on behalf of the CAG any report which the CAG is required under the Constitution or the Government of Union Territories Act, 1963, to submit to the President or the Governor of a State or the Administrator of a Union Territory.

Annexe

Illustration on qualified opinion due to application of Materiality Threshold to

Likely Aggregate Error
crossing the Materiality Threshold

The following errors were found during the financial audit of a State Government.

Details of Errors

1. Misclassification of revenue expenditure noticed Rs.45 crore in sample; projected to population Rs.180 crore
2. Funds transferred to PLA Deposits; noticed from 100% check of nil payment vouchers Rs.22.20 crore
3. Overpayment of Salaries and Pensions Rs.13.45 crore; recovered Rs.3.67 crore
4. Under assessment of revenue Rs.6.2 crore
5. Expenditure without approval of competent authority Rs.32.3 crore; regularization orders received for Rs.20.1 crore
6. Fraudulent payment of grants to Educational Institutions Rs.1.20 crore

The gross disbursements as per Statement No.1 of Finance Accounts were Rs.15,000 crore and materiality is to be taken at 1%.

Calculation of Likely Aggregate Error

1. Misclassification of expenditure noticed Rs.45 crore in sample; projected to population Rs.180 crore	Rs.180.00 crore
2. Funds transferred to PLA Deposits; noticed from 100% check of nil payment vouchers	Rs.22.20 crore
3. Overpayment of Salaries and Pensions Rs.13.45 crore; recovered Rs.3.67 crore; Unrecovered portion	Rs.9.78 Crore
4. Under assessment of revenue Rs.6.2 crore	Not taken into account as this would not affect the proper presentation of accounts
5. expenditure without approval of competent authority Rs.32.3	Rs.12.20

crore; regularization orders received for Rs.20.1 crore; balance expenditure	crore
6. Fraudulent payment of grants to Educational Institutions	Rs.1.20 crore
<i>Likely Aggregate Error</i>	Rs.225.38 Crore

Audit Opinion

Materiality Threshold	Rs.150 crore
Likely Aggregate Error	Rs.225.38 crore

As the the Likely Aggregate Error exceeds the Materiality Threshold, clean audit certificate cannot be given. The audit opinion should be either qualified or adverse depending upon the overall circumstances and the policy of the Headquarters Office.

Chapter 8

Supervision and Review

8.1 This Chapter explains the policies and guidance relating to:

- direction and supervision of the staff carrying out the audit
- review of their work.

8.2 While the objective of both supervision and review functions is the same, viz., to ensure that the audit is done efficiently and effectively so that the audit opinion can be expressed with confidence, there is an essential difference between the two functions. *While supervision is a day-to-day control to ensure that the audit proceeds satisfactorily and that any problems are immediately attended to, review can take place in stages during the progress of work and after its completion.*

8.3 According to the field standards in the Auditing Standards of the Comptroller and Auditor General of India, the work of the audit staff at each level and audit phase should be properly supervised during the audit, and a senior member of the audit staff should review documented work.

Supervision

8.4 The field standards further state that

- Supervision is essential to ensure the fulfillment of audit objectives and the maintenance of the quality of the audit work. Proper supervision and control is, therefore, necessary in all cases, regardless of the competence of individual auditors.
- Supervision should be directed both to the substance and to the method of auditing. It involves ensuring that:
 - (a) the members of the audit team have a clear and consistent understanding of the audit plan;
 - (b) the audit is carried out in accordance with the auditing standards and practices of the Supreme Audit Institution (SAI);
 - (c) the audit plan and action steps specified in that plan are followed unless a variation is authorised;
 - (d) working papers contain evidence adequately supporting all conclusions, recommendations and opinions;
 - (e) the auditor achieves the stated audit objectives; and
 - (f) the audit report includes the audit conclusions, recommendations and opinions, as appropriate.

Structure of supervision

8.5 Supervision is exercised by senior members of audit team and SAI management at various levels:

- by the group supervisory officer and Accountant General, during planning of the individual financial audits;
- by the Audit Officer, during the course of field audit, further supervised by group supervisory officer; and
- by the Accountant General, during review of periodic reports, monitoring and interim appraisals.

Supervision by the audit officer

8.6 Day-to-day supervision should be exercised by the team leader (normally the Audit Officer in charge). Some of the more important supervisory responsibilities of the team leaders are:

- ensuring that the audit work is carried out in accordance with the audit plan, more particularly, in tune with the audit objectives;
- identification of important issues in course of audit;
- ensuring that no significant matters in the context of the audit objectives and evidence required remain unresolved;
- evidence collected fulfils the criteria prescribed in the Auditing Standards;
- the work performed and the results including the process of audit are separately documented, first in support of audit findings, conclusions and recommendations and the second in support of due diligence exercised by the audit team; and above all ensuring that the objectives of audit are fully met.

8.7 The supervisor, as a team leader, acts as a link with management. He is expected to inform higher management (i.e., Group Officer and Accountant General) of any problems and difficulties and, if necessary, to seek approval for the audit plan to be amended.

8.8 The team leader should make sure that other members of the team are aware of what is required of them and that their work performed conforms to standard. If an audit programme cannot be fully executed, the team leader should ensure that any changes to it receive the approval of higher management.

Progress reporting

8.9 The audit officer and group supervisory officer will be responsible for reporting the progress of audit to the next level supervisory officer at intervals as may be provided in the detailed audit plan or as required under the orders of the Accountant General. The progress reports should contain all important information relating to the progress of audit, evidence gathered, analysis of evidence, time spent in audit against the time allotted, dialogue with auditee, problems encountered in the course of audit and modifications, if any, required in the audit plan.

8.10 Assurance memo shall be furnished by the audit team on completion of the

financial audit and on completion of the audit of each unit, as prescribed.

Review

8.11 The field standards state that:

All audit work should be reviewed by a senior member of the audit staff before the audit opinions or reports are finalised. It should be carried out as each part of the audit progresses. Review brings more than one level of experience and judgment to the audit task and should ensure that:

- (a) all evaluations and conclusions are soundly based and are supported by competent, relevant and reasonable audit evidence as the foundation for the final audit opinion or report;
- (b) all errors, deficiencies and unusual matters have been properly identified, documented and either satisfactorily resolved or brought to the attention of a more senior SAI officer(s); and
- (c) changes and improvements necessary to the conduct of future audits are identified, recorded and taken into account in later audit plans and in staff development activities.

8.12 This standard emphasises the importance of involvement of each higher level of supervision and does not, in any way, absolve the lower levels of audit staff carrying out field investigations from any negligence in carrying out assigned duties.

8.13 A financial audit leads to the expression of an opinion on the accounts. The documentation of the audit should show that competent, relevant and reasonable evidence has been obtained to support the conclusion reached. Review is the examination of the documentation by a senior officer who must satisfy himself that all necessary work has been done in accordance with auditing standards and instructions.

8.14 Review should not be left pending till the completion of the audit. It should be conducted as soon as possible after discrete areas of the audit have been finalised and the working papers have been properly assembled. This ensures more effective control and that any necessary changes to coverage can be made promptly.

8.15 By reviewing the work done, the reviewing officer takes responsibility for its quality and for the audit conclusion reached as to whether or not material error exists in the account. If the reviewing officer is not satisfied with the work done, it is his responsibility to ensure that any deficiencies in the audit are remedied.

8.16 There are two review stages, viz., first stage review and second stage review.

First Stage Review

8.17 The first stage review involves a detailed examination of the audit work carried out by the audit team. This should include a detailed examination of the essential

elements of the audit, the documentation and evaluation of systems, and the completed substantive and compliance test programmes and other information supporting the work done and the conclusions drawn.

8.18 The first stage reviewer will need to ensure not just that the necessary work has been done in accordance with the approved audit plan and any amendments to it, but that work has been done in accordance with the auditing standards. In particular, the reviewer should ensure that:

- the standing files are complete and up to date;
- approved audit programmes have been used;
- systems documentation and evaluations are carried out and recorded in the form approved by the SAI India;
- working papers are complete and properly referenced;
- the conclusions reached are supported by evidence contained in the working papers;
- a letter or report is drafted informing the audited entity of any weaknesses revealed by the audit.

8.19 The first stage reviewer should check all calculations crucial to the audit conclusion.

8.20 The reviewing officer should provide evidence on the working papers (for example, through comments, initialled pages, etc.) of the work done by him. Any comments or questions which the reviewer requires the audit party to answer should be documented on a separate review sheet (refer to Annex). If there are matters still outstanding when the working papers are submitted for first stage review they will have been highlighted for the reviewer's attention. The reviewer should recommend action on these matters and add any further point to be brought to the notice of the second stage reviewer.

8.21 After complying with the above requirements, the Examination Folder should be formally passed on to the second stage reviewer with the supporting documentation. The first stage reviewer should also indicate whether he agrees with the audit team's submission regarding the audit opinion to be formed in respect of the accounts.

Second Stage Review

8.22 The second stage review should cover all significant matters, particularly areas where judgments have been made.

8.23 The second stage reviewer takes responsibility for the final conclusion on the audit including any qualifications proposed. He is also responsible for approval of any management letter to be issued to the audited entity.

8.24 The second stage review is a selective examination of the working papers carried out in sufficient depth for the reviewer to satisfy himself that the audit work has been done satisfactorily. Thus the second stage reviewer has also to satisfy himself that the first

stage review has been properly carried out. The further checks made by the second stage reviewer should be evidenced by initials and remarks.

8.25 The second stage reviewer, in addition to reviewing the audit, should also carry out a sufficient review of the financial statements to provide him, together with the conclusions drawn from other audit evidence obtained, a reasonable basis for the proposed opinion on the financial statements.

8.26 The second stage reviewer should endeavour to ensure that all outstanding matters have been cleared before he submits the records to the Office of the C&AG and should record on the Examination Folder that:

- he has completed his review of the papers supporting the examination of the account;
- he is satisfied that sufficient, relevant and reliable evidence has been obtained to support the C&AG's certificate and that the work has been carried out in accordance with the auditing standards of the C&AG; and
- either that he is satisfied that an unqualified certificate can be given or that he recommends a qualified certificate.

8.27 Internal and External reporting of the results of a financial audit examination are considered in the Chapter on Reporting.

Levels of review in the context of Certification of Finance and Appropriation Accounts

8.28 In the context of certification of Finance and Appropriation Accounts, the group supervisory officer supervising the audit teams carrying on the certification audit will be the first stage reviewer. If, under the arrangements prevailing in a particular field office, any Audit Officer is directly entrusted with this responsibility, he will be the first stage reviewer. The Accountant General will be the second stage reviewer.

Quality assurance for supervision and review

8.29 Quality assurance in supervision and review is ensured with the help of the following:

- adherence to the Auditing Standards, Manuals and Guides;
- defined structure and system of supervision and review;
- strict conformity to the prescribed supervision and review system;
- periodic reporting and monitoring during the audit process; and
- peer review and technical supervision review.

8.30 SAI management may prescribe specific supervision and review procedures for each kind of financial audits undertaken while formulating the detailed operational guidelines for financial audit.

