Audit Methodology
&
Audit Programme

PEEYUSH SHARMA & Co.,
Chartered Accountants

Our Mission is to achieve a leadership position in domestic and international markets by providing services to our clients for their business needs with the highest standards of integrity, quality and efficiency. We strive to create an environment to promote group spirit and commitment to excellence amongst our staff, thereby providing opportunity for growth of individual members.

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First let us understand the basic concepts of 'Audit'.

AAS – 1 defines Audit as an **Independent Examination** of the **financial information**, including financial statements, of an enterprise, irrespective of its size and legal form, with a view to **expressing an opinion** thereon.

We come across 3 phrases in the above definition that answer 3 basic question?

1. What is an audit ?	an **Independent Examination**
2. What to audit ?	**financial information**
3. What is the purpose of an audit ?	**expressing an opinion**

The Concept of "Independent Examination"
In any audit, our work is to examine various aspects of the Financial Information, that we are auditing.

Examination implies reviewing, analyzing and testing the accuracy of something.

Independent Examination implies that we are in no way related to the subject that is being examined, i.e., the outcome of the examination should not affect our interests in any way and also that at the time of conducting the examination, we should be free from all kinds of bias and prejudices.

For example, suppose, you have been asked to examine whether a dish prepared by your close relative is tasty or not. Here, even if the food is not tasty, there is a risk that you may say that the food is tasty just to make your relative feel good.

However, if the same food had been prepared by a person, with whom you are not concerned in any way, you would have said the truth that the food is not good, without any glitches.

Independence also implies that we should not audit any information that has been prepared by us.

In the above example, if you yourself had prepared the dish, you would have always felt that the food is good, no matter how bad it really is.

In the field of audit too, the above example holds good. If we conduct the audit of an entity with whom we are related, we may overlook certain important issues to preserve the interests of the entity. Hence there is a risk of issuing a wrong audit opinion. This risk can be overcome by ensuring independence.

<u>Independence in built in the laws:</u>
Section 224 of the Companies Act, together with the Chartered Accountants Act, 1949 and the various notifications issued by the ICAI, ensure the independence of the auditors.

What to audit?
The kinds of audit Chartered Accountants do are related only to Financial Information. Common examples financial information audited by Chartered Accountants are:

1. Financial statements, i.e., Balance sheet, Profit and loss account, Cash Flow Statements, etc.
2. Quarterly Results of listed Companies
3. Financial Information relating to Taxes, both direct and indirect.
4. Specific financial information relating to certain areas.
5. Over all financial performance of the Company (performed more in the field of Internal Audit)

What is the objective of an audit?
The ultimate objective of any audit is to express an opinion on the Financial Information audited.

What is the opinion?
The opinion that we issue takes the form of an audit report in which we state, whether in our opinion the information audited by us reflect a true and fair view of the state of affairs.

Additionally, various statutes require us to report on certain specific matters. In such cases, there is additional onus on the auditors to do the same. Examples of such statutory requirements are CARO by the Companies Act, Form 3CD by the Income Tax Audit, relevant forms of VAT Act, etc.

Statutes may also require us to issue an opinion as to whether the financial information are true and *correct.* In such cases, the responsibility of the auditor increases as he has to vouch for the accuracy of the information. An example of such an audit is tax audit conducted under section 44AB of the Income Tax Act.

What is the difference between 'true and fair' and 'true and correct'?
It is very difficult for an auditor to vouch for the accuracy of any financial information, mainly because we cannot check 100% information and we have to rely on test checks and there is always a possibility that we may miss out on possible cases of errors and frauds. Also, compilation of financial information involves the use of estimates in certain areas and estimates can never be accurate.

Hence, if we were to say that the financial information audited by us is 'true and correct', it would not be entirely justified, as the inherent limitations of audit do not allow us form such an accurate opinion.

However, it is our duty to ensure that our audit procedures are designed in such a way so that no major errors and frauds go undetected and we get a reasonable assurance that there are no **'material misstatements'** in the financial information audited by us. We also have to ensure that the estimates used are reasonable and not absurd. When we achieve the above mentioned objectives, we are in a position to express an opinion that what we have audited does give a reasonably correct picture of the real scenario, though it may not be 100% accurate. The words 'true and fair' are used to express such an opinion.

