Guide to Audit Approach in Small and Medium Sized Firm

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Audit Methodology for Small and Medium Sized Firm:

Audit program /audit methodology /audit approach:

A standard Audit Methodology helps in defining the method for audit and helps in identification of deviation from the prescribed policy.

- ✓ This guide has been prepared specially for audit assistants working in small and mid size firms.
- ✓ The guide is specifically for the audit assistants of small and mid size firms as the method of working in such firms differ greatly from audit procedures of large firms and the scope involved in Audit.

Benefits of standard Audit Methodology:

- ✓ Guides in doing work.
- ✓ Avoids Confusion.
- ✓ Helps in using the experience of previous audit staff.
- ✓ Less deviation in what is expected and what is done actually.

Index of Audit Methodology:

The Audit Methodology has been divided into key points such as:

1. Acceptance of Audit.
2. Planning of Audit.
3. Execution of Audit.
4. Concluding ,Reporting , Archival and File Closure
5. Creation of Knowledge portal.
6. Use of checklist

Acceptance of Audit:

a. Acceptance of Audit for the first time.

   i. Receiving NOC from previous auditor
   ii. Creation of **Permanent Audit** file
      1. Understanding of business (A permanent file should be created describing the business activities of the client)
         a. The nature of client business
         b. Product in which it deals
         c. The key processes in enterprise
         d. Key managerial personnel and their responsibilities
         e. Information can be searched from the public domain and documented. Such sources of info. Are:
            i. MCA portal showing
               1. Company master data
               2. Company index of charges
               3. Directors of the company.
            ii. Website of the company
            iii. Search by using search engines such as Google.
      2. Obtaining basic documents listed in **annexure 3**.

Obtaining client information has become mandatory with the issue of **KYC norms** by the council of ICAI. (Ref. annexure 3 for the KYC norms)

b. Re Appointment of the Auditors.

Documentation of Following:

   i. Notice by the company to the Auditor for reappointment/ Appointment of Auditor
   ii. Resolution of General Meeting for Appointment of Auditor
   iii. Filing of Form 23B with ROC within prescribed time of 30 days from passing of resolution in general meeting.
   iv. Issuing Engagement letter for each audit period before start of audit.
      1. Engagement letter should mention scope and responsibility of auditor
      2. Should be signed and delivered to the client

✓ Checklist can be created to ensure compliance of the appointment formalities.
✓ The checklist needs to be signed off by the audit staff.

2. **<u>Planning of work.</u>**
    a. Pre Audit Meeting and discussions
        i. Preview of permanent Audit file.
        ii. Determining Materiality and trival misstatements
            - ✓ Materiality helps in determining the amount of vouching to be done in the areas and the queries to be ignored.
            - ✓ It helps in focusing on larger issues having financial implications.
            - ✓ Materiality can range between 5-10% of the Turnover of the enterprise.
            - ✓ Materiality should be worked upon by the audit staff and reviewed by the partner (Signed off) before starting of the audit.
            - ✓ It also helps in determining the **sample size** during audit

        iii. Key areas of risk
            - ✓ **Discussions** should be done regarding key areas of risk, based on previous audit experience.
            - ✓ **Partner** should inform the audit team regarding key risk areas.
            - ✓ Expectation of the **client** should be duly considered if the client is of view that certain area has a higher risk of misstatement.

        iv. Client business understanding
            1. Preview of permanent audit file helps to understand the client business.
            2. Pre audit meeting with client should be done in order to understand the major business activities in the business. The same should be documented.

        v. Determinig **sample size** for Vouching:
        Refer Annexure 4 for methodology of determination of samples.
            1. Relevant sample size should be decided upon in the key areas of audit such as:
                a. Purchases.
                b. Sales.
                c. Various heads of Expense.
            2. Cut off:
                a. Vouching has to be done compulsory for the period after and before cut off.
                b. 5 samples of each period after and before cut off should be vouched.
                c. This helps in determining whether cut off has been properly adhered to or not.
                d. Cut off needs to be done for the revenue items only.

vi. Determining the targeted time frame

   a. Work plan should be decided upon for each activity
   b. Delegation of appropriate responsibilities and audit areas should be demarked.
   c. Time required for each audit activity should be estimated in advance by the audit staff and approved by the partner.
   d. Estimate of work hours required should be done based on the audit plan.
   e. **Reporting deadline** should be documented and intimated to client