8.31 Accountants General may design the internal post audit quality review tests for all financial audits and document their findings and improvements introduced in the quality assurance system.

Chapter 9

Quality Assurance

9.1 Keeping in view the importance of ensuring a high standard of audit work, a quality assurance mechanism was set up in the Indian Audit and Accounts Department.

9.2 High quality of audit is achieved with help of a sound quality assurance system within the Department. *The concept of quality assurance encompasses all 'efforts' to ensure that a high quality of service or product is provided.* It is about the 'processes' by which the audit team goes about doing what it does. Part of this is knowing that 'right things' are done at 'right time'; a part of it is doing them the 'right way'. *In short, assuring quality is about 'confidence' that every thing needed for a high quality of work will be done.* While quality assurance system in relation to each stage of audit process has been dealt with in the earlier chapters, overall quality assurance systems and procedures are dealt with in this chapter.

Requirement of Auditing Standards

9.3 The Auditing Standards of the Comptroller and Auditor General of India require that:

“ Because of the importance of ensuring a high standard of work by the audit department, it should pay particular attention to quality assurance programs in order to improve audit performance and results. The benefits to be derived from such programs make it essential for appropriate resources to be available for this purpose.”

9.4 Systems and procedures should be established to:

- Confirm that internal quality assurance processes have operated satisfactorily;
- Ensure the quality of the audit report; and
- Secure improvements and avoid repetition of weaknesses.

9.5 Quality assurance depends on a number of inter-related factors, which might be considered under the following groups:

- *basic conditions* for good performance *i.e.*, the general foundations on which the day to day work depends;
- *quality features*, which are built into the routine procedures for audit work encouraging good performance and reviews to determine the extent to which it is achieved on a continuing basis;
- *supporting elements* needed for good performance, such as provision of adequate resources and facilities; and

- *controls and reviews* designed specifically to examine and improve the quality of performance.

Quality assurance and quality control

9.6 Quality assurance and quality control are not one and the same. Quality assurance is '*process-centric*' while quality control is '*product-centric*'. *Quality assurance system concerns all steps and techniques that the auditors must follow to assure good quality audit while quality control system attempts to make sure that the results of audit are what were expected. The quality assurance is for the entire life cycle of the audit while quality control measures apply to individual stages or products.* Quality assurance system is put in place before the work is undertaken or done while quality control is applied during and after the work is completed.

Quality assurance system in the Department

9.7 The quality assurance system within the Department consists inter alia,

- conducting of audits in accordance with the mandate of the Comptroller and Auditor General of India;
- the Manuals, instructions and guidelines on audit work;
- organisation of audit work with clearly defined responsibilities for staff, audit officers and supervisory officers;
- standards of qualification and competence of the staff members, continuing skill development and training;
- standards for independence, competence, due care, field standards relating to planning, supervision and review, evidence, reporting, and follow-up;
- documentation of the audit and of the management process;
- internal quality control system including the guidance on technical and administrative aspects of quality control; and
- quality assurance review programmes.

Quality assurance review programme

9.8 Audit quality assurance review programme consists of independent *peer reviews* of the activities undertaken within the Department to assess the overall quality of audits. The objective of the programme should be to provide an assurance that the tasks have been performed strictly in accordance with the standards and guidelines as also to establish whether the policies and procedures themselves needed any modifications. Quality assurance reviews address both adherence to the prescribed procedures and the quality of work performed.

Standardisation of quality assurance questionnaire

9.9 While it is not intended to curb the professional instinct of those carrying out quality assurance reviews, the quality of such reviews can be substantially

enhanced with the help of a standard exhaustive questionnaire or check-list, which can form a framework for quality assurance review. Headquarters Office may prescribe detailed questionnaire for quality assurance review, consisting of the questions applicable generally to audit.

Report on quality assurance review

9.10 The result of quality peer assurance reviews may be placed before top management of the Department (Peer Review Board) annually, or on demand during the course of the year. The structure of the report may consist of:

- constitution of the quality assurance review team;
- terms of reference, if any;
- period of coverage and period during which the quality assurance review was carried out;
- highlights of the findings – positive findings on good practices, deficient practices and procedures, and requirement of modification of any of the existing practices and procedures; and
- detailed findings and recommendations.

Standards of assessment

9.11 Until any instructions are amended, the quality assurance review should be carried out with reference to the Auditing Standards and the Audit Manuals and instructions. *The focus of the quality assurance review should be on the quality of processes and task performance, including documentation rather than focussing on the personnel carrying out the audit work.* In other words, rather than being critical, the quality assurance review should aim at assisting in improvement of the quality of performance.

Selection of quality assurance team

9.12 The selection of quality assurance teams shall be made by the Department's top management. In doing so, the independence, objectivity, skill and aptitude of personnel selected for quality assurance review may be kept in mind.

Circulation of quality assurance review findings

9.13 The Headquarters Office may circulate the findings in quality assurance reviews, for internal use within the department, highlighting the best practices or benchmarks in the field offices which may be emulated by others and deficient procedures and practices that should be improved. Such a practice may encourage healthy competitiveness among various offices to attain the highest standard of quality.

Human Resource Development

9.14 One of the most important prerequisite of good quality audit is the competence of audit personnel. The competence of audit personnel is established through qualifications set for each grade of audit personnel, competitive selection process and training and development. The qualifications and the selection procedures for audit personnel are already well established. The Accountants General may give special attention to their training and skill development for audit.

Auditing standards

9.15 The Auditing Standards of the Comptroller and Auditor General of India state the following with reference to the competence of the personnel.

“The auditor and the SAI must possess the required competence.

The audit department needs to command a range of skills and experience necessary for effective discharge of the audit mandate. Persons whose education and experience is commensurate with the nature, scope and complexity of audit task should carry out the audit task. The audit department should equip itself with the full range of up-to-date audit methodologies, including system-based techniques, analytical review methods, statistical sampling, and audit of automated information system.”

Annual training and professional development programme

9.16 Accountants General may include the training requirement of the audit personnel for audits in the overall annual training programme for their offices in a distinct section. The annual training programme should consist of training in regional training institutes or regional training centres or in-house within each office. The training programme may be formulated on the basis of a transparent assessment of the skill and knowledge generally required for conducting audits, the existing level of skill and knowledge and the gap between the two.

9.17 The objective of training and skill development in audit should be to improve the audit acumen, competence and knowledge management. The audit personnel should be made conversant with the practices on audit. The aim should be to make sure that all audit personnel understand the principle and practices alike and simultaneously understand their own responsibility and accountability for compliance to them. The course modules may be continuously improved on the basis of experience gained during the training and feedback from the instructors and participants.

REVIEW SHEET

Name of the Auditee:

Account

Year:

Subject:

Working Paper Reference::

Stage of Review: First / Second

Name of Reviewer:

Designation of Reviewer:

Date of Review:

Reference	Question/ comment	Reply / Action & Signature	Further Remarks of Reviewing Officer with Signature and Date

Chapter 10

Some issues of audit interest

Introduction

10.1 This chapter provides the policies and guidance of Comptroller and Auditor General of India in respect of the following issues.

- Using the work of other auditors and specialists
- Opening balances and comparatives
- Other information published with financial statements
- Position of Audit in relation to fraud and corruption

Using the work of other auditors and specialists

10.2 In some audits, there can be areas where it is both effective and efficient to use the work of others as a source of audit evidence. However, as statutory auditors, Comptroller and Auditor General of India retains the sole responsibility for the audit opinion and the determination of the audit procedures to support the opinion. Hence, before placing reliance on such audit evidence, it is necessary to ensure that it is adequate for audit purposes and that it is consistent with other sources of evidence.

10.3 Some examples of areas where the work of others can be used by Audit are:

- documentation of systems by internal auditors;
- testing carried out by internal auditors;
- retirement benefit liability calculations provided by actuaries.

Using the work of internal auditors

10.4 'Internal audit' is an independent appraisal or monitoring activity set up by the management of an auditee entity to review and evaluate accounting and internal control systems. As such, it can be considered to be part of an organisation's overall internal control system. The function may be provided 'in-house' by staff in full time employment or by a third party (for example an audit firm).

10.5 It is the responsibility of auditee management to establish appropriate internal audit arrangements within each entity. Even if Audit does not plan to use the work of internal audit, it is important to note that it is an aspect of the auditee entity's internal control systems. Hence, Audit should carry out a general assessment of the effectiveness of the internal audit function. Such assessments should take account of the size and complexity of the auditee entities and the desirability of a strong internal audit function.

10.6 In the planning phase of audit, the Accountant General should ensure that the activities of the auditee entity's internal audit function are considered and a sufficient understanding obtained to inform the development of an effective audit approach.

10.7 The Accountant General should aim to obtain a sufficient understanding of the role and scope of internal audit to aid the assessment of the control environment and to enable an initial assessment of whether it may be possible to use any internal audit work. If, as a result of consideration of the role and scope of internal audit, the Accountant General decides that it may be possible and desirable to rely on certain internal audit work, an assessment of the internal audit function should be carried out.

10.8 Internal audit may provide audit evidence on:

- the overall financial control environment;
- the operation of the systems of internal control, including those established to ensure regularity and propriety and the achievement of departmental objectives;
- specific account balances, where these have been subject to investigation or other internal audit work.

10.9 While making an assessment of internal audit function, some of the points to be seen are:

- the status of the internal audit function:
 - does it report to senior management?
 - can it report direct to the board or equivalent level of management / audit committee?
 - are management required to respond/act on its recommendations? what is the actual response?
 - is it empowered to carry out a full range of assignments, or are there significant restrictions on the scope of its work?
- the resources available to the internal audit function – whether there are sufficient staff of suitable calibre to manage and carry out the function?
- the coverage of internal audit work – whether it includes all major areas of operations of the auditee entity
- quality of internal audit work and its documentation – whether the internal audit work is properly planned, supervised, reviewed and documented?

10.10 It is common practice to use a questionnaire, while making an assessment of the internal audit function.

10.11 Where the internal audit function is assessed to be of sufficient status, independence, resources and quality and specific items of its work have been identified as being of potential use to audit, it is necessary to evaluate such work to reach a conclusion on its adequacy. This evaluation should include consideration of:

- the proficiency of the staff who have carried out the work and of their supervisors/managers;
- the level of internal audit management review of the work carried out; and
- the sufficiency of the evidence to support the conclusions reached.

10.12 Depending on the results of the procedures, the Accountant General may decide that the audit team should carry out some limited testing or reperformance of the internal auditors' work.

Using audit certificates supporting grant and subsidy payments

10.13 Sometimes, while making grants and other payments to local authorities and others, Government Departments may impose a condition providing for some sort of certificate or opinion to be provided by the recipients' internal or external auditors.

10.14 If the Accountant General considers to use such certificates as audit evidence, the considerations set out earlier in this Chapter regarding using the work of internal auditors should be kept in view.