What is material misstatement?
A misstatement means a mistake contained in the financial information caused either due to fraud (intentional) or due to error (non intentional). When such mistakes, individually or in aggregate with other mistakes, assumes such proportion that the picture presented by the financial information no longer gives a reasonably correct view of the real scenario, we say that the financial information is materially misstated.

Materiality is a relative term. What may be material for one entity may not be material for another entity. For example, let us consider a Company like Reliance having an annual turnover in excess of 1 lakh crores. On the other hand, let us consider a smaller Company X, having a turnover of 500 crores. In the given scenario a mistake of 10 crores shall be immaterial for RIL but shall be quite material for Company X.

It is essential that before we start any audit, we define the materiality limits for the audit, so that we know what matters to ignore and what matters to lay emphasis on.

The various details about materiality shall be discussed later.

Why Audit?

We audit because the people who use the financial information need an assurance that the financial information being used by them is reliable and not misleading and since it is not possible for each user to check the validity of the financial information separately, the onus is placed upon us to do the same on behalf of the all the users.

Who are the users of the financial information?

i. Shareholders : In corporate environment, the management and the ownership functions are separate. The funds of the owners of the Company (Shareholders) are placed in the hands of the Management (Directors and other officers of the Company), for efficient and profitable utilization. The shareholders need an assurance that their money is being managed properly and is not being siphoned away by the management. They use the financial information in the capacity of owners to find out how the funds have been utilized by the management.

ii. Lenders : Whenever any person (banks, FI's, other lenders) lends money to an entity, he uses the financial information to ensure the credibility of the Company before extending the loan. Even after sanctioning the loan, he uses the financial information to ensure that the funds provided by him are being used for correct purposes, and to ensure that the entity is in a position to service and repay the debt.

iii. Government : The Government uses the Financial Information mainly for collection of various levies and taxes and also for ensuring compliance of various other stipulations. The Government also needs such information to compile statistical data for analysis purposes.

iv. Public, at large : Any entity is a social system, being a part of the society. Hence, various other people are interested in the working of the Company for various other reasons and they can know about it by perusal of Financial Information. Eg; A prospective shareholder deciding whether to buy a share or not.

In order to protect the interests of all the above mentioned users, it is our duty to conduct the audit diligently and properly.

What are the consequences if we do not carry out the audit properly?

The Institute of Chartered Accountants of India requires all its members to be very careful and diligent in performing audits. If a member is found guilty of being negligent, he shall be liable to punishment, which may take the form temporary suspension of the membership and if it is an extreme case of negligence, then his membership can be terminated for life as well. The Companies Act also lays down certain liabilities of members who are grossly negligent in the performance of the audit function.

Even members, who are not signing the audit report, but who have been involved in the audit are liable to punishment, if negligence is proved on their part.

Documentation

In any audit, it is very essential that we keep a proper record of all the work we have done. The process of keeping and maintaining such records is known as 'Documentation'.

Why Document?

It is essential to document the work we have performed for the following reasons:

i. To enable the audit team to understand the audit plan
ii. To enable the reviewer to ensure that the audit has been carried out according to the plan
iii. To ensure that all aspects of the audit have been covered.
iv. To enable future audit teams to understand the methods used for audit of the client.
v. To evidence the fact that proper audit has been carried out, without any negligence, in case there is any review or investigation by the Institute.

What to Document?

The following things **must** be documented in the audit file:

i. Engagement letter of the audit

ii. Audit plan - includes

a. Client details – legal status, industry, nature of business, key activities, applicability of laws and regulations, scale of operations, whether level 1,2 or 3, whether CARO applicable, etc.
b. Composition of the audit team
c. Time targets to meet
d. Materiality levels
e. Specific areas of audit that require special attention
f. Minutes of any meetings between the auditor and the client
g. Minutes of the initial meeting between the audit leader and his team
h. Any changes in the working environment of the client which may affect the audit procedures.
i. Description of the accounting processes / cycles used by the client. Identification of key control points. Validation of controls to check whether the controls are in place. (Not Required in very small audits)
j. Preliminary Analytical Procedures (Not required in small audits. Possible only when draft B/S P/L available before starting the audit or when interim B/S P/L available before starting the audit)
k. Audit procedures to be performed. Extend of checking needed, keeping in mind the extend of reliance to be placed on controls, materiality and results of Preliminary Analytical procedures.

iii. Audit procedures performed - There should be proper documentation of each and every area examined in the course of the audit. The following are the matters to be documented:

a. Audit approach used - Various audit approaches that are commonly used are:
    1. <u>Vouching</u> – Whether 100%? If not, basis of selection of items checked. Coverage, etc. If sampling used, relevant details thereof.
    2. <u>Ledger Scrutiny</u> – document objectives and outcomes of performing the scrutiny
    3. <u>External Confirmations</u> – for loans and advances taken and given, debtor and creditor balances, bank balances, etc.