3. **Executing the work of audit.**

Auditing at Ground level

i. **Discussion with the client:**

1. Discussions with the client should be documented upon
   a. the major business activities during the period
   b. Capital Expansion if any
   c. management / organizational structure
   d. Changes in the overall market scenario which can affect the profitability during the period
2. Ability of the client to adhere to reporting deadlines.
3. Follow up on previous unresolved audit issues and directions issued during previous audit.

ii. **Requirement List:**

- Document summarizing the data required from client's end should be jotted down in the requirement list beforehand so that client can plan accordingly.
- The brief details in requirement list should include:
  - Particulars of data required
  - Time frame in which accountant is required to issue same
  - Whether required in physical format or hard copy
  - Person responsible for same
  - The requirement list should be communicated by way of an email
- Updated requirement list should be sent periodically to help in tracking the actual flow of data.

iii. **Vouching :**

1. Vouching should be based on sample size determined during planning phase.
2. The Determination of sample size can be done based on materiality of determined at the time of planning of audit.

   Refer annexure 4 for methodology of Determination of samples.
3. The observations in vouching of data should be noted down in queries sheet.
4. The manner in which queries' have been solved should be noted down along with queries.
5. Document regarding matter for discussion with partner should be prepared to give highlights of audit points discussed and matter in which the same has been resolved.

4. **<u>Concluding ,Reporting and File Closure:</u>**

Documentation is the key aspect in audit closure which involves:

i. Compliance with the disclosure requirements of the accounting standards (it involves filing of various checklists for ensuring compliance)
ii. Compliance with schedule VI which involves
    a. Filing of Checklist.
    b. One to one comparison of sch. VI with the financials.
iii. **Matter for attention of partner**

It states the key points of discussion to be done with the partner of the firm which covers:

a. Brief description of issue
b. Amount involved
c. Relevant provision of legislature governing the matter
d. Implications on
    i. Audit Report
    ii. CARO report
    iii. Form 3CD
e. Enterprise's opinion on the issue
f. Conclusion by the partner

Preferably a spread sheet should be prepared regarding the same.

iv. **Demarcation of responsibilities:**

The responsibility of accountants of the company should include:

a. Preparing of Financials (except if it is the first year of the enterprise)
b. Preparing of form 3CD and Form 3CA/Form 3CB.

The responsibility of staff should be limited to:

a. Educating the accountant regarding the method of preparing the above mentioned documents.
b. Review of the financials and the reports.

v. **Archival:**

- ✓ Archival involves final closure of the audit file.
- ✓ It ensures that the requirements of maintaining the audit documentation as per AAS-3 are ensured.
- ✓ **Record of client data:**
  A CD-ROM can be taken from the client for the backup of the accounting software so as to ensure that audit evidence is available for same.

- ✓ **Digital Archival:**
  Archival of files should be done in digital form to ensure that the files are retained for 10 years. For this all the manual audit work papers should be scanned.

Key factors for archival are:

a. **Timeline:**
   Fixing timeline for archival. (Preferably from 30 days of signing of Audit Report)
b. **Staff:**
   The staff which is involved in audit of the enterprise should only be responsible for archiving.
c. **Storage Media:**
   Preferably the data should be stored in a separate hot swappable hard disk having following features:
   i. Deletion of files not permitted.
   ii. Overwriting of files not permitted.

   This Facilitates
   - ✓ Tracking the documents changes
   - ✓ Avoiding unauthorized changes to data
   - ✓ User accountability
   - ✓ Avoids Duplicate files

d. **Storage Methodology:**
   The data stored should adhere to following guidelines:
   i. Every document should be **scanned and numbered** to prepare a complete audit file.
   ii. The documentation should be in a standard template.
   iii. The naming of the documents should be in methodology suggested in annexure 2.

   This Facilitates
   - ✓ Record of work done
   - ✓ Referencing the new work with respect to old work. For e.g. for referring the data for certification work from financial statements.

vi. **Sign Off:**

Audit Report:

Before a report is signed by the partner of the firm the office copy of the same should be initialed by the person reviewing the report to ensure correctness of the report.