10.15 If, for any reason, certificates are not available in circumstances where they would be expected, the audit team should consider:

- whether the presence of such a certificate is a requirement of legislation, Government Accounting or any other applicable authority, so that payments in the absence of such certificates will be irregular; or
- whether the certificates simply represent one form of audit evidence, in the absence of which there still may be other sources of audit evidence to provide the required assurance.

10.16 Depending on the outcome of the above, the audit team should consider any implications for our audit certificate and whether a scope limitation or disagreement (due to irregularity) qualification may be appropriate.

Using the work of specialists

10.17 A specialist is some person or firm possessing a professional skill, knowledge or experience in a particular field other than audit or accountancy. When using the work of a specialist, it is necessary to assess their objectivity and professional competence and obtain sufficient and appropriate evidence that their work is adequate for audit purposes.

10.18 It is essential that the audit team should be satisfied as to the professional standing and independence of the specialist and to ascertain whether they possess the skills and competence required. This requires consideration of the specialist's:

- professional certification or licensing by an appropriate, established professional entity;
- experience and reputation;
- lack of conflicts of interest.

10.19 The audit team should also ensure that the scope of the specialist's work is sufficient to meet the relevant audit objectives. If the specialist has been engaged by the entity, the audit team should review the relevant terms of reference. If the Accountant General is engaging the specialist, he should ensure that clear written instructions of audit requirements are provided.

10.20 The other factors to be considered by the audit team include:

- the accuracy and appropriateness of the underlying source data used;
- the assumptions and methods used, and the consistency of their application;
- the results of the specialist's work in the light of overall knowledge of the business and operations of the auditee entity;
- whether the specialist's findings are properly reflected in the financial statements.

Opening Balances and Comparatives

10.21 'Opening balances' are those account balances which exist at the beginning of the period. They are based on the closing balances of the preceding period and therefore reflect the transactions of preceding periods and accounting policies applied in those periods.

10.22 The audit team should obtain relevant, reasonable and competent audit evidence that amounts derived from the preceding period's financial statements are free from misstatements which materially affect the current period's financial statements and that appropriate accounting policies are consistently applied, or where changes have been made, they are properly disclosed and accounted for.

10.23 'Comparatives' are the corresponding amounts and other related disclosures from the preceding period which are part of the current period's financial statements. Except where there has been a prior period adjustment or a change in accounting policy, the opening balances should be consistent with the preceding period's closing balances. The audit team should obtain evidence that:

- the accounting policies used for the comparatives are consistent with those of the current period, or, where this is not the case, that appropriate adjustments and disclosures have been made;
- the comparatives agree with the amounts and disclosures presented in the preceding period and are free from material misstatements in the context of the financial statements of the current period;

- where comparatives have been adjusted to take account of any relevant legislation, accounting standards, rules or instructions, that appropriate disclosures have been made in the financial statements.

10.24 Normally, in the majority of circumstances, the financial statements for the preceding accounting period would have been audited by Comptroller and Auditor General of India and there may have been no prior period adjustments. In such cases, the audit team may rely on the audit work in the preceding period and restrict audit procedures to checking that account balances have been brought forward accurately and the comparatives agree with the audit working papers for the preceding period. Where there are prior period adjustments, the audit team should test the basis for those adjustments and ensure that comparatives and opening balances have been properly restated.

Audit of opening balances as incoming auditors

10.25 In case Comptroller and Auditor General of India is appointed to an audit for the first time, it should normally be possible to obtain audit evidence about the opening balances and comparatives without direct reference to the preceding auditors. The amount of evidence required depends on such matters as:

- the accounting policies followed by the entity;
- whether the preceding period's financial statements were audited and, if so, whether the auditors' report was qualified;
- misstatement; and
- the materiality of the opening balances to the current period's financial statements.

10.26 Audit work in the current period normally provides some assurance on opening balances and to the extent that it does not, the audit party may consult management and review accounting records from the preceding period.

10.27 Audit opinion is not expressed on comparatives as such. Hence, the extent of procedures needed to be performed on comparatives is less than for opening balances. The materiality of any misstatements is judged in terms of their relationship to the current period.

Other Information Published with Financial Statements

10.28 The objective of the policies contained in this chapter is to ensure that inconsistencies or misstatements in other information do not mislead the user and undermine the credibility of the financial statements.

Types of other information

10.29 Some auditee entities include the audited statements within an annual report or similar document. Such information can include:

- Foreword
- Report of the Chief Executive Officer of the entity or the Minister or Secretary of the Government
- Review of activities
- Commentary on performance and achievement of targets
- Compliance with Citizens' Charter or other Government initiatives

10.30 The information contained in these reports or commentaries can be of financial or non-financial nature. For example, the review of activities will may refer to financial information such as the gross or net expenditure on certain activities. Performance commentaries will usually include both non-financial information (for example, public satisfaction ratings or programme achievements) and financial information (for example, grants made, programme expenditure). The financial information may be directly extracted from the financial statements or obtained from other sources.

Forewords to accounts

10.31 These are broadly equivalent to directors' reports for Corporations or Government Companies. In view of the nature of the foreword in terms of its proximity to the financial statements and use of financial information, the audit team should pay particular attention to it, recognising that inconsistencies or misstatements may have a greater impact on the credibility of the financial statements than if they occurred elsewhere in the annual report.

10.32 The audit team should read all other information (financial or non-financial) that is to be issued in any document including the financial statements and consider, keeping in view its knowledge of business and operations of the auditee entity, whether such information contains any apparent misstatements or inconsistencies within itself or with the audited financial statements.

10.33 Where the other information includes information directly verifiable from the financial statements (like financial results, grants, transfers to reserves), the audit team should check it for consistency with the financial statements.

Action to be taken where the audit team identifies misstatements or inconsistencies

10.34 Where the audit team identifies inconsistencies or apparent misstatements, it should first consider whether this throws doubt on any information contained in the financial statements. The team should, therefore, re-examine the relevant audit evidence and conclusions drawn from it in the light of the other information and determine whether the financial statements are in error, the other information is in error, or whether there is an element of inaccuracy within both. The Accountant General should request the management of the auditee entity to make appropriate amendments to the relevant statements.

10.35 If the financial statements are materially incorrect and the auditee entity refuses to make appropriate amendments, the audit certificate should be qualified (see the Chapter on 'Reporting').

10.36 If the inconsistency or misstatement is relatively minor and is in a report or commentary that has little direct linkage to the financial statements, then failure to amend, while undesirable, may not undermine the credibility of the financial statements. In such cases, the Accountant General should raise the matter in a report to management and it may not be necessary to propose a comment within the audit certificate. However, the full details with supporting documents should be furnished to the Headquarters Office of Comptroller and Auditor General of India, while sending the draft audit certificate.

10.37 Where the other information is significantly wrong and is likely to be read with the financial statements, the Accountant General should propose to include an explanatory paragraph within the audit certificate to draw the reader's attention to audit concerns and clearly identifying the inconsistency or inaccuracy and its location.

Position of Audit in relation to Fraud

10.38 In relation to fraud, it is very important to recognise that the primary responsibility for safeguarding the audited entity's funds and assets and to prevent frauds or errors lies with its management. Unless the terms of appointment stipulate something to the contrary, it is not the audit's purpose in carrying out a financial audit to determine whether any fraud has been perpetrated. Detection of fraud is not the main purpose of financial audit and frauds involving collusion, particularly at senior management level, may not be ordinarily detected by normal auditing procedures.

10.39 In financial audit, the audit work has to be planned in such a way as to give a reasonable assurance to detect material misstatement in the account. Hence, it should be kept in mind that if a material fraud was perpetrated and not discovered by audit, the conduct of audit can be called in question, particularly if the evidence was such as would arouse suspicion in an auditor of normal prudence. Hence, the audit party needs to be aware of the possibilities of fraud at the planning stage and should be vigilant while carrying out the audit work.

Awareness at the planning stage

10.40 Though Audit cannot insure against defalcation and frauds, the possibility of their occurrence should be duly kept in mind while preparing for and conducting audit. As the first step, during the Preliminary Systems Evaluation, the adequacy of various accounting systems and procedures, whether set out in the form of a manual or otherwise, should be examined and the extent of check of individual transactions should be determined based on the results of such examination. This is all the more necessary since generally a sample of the transactions is checked in audit and Audit cannot escape responsibility if significant deficiencies in the accounting systems and procedures lead to misuse or abuse of public monies. The concept of Systems Audit is that if an in-depth analysis of the mechanics of a system reveals that it is designed

with appropriate controls, checks and balances to safeguard against errors, frauds, etc., Audit can reasonably assume, without the necessity of undertaking a detailed examination of the individual events or transactions, that the results produced by the system would be fairly accurate. Evaluation of the efficiency and effectiveness of any system will, however, require sample testing of its actual working. For example, in case of withdrawals from bank, the bank statements may be compared with the counterfoils of cheques and entries in cash book to guard against the possibility of alteration in the cheque amounts.

Vigilance during the course of audit work

10.41 During the course of audit work, the audit party should be vigilant and seek explanations, if it comes across possible fraud indicators like

- Missing vouchers
- Production of photocopies of documents instead of originals
- Alterations and erasures in accounting records
- Any unusual accounting entries
- Suppliers and contractors receiving undue preference
- Discrepancies between control accounts and subsidiary records
- Discrepancies between predicted figures and actual figures during analytical review procedures
- Employees in sensitive posts not taking leave

10.42 It should also be recognised that failure to appreciate the significance of what appears to be a trifling irregularity may result in failure to discover an important fraud or defalcation. Therefore, notice may be taken of the cumulative effect of numerous petty errors or irregularities as being indicative of carelessness and inefficiency in the maintenance of accounts or in financial administration generally.

10.43 If no satisfactory explanations are offered and the Audit Party suspects that irregularities may have occurred, it should probe the matter further and inform management of the audited entity. If the irregularities had a material effect on the accounts, suitable qualification in the accounts may be warranted. Audit should also recommend improvement in the control procedures to management for preventing recurrence of bad practices and/or irregularities.

Requirement of Auditing Standards

10.44 The Field Standards stipulate that:

Any indication that an irregularity, illegal act, fraud or error may have occurred which could have a material effect on the audit should cause the auditor to extend procedures to confirm or dispel such suspicions.