4. Reconciliations – mainly for bank balances and debtor/ creditor balances where confirmations have been obtained.
5. Analytical Procedures – Useful in areas such as materials consumed, manpower cost, fuel cost, etc.

b. The fact that the arithmetical accuracy of the area has been checked.

c. The fact that the control totals / sub totals are in agreement with figures appearing in the top Schedule.

d. Exceptions noted, if any.

e. Disposal of the exceptions.

iv. The final trial balance that has been linked to a draft set of accounts. In the draft set of accounts, all the figures must be linked to the top sheets of the respective audit areas. Previous year figures must be compared to previous years *signed accounts.* Arithmetical accuracy should be ensured.

v. Final Analytical procedures – mainly a variation analysis of all areas – B/S as well as P/L

vi. Where CARO is applicable: CARO Checklist, together with documents supporting the figures reported, if any. (Extremely important to have all back up documents in place)

vii. A draft audit report

viii. Copy of the final signed accounts (Known as office copy). The office copy should be checked for arithmetical accuracy with a pencil. It should also be compared thoroughly with the draft copy.

ix. Management Representation letter

x. In case of a public company, representation from the directors regarding section 274 (1) (g).

GENERALISED AUDIT PROGRAMME

Year/Period of Audit ____

Name of the In-charge ____

Name of the Assistant (s) ____

Date/Period of Audit____

1. General:

- Name of the Firm ____
- Constitution with Date ____
- Type of Activity____
- Brief Note on Business activities: ____
- Applicable laws as per Business Activities And their compliance (short note):

  ____

  ____
- Main Finished Product ____
- Main Raw Material____
- Name of Director/Partners____
  (in case of directors with DIN)____
  (in case of partner with profit ratio)____
- Change in Partners and directors
  (Form 32 and DIN compliance)
- PAN No. ____
- Service Tax/VAT No. ____
- CIN No. ____
- TAN/TDS No.____

2. **Previous Year:**
    - Whether last books are closed and stamped
    - Whether opening balances are correctly forwarded
    - Whether last year I.Tax return/RoC return filed
    - Is there any refund due or tax payable

    Details in respect of previous pending assessment/appeals

    Income-tax
    VAT
    Service Tax

3. **Business Address:**
    - Registered Office address
    - Whether return has bee filed from Registered office address (if not, address Of from which the return filed)
    - Other location of business like warehouse etc.
    - Whether PAN have correct address particulars
    - Whether VAT/Service Tax informed about all Business locacation?
    - Change in address properly informed to all the Departments like IT, VAT, RoC?
    - In case of corporates, if books are not maintained At Registered office the same has been informed to RoC
    - All the premise are owned, if not rent/lease deed and the expenses regarding rent, electricity, water, House Tax etc. in books of account. If TDS is applicable whether the same is complied with.
    - In case of companies all the bill, letter heads, receipts etc contains the Registered office address.

4. **Capital:**
    - Is there any negative capital of Proprietor or Partner
    - Is there any new addition, source there of
    - Interest on capital whether authorized by Partnership Deed, rate of interest and particulars (verify Partnership deed and obtained copy thereof)

    In case of corporates:
    - Any addition in authorized is supported by Form 5
    - Any addition in paid up capital supported by Form 2
    - List of old and new shareholding (with percentage)
    - Proof and source of new addition (including PAN)
    - Whether any Share Application is outstanding, how Old it is ? Complete break up with confirmation.
    - Reason for non-allotment
    - Status of Share Application Forms/Share Certificates And transfer deeds

No Transaction made during the period

- Is there any special case like bonus issue (Right issue in case of Ltd. Companies) etc.

5. Reserve & Surplus:

Applicable in case of companies and Trusts:

- General reserve, Revaluation Reserve, Share Premium P& L account balance etc. has been separately shown
- Share Premium has been verified with Form 2

6. Unsecured Loan:

- List of Unsecured Loan to match with Control a/c
- Confirmation in respect of all outstanding loans with complete address and PAN particulars.
- Detailed list of loan taken u/s 269SS and loan repaid u/s 269T as per 3CD report
- All loan are interest bearable, if not why so (if yes rate of interest and interest details with marking payment to relatives and directors)
- Whether interest rate is consistently followed. Check interest calculation and TDS thereon.
- Whether TDS compliance made on such interest payment
- In case of Corporates whether loan are only obtained from corporated bodies, shareholders, directors and their relatives.