This makes the person reviewing the report to be accountable for the same.

Certification work:

Every certificate should be **serially numbered** to ensure

- fees of the certificate can be tracked
- To identify any fake certificate
- To facilitate record keeping of the certificate

vii. Letter of Weakness and Audit observations:

- ✓ Audit observation summarizes the observations of audit staff based on the audit experience.
- ✓ Draft Letter of weakness should be first communicated to the ground level staff involved in accounting process.
- ✓ Contents of Letter of Weakness should involve:
  - o The difficulties in exchange of data faced by the audit staff
  - o Adherence to timeliness in exchange of data
  - o Technical Queries unresolved during course of audit on :
    - ▪ Accounting Standards
    - ▪ Companies Act
    - ▪ Other relevant legislations.
  - o Other non compliances which do not have a bearing on the financial statements such as :
    - ▪ Compliance with Factories Act
    - ▪ Bonus Act
    - ▪ PF Act etc.
  - o Other Compliances which needs to be ensured at the time of next audit and time frame for completion of same by the accountant.

5. Creation of Portal:

Creation of a portal for ensuring that all the materials which are required for reference are available handy.

Method:

Step 1: Creating a blog for giving a link to all the documents

Step 2: For the documents which are already available on internet a link can be given to those documents

Step 3: Shared Documents facility is available on Google for the documents not available on internet. User can upload the documents for free on docs.google.com

6. Use of Checklists

Use of Checklists for ensuring compliance with

a. Appointment Formalities have been complied with like
    i. Receiving NOC from previous auditor
    ii. Notice by the company to the Auditor for reappointment/ Appointment of Auditor
    iii. Resolution of General Meeting for Appointment of Auditor
    iv. Filing of Form 23B within prescribed time
    v. Issuing Engagement letter for each audit period
b. Accounting Standards
    i. The applicability of AS
        i. For Companies ensuring compliance with AS Rules, 2006
        ii. For other entities based on AS Rules
c. Companies Act
    i. Schedule VI
    ii. Section 372A for ensuring limit of borrowings does not exceed that provided in Section 372A
    iii. Miscellaneous provisions like
        i. Appointment of Auditors
        ii. Appointment of Directors
        iii. Reconciliation of charges with Charge register
d. Reporting
    i. Checklist for CARO Compliance.
    ii. Checklist for reporting in Form 3CD and firm related guidance.

Annexure 1: List of materials which is required to be uploaded on the blog:

1. Accounting Standards:
    a. Bare Accounting Standard

    b. Interpretations of Accounting Standard Interpretation Committee

    c. Guidance Note on Accounting issued by ICAI

    d. Expert advisory committee opinions related to the accounting in specific issues

    e. Financial Reporting and Review Board of India Recommendations

2. Companies Act
    a. Bare Act
3. Income Tax Act
    a. Bare Act
    b. Rates of TDS
    c. Guidance note on Tax audit Issued by ICAI.
4. Audit Methodology of the firm
5. Checklists for Audit as mentioned in Audit approach
6. Standards on Auditing

Annexure 2: Documentation methodology

<table>
<tr><th><u>Template</u></th><th><u>Example</u></th></tr>
<tr><td>Group number and name
o Company number and name
▪ Relevant financial year
• Companies Act
o Reporting
▪ CARO Report and other report
▪ Audit Report and Financials
• Income Tax
o Form 3CD
o Other Forms like Form 3CB
• Certification work
• Other work</td><td>File number A1.01.1011.C.Annual_Report.doc

Vastupal(A)
o Vastupal Bearing Races (A1.01)
▪ Relevant financial year (A1.01.1011)
• Companies Act
o Reporting (A1.01.1011.C)
▪ CARO Report and other report
▪ Audit Report and Financials (A1.01.1011.C.Annual_Report.doc)
• Income Tax
o Form 3CD
o Other Forms like Form 3CB
• Certification work
• Other work</td></tr>
</table>

Annexure 3: Documents to be obtained for permanent audit file

1 **Appointment letter.**

2 **In case of new Audit NOC of previous Auditors.**

3 **Copy of Previous year Audit Report / previous year's balance sheet & P&L duly certified by the Management in case no audit was undertaken in previous year.**

4

Company	Partnership firm	Trust
Memorandum of Association	Partnership deed	Trust Deed
Articles of Association		

Other relevant information to be obtained :

Copy of Relevant regd. No.