10.45 The Reporting Standards stipulate that:

- **With regard to fraudulent practice or serious financial irregularities detected during audit or examined by audit, a written report should be prepared. This report should indicate the scope of audit, main findings, total amount involved, modus operandi of the fraud or the irregularity, accountability for the same and recommendations for improvement of internal control system, fraud prevention and detection measures to safeguard against recurrence of fraud/ serious financial irregularity.**
- The auditee may also be required by law or regulation to report certain fraud or illegal acts to specified internal or external parties (for example, to a Central/State Government investigating agency or Central/State Vigilance Commission). If auditors have communicated such illegal acts to the auditee, and it fails to report them, then the auditors should include such matters in their report.
- The report on the financial statements should either (1) describe the scope of the auditors' testing of compliance with laws and regulations and internal control over financial report in and present the results of those tests or (2) refer to the separate report(s) containing that information. In presenting the results of those tests, auditors should report fraud, illegal acts, other material non-compliance, and reportable conditions in internal control over financial reporting. In some circumstances, auditors should report fraud and illegal acts promptly to the specified authority in the audited entity.
- These responsibilities are in addition to and do not modify auditors' responsibilities to (1) address the effect fraud or illegal acts may have on the report on the financial statements and (2) determine that the approximate authority are adequately informed about fraud, illegal acts, and reportable conditions.
- When auditors conclude based on evidence obtained, that fraud or an illegal act either has occurred or is likely to have occurred they should report relevant information. Auditors need not report information about fraud or an illegal act that is clearly inconsequential.
- In reporting material fraud, the auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances identified should be related to the universe or the number of cases examined and be quantified in terms of money value, if appropriate. In presenting material fraud, auditors should ensure that standard for objectives, scope and methodology, audit results and presentation standards, as appropriate are observed. Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.
- When auditors detect fraud, illegal acts, or other non-compliance that are not of material nature, they should communicate those findings to the

auditee, preferably in writing and should refer to such communications in their report on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, and other non-compliance.

- Management is responsible for taking timely and appropriate steps to remedy fraud or illegal acts that auditors report to it. When fraud or an illegal act involves assistance received directly or indirectly from another government or agency, (for example Central Government Grants received by the State Government or a government agency including an autonomous body received a government grant) auditors may have a duty to report it directly (to the other government/agency) if management fails to take remedial steps.
- Auditors should obtain sufficient, competent and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts.
- Auditors under some circumstances may be required to report promptly indications of certain types of fraud or illegal acts to law enforcement or investigatory authorities. When auditors conclude that these type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities and/or legal counsel if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

Chapter 11

Financial (Attest) Audit in different types of auditee entities

Different types of auditee entities

11.1 The Indian Audit and Accounts Department carries out financial audits of the following entities resulting in certification of financial statements as well as preparation of separate audit reports on transactions and accounts of the entities.

<i>Entity</i>	<i>Types of Financial Statements certified</i>
Union Government	Finance Accounts; Appropriation Accounts
Union Territory Governments	Finance Accounts; Appropriation Accounts
State Governments	Finance Accounts; Appropriation Accounts
Autonomous Bodies	Balance Sheet; Income and Expenditure Account / Revenue Account
Statutory Corporations	Usually Balance Sheet; Profit and Loss Account/ Revenue Account
Government Companies	Balance Sheet; Profit and Loss Account (This is a supplementary audit after the work of the Statutory Auditor is completed)
World Bank Aided Projects	Statements of Expenditure relating to Projects aided by World Bank

Accounting Environment

11.2 In view of the diverse nature of the auditee entities, the accounting environment is also varied.

11.3 The Union and Provincial (State) Governments presently follow cash based accounting. Switching over to accrual based accounting is under consideration which may take place gradually over a period of time. The Corporations and autonomous bodies mainly follow accrual based accounting. The Government Companies invariably follow accrual based accounting as it is mandatory under the provisions of the Companies Act, 1956. They are also required to follow the Accounting Standards of the Institute of Chartered Accountants of India. The Externally aided projects follow the method of accounting adopted by the implementing agency.

11.4 The audit mandate of the Comptroller and Auditor General (CAG) regarding financial (attest) audit varies according to the nature of auditee entity. The Constitution of India read with the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971(hereinafter called the 'Act') confer a very wide audit mandate on the CAG.

11.5 Separate instructions may be issued from time to time in respect of financial (attest) audit of entities like Autonomous Bodies, Statutory Corporations and Government Companies and Externally Assisted Projects, which may be updated from time to time. However, the general concepts and principles in this Manual are normally relevant for any kind of financial (attest) audit and may be suitably adapted for audit of these entities. The provisions in this Manual are generally applicable irrespective of the basis of accounting (cash or accrual).

Financial (attest) audit of Accounts of State Governments

11.6 In respect of the accounts of State Governments, the CAG acts as the sole auditor, by virtue of the provisions in the Constitution of India and the legislation (Act).

11.7 Section 13 of the Act requires the Comptroller and Auditor General to audit all transactions of the Union, of the States and of the Union Territories having a Legislative Assembly, relating to the Contingency Funds and Public Accounts and to audit all trading, manufacturing, profit and loss accounts and balance sheet and other subsidiary accounts kept in any department of the Union or of a State or a Union Territory. This Section also enjoins on the Comptroller and Auditor General the duty to report on the accounts, expenditure or transactions so audited by him.

11.8 The annual accounts of the Government (Finance Accounts and Appropriation Accounts) are certified by the CAG. The Finance Accounts contain the details of receipts and expenditure of the Government under various Statements. The Appropriation Accounts contain grant wise comparison of the budget and actual expenditure.

11.9 Appendix-I to the Manual details the financial (attest) audit methodology to be followed for the audit of accounts of State Governments.

Financial (Attest) Audit of Union Government Accounts

11.10 In respect of the accounts of Union Government, the CAG acts as the sole auditor, by virtue of the provisions in the Constitution of India and the legislation (Act).

11.11 As in the case of State Governments, the annual accounts of the Government (Finance Accounts and Appropriation Accounts of the Union Government) are certified by the CAG.

11.12 The provisions of Appendix-I of the Manual can also be adapted in the case of financial (attest) audit of Union Government.

Financial (Attest) audit of autonomous bodies

11.13 In respect of Autonomous Bodies and Authorities, the Act has made provisions in Sections 14 and 15 for the audit of the accounts of authorities and bodies receiving financial assistance in the form of grants or/and loans from the Government of India or a

State or Union Territory, subject to certain conditions and criteria specified in those Sections.

11.14 Section 20 provides for the audit of the accounts of certain bodies or authorities (not being Government Companies/Corporations covered by Section 19 or whose audit has not been entrusted by or under any law made by Parliament) by the SAI India on the request/entrustment by the President or Governor of a Province (State / Union Territory). The financial statements certified are normally the Income and Expenditure Account and Balance Sheet.

Financial (attest) audit of Government Companies and Corporations

11.15 Section 19 of the Act deals with the duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of Government Companies and Corporations. These duties and powers are to be performed and exercised under Sub-sections (1) and (2) of Section 19:

- (i) in the case of Government Companies, in accordance with the provisions of the Companies Act, 1956 contained in Sections 617 and 619 thereof; and
- (ii) in the case other Corporations set up by or under law made by the Parliament, in accordance with provisions of the respective Legislations.

11.16 In respect of Government Companies, the Chartered Accountants act as the Statutory Auditors under the Companies Act, 1956 and conduct audit of accounts. They are appointed by the SAI India. The annual financial statements certified are the Profit and Loss Account and Balance Sheet.

11.17 In respect of financial (attest) audit, the CAG conducts only a supplementary or test audit on the work of the Chartered Accountants. In addition, the CAG also conducts audit of regularity and performance audit.

11.18 The Chartered Accountants conduct their audit in accordance with the Auditing Standards of the Institute of Chartered Accountants of India. After they issue their audit certificate, the supplementary audit is conducted by the CAG and comments, if any (termed 'provisional comments') are issued. The provisional comments are modified / dropped after considering the replies of the company and statutory auditors and final comments, if any are issued.

11.19 In the case of the Corporations established by a Law of Parliament, the duties and powers of the CAG are to be exercised in accordance with the respective legislation. However, the position of a Corporation established by a law made by the Legislature of a State or of a Union Territory is different. Under the Constitution, only Parliament can prescribe by law the duties and powers of the Comptroller and Auditor General. Sub-section (3) of Section 19 of the Act provides that audit of a Corporation established by law by the Legislature of a State or Union Territory can be entrusted to the Comptroller and Auditor General in the public interest by the Governor of the State or the

Administrator of the Union Territory concerned after consultation with the Comptroller and Auditor General and after giving a reasonable opportunity to the concerned Corporation to make representations in respect of the proposal for such audit.

11.20 In respect of some Government Corporations, sometimes the CAG acts as the sole auditor, if there is such a provision in the governing legislation. The financial statements certified are generally Profit and Loss Account or Revenue Account and Balance Sheet.

11.21 In case of audit of Government Companies, the Auditing Standards of ICAI are also applicable (as provided in the Auditing Standards of CAG).

Financial (attest) audit of externally aided projects

11.22 In respect of externally aided projects, for example, World Bank assisted projects, the SAI India acts as an independent auditor for the purpose of certifying the Statement of Expenditure (SOE).

Technical Procedures

11.23 The technical procedures can be divided into two types, viz., off site and on site.

Off site Audit

11.24 In case of the accounts of State governments, the vouchers are received in the offices of the SAI India. A Wing called Central Audit Wing carries out audit of the vouchers in accordance with prescribed scale. Any matters requiring further scrutiny are referred to field audit parties who conduct on site audit. The voucher level compilation (VLC) data available in the accounting offices is also made use of during Off site audit.

11.25 Off site audit may be supplemented by on site audit to such extent as may be prescribed by the CAG.

Onsite Audit

11.26 Onsite audit is conducted in the premises of the auditee entities by peripatetic parties. Here, the parties verify the basic records. In case of some Government Companies and Corporations, Resident Audit Parties are stationed in the premises of the auditee entities who conduct on site audit.

11.27 As far as the techniques of gathering evidence are concerned, the principal source of evidence for audit conclusions are indicated in the chapter on 'Field Audit'.

Format of Audit Certificates

11.28 The audit certificate should express the opinion of CAG on the accounts audited in accordance with the provisions contained in the Chapter on 'Reporting'. The requirements of any special governing legislation and donor agencies (in the case of

externally aided projects) should also be kept in view in respect of the language to be used in the audit certificates.

11.29 In the case of Government Companies, the CAG does not act as the sole auditor, but conducts only supplementary audit. The observations of the SAI India are issued in the form of comments. The Chartered Accountants, who act as Statutory Auditors and carry on the primary audit work, certify the 'true and fair view' of the accounts in accordance with the requirements of the Companies Act, 1956.

11.30 Separate instructions are available in respect of the financial (attest) audits of entities like Autonomous Bodies, Statutory Corporations and Government Companies and Externally Assisted Projects, which may be updated from time to time. However, the provisions general concepts in this Manual are generally applicable normally relevant for any kind of financial (attest) audit and may be suitably adapted for audit of these entities. The provisions in this Manual dealing with financial audit are also generally applicable irrespective of the basis of accounting (cash or accrual).

Chapter 12

Organisational arrangements

Responsibility for financial (attest) audit

12.1 The provisions in this part explain the responsibilities of offices and staff in relation to financial (attest) audit. They focus on the roles and does not cover any wider responsibilities which may apply to the audit personnel by virtue of their functions or their employment.

12.2 The general principle is that the respective Accountant General shall be responsible for the financial audit of an auditee entity whose Headquarters Office falls under his primary audit jurisdiction. In some cases some units of the auditees may happen to come under the audit jurisdiction

of other Accountants General, in which they shall be treated as sub auditors and they shall be responsible for conducting the financial audit of the respective units in accordance with the prescribed arrangements in the Indian Audit and Accounts Department.