7. Secured Loan:

- Balance in respect of each outstanding of Secured Loan to match with respective lenders statement
- Copy of agreement or any formal document signed to verify terms of loan, interest rate etc.
- Interest are duly provided for, check interest calculationTDS compliance if applicable
- In case of corporate, whether charge to be created the same has been created
- If any secured loan completely repaid whether the charge earlier created has been satisfied.
- Disclosure of charge details in balance sheet.

8. Current Liabilities:

- List of creditors to be tallied with control account
- There is no negative (debit) balance in Creditor list and/orClassification is proper
- Ledger scrutiny to determine:
  1. Small balance has been written off
  2. Creditors with no transaction and same balance
  3. Only having one side entries
  4. Cases, which speaks about adjustments
- Whether confirmation of major creditors obtained

- Break-up in respect of all the other CL heads like EMD, Expenses payable etc has been obtained.
- Amount due to SSI units should be separately determined for schedule VI disclosure
- Provision for different outstanding expenses and clearance of old outstandings.
- All the statutory dues like TDS, PF, ESI, VAT etc. payable has been timely deposited (obtain copies)

9. Provisions

- Provision for Income-tax, FBT, Wealt-tax, Dividend tax
- Adjustments of previous provision with prepaid taxes
- Provision for deferred tax liabilities/assets as per AS 22
- Provision for liability of retirement benefits
- Whether contingent liability needs provision or vice versa
- In case of dividend declaration whether trsf to reserve is correct
- In case of NBFC – Trsf to reserve as per RBI regulation.

Provision for Income tax:

- Depreciation effect of I.Tax act.
- Determination of liability from MAT point of view.
- Disallowance of Expenses
- Prior Period items
- Deferred tax assets need to be taken as revenue expenses
- Effects of Sale of assets
- Effect of carry forward and set off of losses & dep
- Calculation of expenses pertaining to exempted income

10. Contingent Liability:

Bank guarantee outstanding but not revoked
Bills discounted
Disputed matters in respect to tax, vendor payment etc.

11. Fixed Assets

- Fixed assets register maintained
- New assets addition – Verify proofs
- Effect of Incidental expenses like insurance, tax, etc.
- Small items, consumables- wrongly classified as assets
- Classification of addition is proper heads and period wise
- In case of sale :
  Under I. Tax – Block of assets rules followed
  Under Roc – Gross block has been adjusted
- Whether old items need written off
- Depreciation calculation as per I.Tax (Whether opening from previous I.tax chart taken)- verify rates & calculation Total of chart to verify with controls.

- Depreciation calculation as per ROC – Method should be consistently followed, rate, and calculation to verify. Total of chart to verify with controls.

12. Investments

- Classify the investment in heads like Immovable, shares, Debentures, securities, interest in partnership firm etc.
- Classification of investments in shares in quoted and Unquoted investments
- Physical verification of documents in respect of at least of new investments
- Income to be received from investments should be verified
- TDS if any deducted has been correctly accounted for and Income has been correctly grossed up
- Whether erosion in the value of investments has been provided for (check the accounting policy)
- Is there any investment which is not held in the name of Company or is benami

13. Inventories

- Classify the items like raw material, WIP, Finished Goods Consumables, packing goods , spare parts etc for which closing quantity and value to determine.
- Is there any stock register maintained
- Is there any negativity in stock noticed during the year?
- Where stock register maintained - apply the FIFO method or any other method that has been consistently followed.
- While arriving the cost all incidental expenses has been taken in to account to determine inventory value.
- In case of manufacturing company the total consumption sheet should be drawn and should be compared with standards to determine major deviation in consumption pattern
- Whether wastages have any major deviation
- In case of inventory determined on GP formula, the facts that GP rates are in order should be verified.
- Make the complete working sheet recording all assumption
- Prepare summary statement of quatitative details as required for 3CD report and Schedule VI

14. Sundry Debtors

- List of debtors to be tallied with control account
- There is no negative (credit) balance in debtors list and/or classification is proper
- Ledger scrutiny to determine:
    1. Small balance has been written off
    2. debtors with no transaction and same balance
    3. Only having one side entries
    4. Cases, which speaks about adjustments
- Whether confirmation of major debtors obtained
- Classification of debtors' age wise especially less than and more than six months

- Is there any provision requiring for doubtful debts?