1	Permanent Account No.	
2	TAN	
3	CST regd. No.	
4	VAT regd. No.	
5	Providend fund regd. No.	
6	ESI Regd. No.	
7	Corporate Identification No.(Only for Companies)	
8	DIN (of all directors)	
9	Excise duty registration	
10	Service Tax registration	
11	Professional Tax regd. No.	
12	IEC Code	

Details of all the partners / directors :

Sr.No	Name	Ratio of profit sharing (Only in case of Partnership firm)	Share holding of Director	
1				
2				

Details of all bank accounts:

Sr.No	Name of Bank	A/C No.	Type of A/c
1			
2			

Bank facilities obtained:

Sr.No	Nature of Bank Facilities	Amount	SecurityGiven
1			
2			

Nature of Business

	Tick Whatever applicable
Trading	☐
Manufacturing	☐
Service provider	☐

Detailed description of business and relevant code according to Income Tax Rules

Items in which company/firm deals

Sr.No	Item	HSN Code	ITC Code
1			

Production Capacity

1 Licensed Capacity

2 Installed Capacity

3 Actual Capacity (Based on previous year's production)

Particulars of Inventories

Sr.No	Particulars	Fiished good/ raw material
1		

Addresses of Offices and Godowns Location

Regd. Office (only for companies)

Godown

Obtain information of laws applicable to the client:

(AAS 21 compliance of various laws applicable to the client) Tick Whatever applicable

1	The factories Act, 1947	
2	Excise & Customs Act	☐
3	The Foreign exchange Management Act, 1999	☐
4	The Payment of Bonus Act, 1965.	☐
5	The Employee Providend fund and Miscellaneous Act, 1952.	☐
6	ESI Act	☐
7	Service Tax Act	☐
8	The Companies Act, 1956	☐
9	VAT	☐
10	Any other special Act applicable	☐

KYC norms of ICAI

Announcement of KYC Norms

All the members of Institute of Chartered Accountants of India (ICAI), who are in practice, are hereby informed that the Council has formulated the following Know Your Client Norms (KYC norms) at it's 307th Meeting held on 13th July, 2011, which shall be recommendatory in nature, and apply only in case of attest function.

KNOW YOUR CLIENT (KYC) NORMS

The financial services industry globally is required to obtain information of their clients and comply Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI thought it necessary to recommend such norms to be observed by the members of the profession who are in practice. In light of this background, the Council of ICAI approved the following KYC Norms. However, these norms are recommendatory in nature and every Chartered Accountant carrying out attest function is encouraged to follow them.

1. ENTITY INFORMATION

A. GENERAL INFORMATION

- Name of the Entity
- Type of Entity
- Business Description

B. CORPORATE STRUCTURE

- Name of ultimate parent company
- Name of Parent company

- Name of Affiliates

C. REGULATORY INFORMATION

- Company PAN No
- Company Identification No
- Directors' Identification No
- Directors' Names & Addresses
- Name(s) and Addresses of Companies, in which above person is director.

D. ENGAGEMENT INFORMATION

- Type of Engagement

2. OTHER INFORMATION

- Entities financial Information
- Name of the ultimate parent Auditor
- Any known violation of any Law/Regulations

This decision shall be in force from 13th July, 2011.

Annexure 4: Example showing the materiality level:

Sr. No.	Particulars	Amount
1.	Turnover of the company:	Rs. 10 crore
2.	Materiality based on risk of audit and previous audit exposure	5%
3.	Materiality Level	Rs. 50 lacs
4.	Expense under head Legal and Professional Services	Rs. 75 Lacs
5.	Multiplicity factor based on risk	20x
6	Number of samples to be tested (75/50)*20	30

Sr. No.	Audit Risk and reliance of internal controls Control Combination	Multiplication factor*
1	High Audit Risk and not relying on control	20x
2	Low Audit Risk and not relying on control	15x
3	High Audit Risk and relying on control	10x
4	Low Audit Risk and relying on control	5x

Note: * Multiplication factor can be changed based on Audit risk.