Responsibility for Audit of Entities of State Governments and Union Territory Governments

12.3 The following offices are responsible for providing assurance in connection with various entities of State Governments and Union Territory Governments.

<i>Nature of assurance</i>	<i>Accountant General</i>

	<i>responsible</i>
For the certification of the annual accounts as a whole, including the audit of Civil Departments	The Principal Accountant General (Civil Audit) or Accountant General (Civil Audit)
For providing assurance regarding Works and Forests Accounts portion in cases where they are being audited by the Accountant General (Commercial, Works and Receipt Audit)	The Accountant General (Commercial, Works and Receipt Audit)
For providing assurance	The Accountant

regarding Receipts portion in cases where they are being audited by the Accountant General (Commercial, Works and Receipt Audit)	General (Commercial , Works and Receipt Audit)
For providing assurance regarding the internal controls in Treasuries, Sub-Treasuries and Pay & Accounts Offices in cases where they are being inspected by the Accountant General (A&E)	The Accountant General (A&E) or the Senior Deputy Accountant General (A&E) or Deputy Accountant General (A&E)

	holding charge of an independent Office
For financial (attest) audit of Autonomous Bodies	The Principal Accountant General (Civil Audit) or Accountant General (Civil Audit) or the Accountant General (Commercial , Works and Receipt Audit)

	concerned in accordance with the audit jurisdiction
For financial (attest) audit of Government Companies and Corporations	The Principal Accountant General (Civil Audit) or Accountant General (Civil Audit) or the Accountant General (Commercial , Works and Receipt

	Audit) concerned in accordance with the audit jurisdiction
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Responsibility for Audit of Accounts of Union Government

12.4 The following offices are responsible for providing assurance in connection with Finance and Appropriation Accounts.

For the certification of the Finance and Appropriation Accounts as a whole, including the audit of Civil	The Director General of Audit (Central Revenues)
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Departments under his audit jurisdiction	
For providing assurance regarding the portion of the Accounts pertaining to Economic and Service Ministries	The Principal Director of Audit (ESM)
For providing assurance regarding the portion of the Accounts pertaining to Scientific Departments	The Principal Director of Audit (Scientific Department s)
For providing assurance regarding the portion of Accounts pertaining to the Pay and Accounts Offices and Union Government Offices	The Principal Director of Audit (Central), Mumbai

situated outside Delhi	<p>The Principal Director of Audit (Central), Kolkata</p> <p>The Principal Accountant General (Civil Audit) in respective States</p> <p>Accountant General (Civil Audit) in respective</p>
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	States Accountant General (Commercial, Works and Receipt Audit) in respective States
For providing assurance regarding the portion of Accounts pertaining to the Postal Department	Director General of Audit (P&T)
For providing assurance regarding the portion of Accounts pertaining to the Ministry of Defence	Director General of Audit (Defence

	Services)
For providing assurance regarding the portion of Accounts pertaining to the Ministry of Railways	Respective Principal Directors of Audit (Railway)
For financial (attest) audit of Autonomous Bodies	The Director General (Audit) or Principal Accountant General (Civil Audit) or Principal Director of Audit or Accountant General (Civil Audit)

	or the Accountant General (Commercial, Works and Receipt Audit) concerned in accordance with the audit jurisdiction
For financial (attest) audit of Government Companies and Corporations	The Principal Director of Commercial Audit and Ex-Officio

	Member Audit Board concerned or such other Accountant General Officer as may be prescribed in accordance with the audit jurisdiction
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12.5 The respective Principal Directors (Railways) should be responsible for providing assurance regarding to their respective zonal accounts. However, for the entire grant, the Principal Director (Railways) at Headquarters may be responsible, based upon the assurance received from the various Principal Directors of Audit (Railway Zones).

12.6 The details regarding the certificates to

be provided by the respective Accountants General may be prescribed in separate instructions.

12.7 The Accountants General may delegate the work to Group Officers and Audit Officers reporting to them, but shall continue to be responsible for managing all the audit activities and ensuring that the policies of Comptroller and Auditor General of India on financial audit are implemented.

12.8 The Accountants General shall ensure that staff with appropriate skills and experience are entrusted with the work of financial audit.

Liaison with other sub auditors at the audit planning stage

12.9 Sometimes it may happen that the auditee entity can have units operating in different locations falling under the audit jurisdiction of different Accountants General. The Accountant General responsible for the certification of the annual accounts as a whole is termed as 'principal auditor' and the other Accountants

General who are also responsible for the audit of the units of the entity are termed as 'sub auditors'.

12.10 As part of the planning process, the Accountant General acting as principal auditor should consider whether formal requirements should be sent to the sub auditors in respect of the audit of units of the auditee entity, under their jurisdiction. He may also indicate any areas requiring special consideration, sample sizes, suggested audit procedures and the time frame within which their findings should be communicated to him, keeping in view the overall time frame for the audit. It is preferable to hold meeting between the principal auditor and sub auditors for better co-ordination and smoothening the audit process.

12.11 The sub auditors shall communicate their findings, together with working papers. They shall also, if required by the principal auditor, furnish copies of their findings as set out in the inspection reports and any management letters issued by them, together with supporting working papers.

12.12 For the purposes of any clarifications regarding sampling and projection of errors involving the transactions audited by the primary auditor and sub auditors, the advice of the Statistical Advisor at Headquarters Office may be obtained.

Cell on financial (attest) audit

12.13 A separate cell on financial (attest) audit may be formed within each Group in every Audit Office headed by a Senior/Audit Officer, to deal with the certification work. Copies of all local audit Inspection Reports, audit memos, other relevant reports like treasury inspection reports (from accounts and entitlement offices), findings of audit parties carrying on financial audit work should be marked to this Cell. The Cell should scrutinize the material and segregate and consolidate observations having effect on the certification of annual accounts.

12.14 The Cell should communicate the audit objections to the concerned auditee entities, get the replies verified and propose qualifications/comments for inclusion in audit certificate. The Cell should also propose the Management Letters for issue, in case of weaknesses in internal controls.

Chapter 13

Summary of issues

13.1 This chapter summarises the various issues involved in financial (attest) audit.

13.2 The numerous steps in the financial audit process can be broadly grouped in three phases:

- i. Planning
- ii. Executing
- iii. Reporting

13.3 A timely, well-thought-out and well-executed planning effort is essential to the performance of an effective and efficient financial audit. In the initial planning stage, Audit should obtain or, in the case of a recurring audit, update understanding of the auditee, its activities, operations and control environment. This results in an overall audit plan. The planning phase covers the following steps/activities.

- Describing the auditee
- Establishing Audit Objectives and Scope
- Determining Materiality
- Assessing Risk
- Preparing Audit Plan
- Preparing Detailed Audit Programmes

13.4 The execution phase covers the following steps to carry out the audit.

- *Sampling for test of controls*
- *Performing Controls Testing Procedures:*
- *Performing Analytical Review*

- *Sampling for Substantive Test of Details*
- *Performing Substantive Test of Details*
- *Review of Working Papers*

13.5 The reporting phase generally covers the following steps.

- *Deriving Conclusions and Evaluate Audit Findings*
- *Reporting*

13.6 A management letter may also be issued to the management of the auditee indicating the weaknesses in internal controls.

Primary auditors and sub auditors

13.7 An auditee entity can have units operating in different locations falling under the audit jurisdiction of different Accountants General. The Accountant General responsible for the certification of the annual accounts as a whole is termed as 'principal auditor' and the other Accountants General who are also responsible for the audit of the units of the entity are termed as 'sub auditors'.

13.8 Smooth co-ordination is essential between the primary and sub auditors regarding planning, execution and reporting processes. Some areas that may require special attention include selection of sample sizes, suggested audit procedures and time frame for field work and communication of findings.

13.9 A separate cell on financial (attest) audit may be formed within each Group in every Audit Office headed by a Senior/Audit Officer, to deal with the certification work.

Planning for financial audit in the context of Government Accounts

Finance Accounts and Appropriation Accounts can be taken as the annual accounts of the Government. As per the revised formats of Audit Certificates being prescribed, the CAG will certify these accounts *inter alia* stating that the audit was planned and performed so as to obtain all information and explanations considered necessary in order to provide sufficient evidence to give *reasonable assurance that the annual accounts are free from material misstatement. Hence, the planning for financial audit work should support the CAG's opinion given in the Audit Certificate.*

Assertions for reasonable assurance

If the items of receipts and disbursements fulfil following assertions and there are no material errors, it can be certified with reasonable assurance that the accounts are free from material mis-statement.

- Completeness
- Occurrence
- Measurement
- Disclosure
- Regularity

Ensuring the above assertions

In a typical State Government scenario, the Accountant General (A&E) (who compiles the accounts and prepares Finance and Appropriation Accounts) receives accounts from different sources; the process of accounting varies for each of these sources. Even within one source, the accounting process of different components may vary. This calls for appropriate sampling and auditing techniques to suit the requirements of the particular component. Keeping this requirement in view, the accounts can be divided into the following areas:

a) Treasury Accounts

- ❖ Service head expenditure
- ❖ Service head receipt
- ❖ DDR head expenditure
- ❖ DDR head receipt

b) Compiled Accounts

- ❖ Public Works Department, Public Health Engineering Department, Irrigation Department, etc.
- ❖ Forest Department
- ❖ Departmental Officers

c) Inter-Government transactions

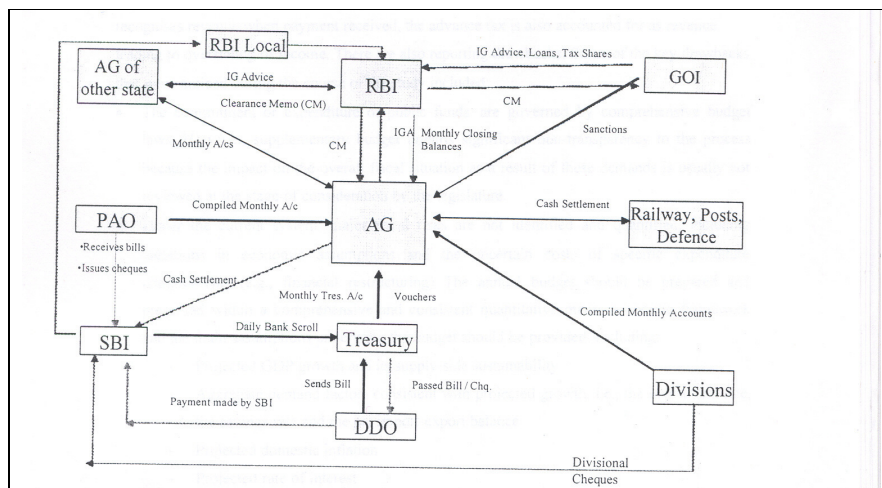
d) Transactions originating in AG's office

e) Finalisation of annual accounts

The main entities involved in this accounting are:

- Drawing and Disbursing Officers (DDOs) (includes divisions of PW and Forest)
- Treasuries
- Office of the AG (A&E)

The flow of accounting information is shown in the following chart.



The audit approach is indicated in the tabulation on next page.

<i>Area</i>	<i>Documents to be audited</i>	<i>Where audit is to be conducted</i>	<i>Steps to be followed</i>	<i>Method of sampling and analysis</i>
(1) Treasury Accounts 1.1 Service head expenditure	Lists / schedules of Payments, Vouchers, Schedule of dockets for compiled accounts	Central Audit (in AG Office); DDO Offices (in local audit)	<p>(a) Document the understanding of the Auditee (i.e., State Government as a whole and its Departments)</p> <p>(b) Perform Preliminary Analytical Procedures</p> <p>(c) Undertake IT Audit of the systems in AG (A&E) Office (like VLC) and also computerisation of Treasuries and PAOs in State Government</p> <p>(d) Carry out Risk Assessment for Departments, Heads of Accounts (category of transactions) and DDOs</p> <p>(e) Grade the risk as High, Medium or Low</p> <p>(f) Work out</p>	<p>Suitable sampling technique</p> <p>Attribute sampling for tests of controls</p> <p>Monetary Unit Sampling for substantive tests of details</p> <p>Samples could be drawn department wise (for Salary and Non Salary) and the sample sizes would depend on the perceived risk of the departments (for Salary and Non Salary Transactions)</p>

			<p>Planning Materiality as per Headquarters instructions (this should be less than the reporting materiality).</p> <p>{The risk can be identified based on parameters like proportion of non-salary expenditure, past budget excesses, previous errors noticed, Nil Payment vouchers, AC Bills, etc. as indicated in the Manual}</p> <p><u>For monthly</u> <u>Central Audit</u></p> <p>(g) Select vouchers from VLC data or any other available source (like floppy / CD from State Government containing voucher wise details) for central audit</p> <p>(h) Audit the selected vouchers at Central Audit</p>	
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			<p>Wing (CAW) (The audit should be with reference to the financial statement assertions - completeness, occurrence, measurement, disclosure and regularity and any other audit objectives spelt out in the audit plan)</p> <p>(i) Communicate audit results to the Cell on Financial Audit</p> <p><u>For Local Audit</u></p> <p>(j) Select DDOs statistically for financial (attest) audit based on DDO risk assessment</p> <p>(k) For each selected DDO select sample of vouchers / transactions from VLC data and give to the audit parties.</p> <p>(l) Carry on local audit (with reference to the financial statement</p>	
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			<p>assertions and other audit objectives)</p> <p>(m) Communicate a copy of the audit findings to the Cell on Financial Audit.</p> <p><u>In the Cell on Financial Audit</u></p> <p>(n) analyze results of central audit and local audit and merge results statistically.</p> <p>(o) Based on sample result, extrapolate to the population</p> <p><u>Note:</u> In case of States where treasuries render compiled accounts to the AG, the voucher wise data may be collected on CDs or by e-mail, after satisfying about the accuracy of the data</p>	
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1.2 Service Head Receipts	Schedule of Receipts (SOR), compiled accounts, Challans and Bank Scrolls	1. Treasury (since all challans may or may not be received in AG Office)	<p>(a) Take a sample of challans in the treasury; if Treasury Inspection is in December, sample from challans of April to December</p> <p>(b) Checks to be exercised include:</p> <p>(i) Checking whether all the sampled challans appear in respective bank scrolls and amounts are correctly shown.</p> <p>(ii) Whether the classification entered in challans has been correctly entered in the compiled accounts of the treasury.</p>	<p>Suitable sampling technique</p> <p>Attribute sampling for tests of controls</p>
		2. Central Audit	Select a sample of different SOR figures (monthly) and check whether they have been entered correctly in VLC	Attribute Sampling for testing of controls

		3. State Receipts Audit (SRA) Wing during audit of Revenue Departments concerned	Select a sample from the records of auditee consisting of different returns submitted by assesses during the financial year concerned. These returns will show details of advance tax paid or other payments. Copies of challans will be attached with returns. Check whether amounts claimed to have been remitted by assessee through challans are correctly reflected in the bank scrolls (by comparing with records at concerned bank/treasury).	Attribute Sampling for testing of controls
		4. Combining results	The results against Sl. Nos. 1, 2 & 3 have to be combined statistically and projected to population of service head receipts	

1.3 DDR Head expen- diture/ receipt	Lists of Payment (LOP)/ Cash Account, Schedules of Payment (SOP) / Schedules of Receipts (SOR), vouchers (if available), Plus and Minus Memoranda	Central Audit, Treasury Inspection	<p>(a) In CAW, take the sample of vouchers/SOP monthly and conduct the audit (The checking should be with reference to the financial statement assertions and other audit objectives --this will include the correct depiction of transactions by AG (A&E) in VLC).</p> <p>(b) In CAW and treasury, check relevant broadsheets / other records of DDR heads to ensure that they agree with the figures as per the SOP/SOR</p> <p>(c) Analyze the results and extrapolate to population</p>	<p>Attribute Sampling for testing of controls</p> <p>Monetary Unit Sampling for testing of details</p>
<p>(2) <i>Com- piled Accounts</i></p> <p>2.1 Works Accounts</p>	Monthly accounts, Schedule dockets, vouchers	Central audit and DDO level	(a) Since voucher wise details are not captured in works accounts in order to do the sampling, a simple computer	<p>Attribute Sampling for testing of controls</p> <p>Monetary Unit Sampling for testing of</p>

			<p>spreadsheet /programme consisting of fields like month of account, Schedule Docket No., voucher No., DDO code and voucher amount could be developed.</p> <p>(b) Enter the above particulars from the vouchers enclosed in Schedule docket.</p> <p>(c) Take sample and conduct audit of vouchers</p> <p>(d) Subsequent local audit at divisions can be done as outlined against Sl. No.1.1 above against service head expenditure.</p>	details
2.2 <i>Forest Accounts & Departmental Officers</i>	Monthly accounts, vouchers	Central Audit, DDO	<p>As in the works accounts, since the voucher details are not captured. Steps discussed in respect of works accounts could be followed.</p>	<p>Attribute Sampling for testing of controls</p> <p>Monetary Unit Sampling for testing of details</p>
(3) <i>Inter</i>	RBI advices, Clearance	Central Audit	(a) Sample of these	Attribute Sampling for

<i>Govern- mental Transa- ctions</i>	Memos, Inward and outward accounts, Register of valuables		documents could be checked for the financial statement assertions and other audit objectives, if any. (b) Analyze the results and extrapolate to population.	testing of controls Monetary Unit Sampling for testing of details
(4) Transa- ctions origi- nating in AG's office	Transfer Entries (TEs) and Sus- pense slips	Central Audit	(a) TEs more than the prescribed amount, say, Rs. 10 crore could be checked 100% with reference to the financial statement assertions and other audit objectives, if any. (b) For other TEs sample could be drawn and correctness of accounting could be verified. (c) Analyze results and extrapolate to population.	Attribute Sampling for testing of controls Monetary Unit Sampling for testing of details
(5) Finali- zation of annual accou-nts	Finance accounts statements, Grant statements and comments, grant registers, reappropriation	Central Audit	(a) Checking of these documents on the lines of prescribed checks and additional checks already recommended in Manual	Monetary Unit Sampling for testing of balances below the prescribed limit (set for 100%)

	orders		(b) For Analytical Review, checking would be 100% (c) For checking of balances, high value of balances above a prescribed limit in each statement – 100% checking. For others, sampling may be adopted.	checking)
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Based on the results obtained after the analysis conducted in all different areas, it could be possible to workout the overall errors by statistically combining the errors in each of the five categories. In case of any doubt or difficulty, advice of the Statistical Advisor in the Office of the Comptroller and Auditor General of India can be sought. If the total value is less than the materiality threshold value fixed, then it could be concluded that there are no mis-statements. In case the total value crosses the materiality threshold value, then a qualified opinion could be given.

For Union Government Accounts, a similar process should be adopted by the Principal Auditor and sub Auditors.

IT Audit as part of Financial audit

Where IT systems are used for the purpose of generating financial statements, it is essential to carry out IT Audit of such systems.

IT Audit of the following systems may be carried out.

<i>Systems in Offices of</i>	<i>To be done by</i>
AG (A&E) like VLC, GPF and Pension	AG (Audit)
Treasuries	AG (A&E)
Controller General of Accounts	DG (Audit-CR), PDs (Central) and AsG (Audit) in case of branches/regional offices

The COBIT framework of the IT Governance Institute and the Information Systems Audit and Control Association (ISACA) has been approved by the Comptroller and Auditor General of India for adoption in the IT Audits undertaken by the Indian Audit and Accounts Department. The Instructions issued by the IT Audit Wing of Headquarters Office on IT Audit may be followed while carrying IT Audit.

Appendix II

Financial (attest) audit in an IT Environment

Nature of the present guidance

- (1) The guidance given in this Annexe is preliminary. The audit team should consult the instructions issued by the IT Audit Wing of the Office of the Comptroller and General of India, while undertaking financial (attest) audit in an IT environment.

IT Environment in the Organizations audited by the Indian Audit and Accounts Department

- (2) Almost all the State Governments, Union Government Departments, Railways, Defence, Telecom sector, Statutory Corporations, Government Companies and Autonomous Bodies have embarked on computerization projects and announced IT initiatives and IT policies. The Government of India has taken a number of measures to implement e-governance initiatives, digital signature and public key infrastructure, changes in the Statutes and Rules for electronic documents, in terms of the Information Technology Act 2000. Several such measures are transforming the business processes within the Government and generally in all walks of life.

A survey conducted by the Office of the Comptroller and Auditor General of India during 2001 and updated in 2003 revealed that there are more than 2000 Accounting Systems / Financial Management Systems operational in Government Organizations in India.

- (3) The Offices of the Accountant General (A&E), who compile accounts on behalf of the State Governments, have implemented Voucher Level Computerisation (VLC) using Oracle software. Most of these Offices have also computerized the General Provident Fund and Pension Wings.
- (4) The Organisation of the Controller General of Accounts (CGA) which compiles the accounts of the civil departments of the Union Government has computerised its accounting functions carried on in its offices.
- (5) Many Treasuries and Pay and Accounts Offices of the State Governments have also computerized their accounting functions.

The Effect of IT Environment on Financial (attest) audit

- (6) IT environment can be said to exist when a computer of any type or size is involved in the processing of financial information of significance to the audit, whether that computer is operated by the auditee entity or by a third party.
- (7) The Auditing Standards of the Comptroller and Auditor General of India require that

“Where accounting or other information systems are computerized, the auditor should determine whether internal controls are functioning properly to ensure the integrity, reliability and completeness of the data.”

- (8) The effect of IT environment on financial (attest) audit is considered in more detail in subsequent paragraphs.

Overall objective and scope of an audit

- (9) It is very important to note that the overall objective and scope of an audit does not change in the IT environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the auditee organization. Accordingly, the IT environment may affect:

- the procedures followed by the auditor in obtaining a sufficient understanding of the accounting and internal control systems
- the auditor's evaluation of inherent risk and control risk through which the auditor arrives at the risk assessment
- the auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective

- (10) While determining the effect of the IT environment on the financial (attest) audit, the auditor should evaluate, *inter alia*, the following factors:

- (a) the extent to which the IT environment is used to record, compile and analyze accounting information;
- (b) the system of internal control in existence in the auditee organization with regard to:
 - i. flow of authorised, correct and complete data to the processing center;
 - ii. processing, analysis and reporting tasks undertaken in the installation; and
- (c) the impact of computer-based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

Skills and Competence

- (11) The auditor should have sufficient knowledge of the computer information systems to plan, direct, supervise, control and review the work performed.

The sufficiency of knowledge would depend on the nature and extent of the IT environment. The auditor should consider whether any specialized IT skills are needed in the conduct of the audit. Specialized skills may be needed, *inter alia*, to:

- obtain sufficient understanding of the effect of the IT environment on accounting and internal control systems;
 - determine the effect of the IT environment on the assessment of overall audit risk and of risk at the account balance and class of transactions level; and
 - design and perform appropriate tests of control and substantive procedures.
- (12) If specialized skills are needed, the auditor would seek the assistance of an expert possessing such skills.
- (13) Any decision to engage an outside professional (outside the Indian Audit and Accounts Department) would requires the approval of the competent authority.

Planning the audit

- (14) The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and to determine the nature, timing and extent of the audit procedures. Such an understanding would help the auditor to develop an effective audit approach.
- (15) In planning the portions of the audit which may be affected by the IT environment, the auditor should obtain an understanding of the significance and complexity of the IT activities and the availability of the data for use in the audit. This understanding would include such matters as:
- (a) the computer information systems infrastructure [hardware, operating system(s), etc., and application software(s) used by the entity, including changes, if any, therein since last audit].
 - (b) the significance and complexity of computerized processing in each significant accounting application. Significance relates to materiality of the financial statement assertions affected by the computerized processing. An application may be considered to be complex when, for example:
 - the volume of transactions is such that users would find it difficult to identify and correct errors in processing.
 - the computer automatically generates material transactions or entries directly to another application.

- the computer performs complicated computations of financial information and/or automatically generates material transactions or entries that cannot be (or are not) validated independently.
 - transactions are exchanged electronically with other organizations [as in electronic data interchange (EDI) systems] without manual review for propriety or reasonableness.
- (c) determination of the organizational structure of the auditee organization's IT activities and the extent of concentration or distribution of computer processing throughout the entity, particularly, as they may affect segregation of duties.
- (d) determination of the availability of data.
- (16) Source documents, computer files, and other evidential matter that may be required by the auditor may exist for only a short period or only in machine-readable form. Computer information systems may generate reports that might be useful in performing substantive tests (particularly analytical procedures). The potential for use of computer-assisted audit techniques (CAATs) may permit increased efficiency in the performance of audit procedures, or may enable the auditor to economically apply certain procedures to the entire population of accounts or transactions.
- (17) When the computer information systems are significant, the auditor should also obtain an understanding of the IT environment and whether it may influence the assessment of inherent and control risks. The nature of the risks and the internal control characteristics in IT environments include the following:
- *Lack of transaction trails*
 - *Uniform processing of transactions*
 - *Lack of segregation of functions*
 - *Potential for errors and irregularities*
 - *Capability for automatic initiation or execution of transactions*
 - *Dependence of manual controls over computer processing*
 - *Potential for increased management supervision*
 - *Potential for the use of computer-assisted audit techniques*
- (18) Both the risks and the controls introduced as a result of these characteristics of computer information systems have a potential impact on

the auditor's assessment of risk, and the nature, timing and extent of audit procedures.

(19) In undertaking audit of IT Systems as a component of a financial (attest) audit, the audit approach should be risk based. There are four procedures that should be planned for in developing the approach in order to be able to conclude on the effectiveness of controls over the information technology processes that have a direct impact on the processing of financial information:

- determine the scope of audit analysis of the information technology processes by identifying how they support important business processes and the processing of financial information;
- obtain background information about the auditee organization's IT environment, including information about applications supporting the critical business processes, together with the underlying platforms and those to which they are networked;
- conduct a walk-through of those information technology processes deemed to have a direct and important effect on the processing of financial information to confirm the auditor's understanding of the process design and related controls; and
- based upon the understanding of the information technology processes, evaluate the effectiveness of the design of each of the major information technology processes and related internal controls. If an evaluation cannot be made at the major process level, understand the information technology process at a lower level (e.g. sub-process level) and evaluate the effectiveness of the design of the sub-process. For those information technology processes that do not have a direct and important effect on the processing of financial information, a decision should be taken regarding the additional work, if any, to be performed.

(20) While evaluating the reliability of the accounting and internal control systems, the auditor should consider whether these systems, *inter alia*:

- a. ensure that authorised, correct and complete data is made available for processing;
- b. provide for timely detection and correction of errors;
- c. ensure that in case of interruption in the working of the IT environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;
- d. ensure the accuracy and completeness of output;
- e. provide adequate data security against fire and other calamities, wrong processing, frauds etc.;

- f. prevent unauthorized amendments to the programs; and
- g. provide for safe custody of source code of application software and data files.

Assessment of Risk

- (21) The auditor should make an assessment of inherent and control risks for material financial statement assertions. The financial statement assertions are explained in Chapter 2. In taking a risk-based approach, the auditor should focus on those areas that pose the greatest risk to the entity not presenting proper / true and fair financial statements.
- (22) The inherent risks and control risks in an IT environment may have both a pervasive effect and an account-specific effect on the likelihood of material misstatements, as follows:
 - The risks may result from deficiencies in pervasive IT activities such as program development and maintenance, system software support, operations, physical IT security, and control over access to special-privilege utility programs. These deficiencies would tend to have a pervasive impact on all application systems that are processed on the computer.
 - The risks may increase the potential for errors or fraudulent activities in specific applications, in specific databases or master files, or in specific processing activities. For example, errors may occur in systems that perform complex logic or calculations, or that must deal with many different exception conditions. Systems that control cash disbursements or other liquid assets are susceptible to fraudulent actions by users or by IT personnel.
- (23) As new IT technologies emerge for data processing, they are frequently employed by auditee organizations to build increasingly complex computer systems that may include micro-to-mainframe links, distributed data bases, end-user processing, and business management systems that feed information directly into the accounting systems. Such systems increase the overall sophistication of computer information systems and the complexity of the specific applications that they affect. As a result, they may increase risk and require further consideration.
- (24) An Auditor, in undertaking audit of IT Systems as a component of a financial (attest) audit needs to be aware of the following common areas that present potential risks in an IT environment that are relied upon to produce financial data:
 - The auditee develops and operates their own applications rather than outsourcing and the use of established industry and financial packages;

- Aspects of the entity's industry or internal environment may affect the development and application of controls. For example competitive pressure to introduce Electronic Data Interchange may result in the entity using an IT System is not adequately controlled or not performing in accordance with specifications;
- The users have or can grant access to specific functions or data;
- Users have the ability to change data and develop reports (for example to change data or formulae on spreadsheets);
- Pervasive IT (such as systems development and program maintenance and control over users' access to sensitive functions) affects the reliability of all application systems that are processed on the computer. The impact of these controls is dependent on both the extent to which they apply to specific applications (for example, whether the aspects of the systems in which the auditor has an interest are developed and controlled centrally) and the extent to which the quality of the controls is appropriate to the level of risk associated with that application (or the aspect of the application in which the auditor has an interest);
- The nature and extent of documentation regarding the IT System is appropriate given the complexity of and inherent risks faced by the IT environment;
- Factors that affect the quality of audit evidence available, for example, a paperless environment, may increase the potential for audit evidence to be incomplete, unreliable or difficult to obtain;
- Specific risks associated with a particular IT environment are identified, for example, electronic funds transfer systems where the risk of irregularities may be increased or a complex IT environment where the risk of error may be higher;
- End-user computing, which refers to any individual exercising control over and using a particular resource or more particularly a software application, is used to produce financial information, in particular where this use may be more susceptible to manipulation;
- Users lack the time, discipline or knowledge to effectively monitor the results of processing.

Audit Procedures

- (25) The auditor should consider the IT environment in designing audit procedures to reduce audit risk to an acceptably low level. He should make enquiries and particularly satisfy himself whether:

- (a) adequate procedures exist to ensure that the data transmitted is correct and complete; and
 - (b) cross-verification of records, reconciliation statements and control systems between primary and subsidiary records do exist and are operative and that accuracy of computer compiled records is not assumed.
- (26) The auditor's specific audit objectives do not change whether accounting data is processed manually or by computer. However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing.
- (27) The auditor can use manual audit procedures, or computer-assisted audit techniques, or a combination of both to obtain sufficient evidential matter. However, in some accounting systems that use a computer for processing significant applications, it may be difficult or impossible for the auditor to obtain certain data for inspection, inquiry, or confirmation without computer assistance.
- (28) The IT Systems can help the auditor in using analytical procedures (for analyzing ratios and trends, identifying unusual items, etc.).
- (29) The IT Systems can be of great help to the auditor in making use of sampling techniques and generating random samples. IT Systems can facilitate the application of Monetary Unit Sampling, which is widely used in financial (attest) audit.
- (30) The auditor can also extract the relevant records required by him using IDEA Package.

Documentation

- (31) The auditor should document the audit plan, the nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained. In an audit in IT environment, some of the audit evidence may be in the electronic form. The auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required.

IT Audit in the Indian Audit and Accounts Department

- (32) The Indian Audit and Accounts Department has recognized the importance of undertaking audit of the IT Systems. The Strategic IT Audit Plan (2003-2008) of the Indian Audit and Accounts Department, in its Vision portion, states that in view of the widespread use of Information Technology in the auditee organizations under the audit control of Comptroller and Auditor General of India, it has become imperative to consolidate the IT Audit efforts in the Indian Audit

and Accounts Department and put in place a structure and mechanism to further strengthen the functions. Attestation and certification of financial statements is one of the focus areas in the Strategic IT Audit Plan.

- (33) To begin with, the Indian Audit and Accounts Department will adopt the following software as Standard Audit Tools:
- (i) Microsoft Office including Microsoft Access
 - (ii) IDEA
 - (iii) Structured Query Language (ANSI-SQL in SQL *Plus environment)
- (34) The COBIT framework of the IT Governance Institute and the Information Systems Audit and Control Association (ISACA) has been approved by the Comptroller and Auditor General of India for adoption in the IT Audits undertaken by the Indian Audit and Accounts Department
- (35) In the Indian Audit and Accounts Department, the IT Audit Wing has devised a Criticality Assessment Tool for IT Systems which has a point system for each of the parameters of the system. It covers investment, hardware complexities, software complexities, dependence of the organization on the system etc. The tool provides a score card and the score worked out would measure the informed perception of complexity of the system. Any system that scores more than the prescribed score will be considered critical and based on the score, Heads of Departments of field offices would be able to assess the complexity involved and the audit resources required to be deployed. IT systems scoring more than 350 points or more have to be audited using all the processes in COBIT framework.

Glossary

Accountant General	Refers to the heads of field offices of Comptroller and Auditor General of India, which constitute the senior management cadre within the Indian Audit and Accounts Department and are entrusted with the responsibility of audit of specified entities or entities in specific regions or carrying specific functions. This term used in the Manual includes Principal Accountant General, Accountant General, Principal Director and Director General, who are responsible to manage and control the field audit functions on behalf of Comptroller and Auditor General of India.
Accounting Control System	A series of actions which is considered to be part of the total internal control system concerned with realising the accounting goals of the entity. This includes compliance with accounting and financial policies and procedures, safeguarding the entity's resources and preparing reliable financial reports.
Administrative Control System	A series of actions, being an integral part of the internal control system, concerned with administrative procedures needed to make managerial decisions, realise the highest possible economic and administrative efficiency and ensure the implementation of administrative policies, whether related to financial affairs or otherwise.
Appropriation Accounts	Annual accounts of Governments in India showing the expenditure against the budget in respect of different grants and explaining any substantial differences.
Assertions	They are the fundamental messages about the economic realities of the entity which management conveys to the users through the financial statements. They are not expressly stated in the financial statements. Rather, they are implied. In the case of receipts and payments or income and expenditure account items of a Government entity, the assertions are completeness, occurrence, measurement, disclosure and regularity. In the case of balance sheet or items of assets and liabilities of a Government entity, the assertions are completeness, existence, valuation, ownership and disclosure.
Assurance	It refers to the degree of satisfaction obtained by the auditor regarding the reliability of assertions made by the entity for the users of financial statements.

Audit Evidence	Information that forms the foundation which supports the auditor's or Comptroller and Auditor General's opinions, conclusions or reports.
Types:	
Competent Evidence:	Information that is quantitatively sufficient and appropriate to achieve the auditing results and is qualitatively impartial such as to inspire confidence and reliability.
Relevant Evidence:	Information that is pertinent to the audit objectives.
Reasonable Evidence:	Information that is economical in that the cost of gathering it is commensurate with the result which the auditor is trying to achieve.
Audit Mandate	The auditing responsibilities, powers, discretions and duties conferred on the Comptroller and Auditor General under the constitution or other lawful authority of a country.
Audit Objective	Audit Objective A precise statement of what the audit intends to accomplish and/or the question the audit will answer.
Audit Officer	Refers to the team leader or audit manager of the audit team, who may be of the rank of a Senior Audit Officer or an Audit Officer.
Audit Planning	Defining the objectives, setting policies and determining the nature, scope, extent and timing of the procedures and tests needed to achieve the audit objectives.
Audit Procedures	Tests, instructions and details included in the audit programme to be carried out systematically and reasonably.
Audit Programme	Audit requirements and procedures necessary to implement the audit objective.
Audit Risk	It refers to the possibility that the auditor expresses an unqualified opinion or clear opinion when the financial statements are materially misstated. It is the additive inverse of assurance. If audit risk is 5% in a given audit situation, the assurance will be 95%.
Audit Sampling	Statistics-based techniques that extrapolate from specific cases to make assertions about the population as a whole and are used when it is not feasible to analyse entire populations <i>e.g.</i> , invoices/ vouchers, and elements of internal control systems, entity units, <i>etc.</i>
Audit Scope	The framework or limits and subjects of the audit.
Auditee Entity	The organization or its unit, programme, activity or function subject to audit by the Comptroller and Auditor General of India.
Auditing Standards	Auditing standards provide minimum guidance for the auditor that helps determine the extent of audit steps and procedures that should be applied to fulfil the audit objective. They are

	the criteria or yardsticks against which the quality of the audit results are evaluated.
Authorities	Relevant Acts of Parliament or Legislature, Statutory Instruments, directions, regulations, or other statutory guidance, and authorities issued by the Finance Department and by sponsoring Departments using powers given in statute with which entities are required to comply.
Due Care	The appropriate element of care and skill which a trained auditor would be expected to apply having regard to the complexity of the audit task, including careful attention to planning, gathering and evaluating evidence, and forming opinions, conclusions and making recommendations.
Entity	Refers to an organisation, which is subjected to audit – both for the headquarters and the field units.
Entity	The generic term used for any Government Department, autonomous body, Government Company, Statutory Corporation, or other body or authority preparing financial statements and subject to audit by Comptroller and Auditor General of India.
Executive	The branch of government which administers the law.
Field Standards	The framework for the auditor to systematically fulfil the audit objective, including planning and supervision of the audit, gathering of competent, relevant and reasonable evidence, and an appropriate study and evaluation of internal controls.
Finance Accounts	Annual accounts of Governments in India showing the receipts and disbursements during the financial year under different heads of account and other information (regarding guarantees, investments, loans, etc.)
Financial Systems	The procedures for preparing, recording and reporting reliable information concerning financial transactions.
Findings, Conclusions and Recommendations	Findings are the specific evidence gathered by the auditor to satisfy the audit objectives ; conclusions are statements deduced by the auditor from those findings; recommendations are courses of action suggested by the auditor relating to the audit objectives.
Fundamental	A matter becomes fundamental (sufficiently material) rather than material when its impact on the financial statements is so great as to render them misleading as a whole.
General Standards	The qualifications and competence, the necessary independence and objectivity, and the exercise of due care, which shall be required of the auditor to carry out the tasks related to the field standards and reporting standards in a competent, efficient and effective manner.
Government Departments	These represent the top tier of Government.

Independence	The freedom of the Comptroller and Auditor General in auditing matters to act in accordance with its audit mandate without external direction or interference of any kind.
Internal Audit	The functional means by which the managers of an entity receive an assurance from internal sources that the processes for which they are accountable are operating in a manner which will minimise the probability of the occurrence of fraud, error or inefficient and uneconomic practices. It has many of the characteristics of external audit but may properly carry out the directions of the level of management to which it reports.
Internal Control	The whole system of financial and other controls, including the organisational structure, methods, procedures and internal audit, established by management within its corporate goals, to assist in conducting the business of the audited entity in a regular economic, efficient and effective manner ; ensuring adherence to management policies ; safeguarding assets and resources ; securing the accuracy and completeness of accounting records ; and producing timely and reliable financial and management information.
International Organisation of Supreme Audit Institutions (INTOSAI)	An international and independent body which aims at promoting the exchange of ideas and experience between Supreme Audit Institutions in the sphere of public auditing.
Legislature	The law making authority of a country, for example, the Parliament of India.
Materiality and Significance	<p>In general terms, a matter may be judged material if knowledge of it would be likely to influence the user of the financial statements or the performance audit report.</p> <p>Materiality is often considered in terms of value but the inherent nature or characteristics of an item or group of items may also render a matter material - for example, where the law or some other regulation requires it to be disclosed separately regardless of the amount involved.</p> <p>In addition to materiality by value and by nature, a matter may be material because of the context in which it occurs. For example, considering an item in relation to the overall view given by the accounts, the total of which it forms a part ; associated terms ; the corresponding amount in previous years. Audit evidence plays an important part in the auditor's decision concerning the selection of issues and areas for audit and the nature, timing and extent of audit tests and procedures.</p>
Misstatement	It refers to erroneous statements / information given in financial statements or omission of facts or information from the financial statements.
Opinion	The auditor's written conclusions on a set of financial statements as the result of a financial or regularity audit.

Parliament and Legislature	The reports of Comptroller and Auditor General of India in respect of the matters relating to the Union Government are presented to the Indian Parliament. The Union of India consists of provinces, called states. The law making organ for the states is referred to as the state legislature, or legislature. The reports of Comptroller and Auditor General of India on matters relating to the states are presented to the respective state legislature.
Planning	Defining the objectives, setting policies and determining the nature, scope, extent and timing of the procedures and tests needed to achieve the objectives.
Postulates	Basic assumptions, consistent premises, logical principles and requirements which represent the general framework for developing auditing standards.
Public Accountability	The obligations of persons or entities, including public enterprises and corporations, entrusted with public resources to be answerable for the fiscal, managerial and programme responsibilities that have been conferred on them, and to report to those that have conferred these responsibilities on them.
Quality Assurance	Policies, systems and procedures established by Comptroller and Auditor General to maintain a high standard of audit activity.
Quality Control	The requirements applicable to the day-to-day management of audit assignments.
Reasonable Assurance	It means high, but not an absolute (100%) assurance that financial statements are free from material misstatements.
Recommendations	See Findings, Conclusions and Recommendations.
Regularity Audit	Attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions on financial statements ; attestation of financial accountability of the government administration as a whole ; audit of financial systems and transactions, including an evaluation of compliance with applicable statutes and regulations ; audit of internal control and internal audit functions ; audit of the probity and propriety of administrative decisions taken within the audited entity ; and reporting of any other matters arising from or relating to the audit that the Comptroller and Auditor General considers should be disclosed.
Reliability	It refers to the congruence between the assertions made by the financial statements and the actual position.
Report	The auditor's written opinion and other remarks on a set of financial statements as the result of a financial or regularity audit.

Reporting Standards	The framework for the auditor to report the results of the audit, including guidance on the form and content of the auditor's report.
States	The Union of India consists of provinces, called States.
Supervision	An essential requirement in auditing which entails proper leadership, direction and control at all stages to ensure a competent, effective link between the activities, procedures and tests that are carried out and the aims to be achieved.
Supreme Audit Institution (SAI)	The public body of a State which, however designated, constituted or organised, exercises by virtue of law, the highest public auditing function of that State.

Some Common Abbreviations

AG	Accountant General
AR	Audit Risk
ATN	Action Taken Note
CAG	Comptroller and Auditor General of India
COPU	Committee on Public Undertakings
CR	Control Risk
DDO	Drawing and Disbursement Officer
DGS&D	Director-General of Supplies and Disposals
DP	Draft Paragraph
DR	Detection Risk
DST	Direct Substantive Testing
FRBM	Fiscal Responsibility and Budget Management
GFR	Government Financial Rules
GPF	General Provident Fund
IA&AD	Indian Audit and Accounts Department
ICAI	Institute of Chartered Accountants of India
IDEA	Interactive Data Extraction and Analysis
IFAC	International Federation of Accountants
INTOSAI	International Organisation of Supreme Audit Institutions
IR	Inherent Risk; Inspection Report
IT	Information Technology
LOPs	Lists of Payments

MUS	Monetary Unit Sampling
PAC	Public Accounts Committee
PAO	Pay and Accounts Officer
PDP	Potential Draft Paragraph
PHE	Public Health Engineering Department
PRI	Panchayati Raj Institution
PWD	Public Works Department
RBI	Reserve Bank of India
SAI	Supreme Audit Institution
SAR	Separate Audit Report
SBA	Systems Based Audit Approach
VLC	Voucher Level Computerisation