15. Cash & Bank Balance

- Determine there is no negative cash during the year
- Obtain a certificate from management of balancecash in hand as on balance sheet date
- Statement for all the bank accounts obtained
- Bank reconciliation statement for all the banks prepared, obtain copy of BRS and last page of BS.
- Whether BRS do have entries that needs passing of rectification entries?
- Classify the funds like with different bank under Scheduled and non-scheduled bank category
- Verify the FDR with physical receipts
- Verify the interest receivable calculation
- Verifty whether TDS on interest has been correctly accounted for

16. Other Current Assets

- Determine that security deposit shown in BS are refundable
- In case of interest bearing security whetherInterest has been provided?
- Determine that prepaid portion has been segregated out of various eligible expenses (Insurance, AMC etc)
- Are break-up in respect of all the current assets available?
- Is there any I.Tax or other department, refund is long outstanding?
- Collect the details and challans of Advance tax, TDS Receivables, FBT paid, wealth-tax etc. Determine the authenticity of un-expired VAT, CENVAT etc.

17. Loans and Advances

- Obtain the break-up (if any) of control a/c
- Otain confirm in respect of all loan outstanding as on Balance Sheet date.
- If there is any agreement whether the condition of repayment and interest etc. are complied with
- Determine the cases of default of repayment and interest payment
- Whether interest has been correctly calculated and provided for including TDS
- Advances to staff or other parties (Imprest) are routinely adjusted or are long outstanding?
- Advance to staff (salary) needs adjustments

18. Miscellaneous Assets

- Preliminary Expenses o/s are routinely written off
- Deferred Revenue Expenses has been properly classified, w/off, disclosed.
- Policy has been determined and reflected in notesto accounts
- The DRF has been rightly treated in computation

19. Purchases

- Carry out the Purchase vouching ***on actual basis***
- Verify whether outstation purchases are ***supported by transportation evidence*** and expenses

- The bill are in the parties name and address denoted is correct (see the VAT complexity)
- Import purchases are duly supported with all ***the custom documents?***
- Fluctuation on import payments are separately shown Under Income/loss from ***Exchange Fluctuation A/c***
- Is there any high seas purchases whether the procedure adopted for same is right?
- Whether ***classification of Purchase*** is right as per VAT and Excise rules?
- Whether ***Purchase register as per VAT rule*** maintained
- Accounting for purchase in respect of ***VAT & CENVAT credits is right*** and only eligible credits has been considered.
- Purchases returns are rightly recorded and not recorded as Sales
- Verify that various purchase related information furnished with VAT department etc. are tallied with books ***(Returns)***
- Is there proper system of ***maintaining credit notes*** received from the parties and same has been rightly accounted f**or**

20. Sales

- Carry out the Sales vouching ***on actual basis***
- Whether ***retail/or tax invoice*** has been rightly raised on customers? Invoices carry the VAT no.
- Make out ***quarterly/monthly statement chart*** to cross check with the Sales register; whether ***returns*** are timely filed.
- Verify whether outstation sales are supported by***transportation evidence*** and expenses
- The bill are in the parties name and address denoted is correct (see the central sales angle)
- Exports are duly supported with all the ***custom documents*** and recorded on GR prices?
- Fluctuation in realization are separately shown under Income/loss from ***Exchange Fluctuation A/c***
- Is there any high seas sales whether the procedure adopted for same is right?
- Whether ***classification of sales*** is right as per VAT and Excise rules?
- Whether ***Sales register as per VAT rule*** maintained
- Accounting for sales in respect of ***VAT & CENVAT credits is right***
- ***Sales returns are rightly recorded*** and not recorded as Purchases
- Is there proper ***system of maintaining debit notes*** received from the parties and same has been rightly accounted for.

21. Gross Receipts (Service Industry)

- Carry out the Receipts vouching on actual basis
- Whether invoice has been rightly raised clearly Showing Service tax no. and amount of tax.
- Make out quarterly/half yearly statement chart to cross check with the ledger; whether returns are timely filed and tax are timely deposited.

22. Input Credit for Services

In case of Auditee who are covered under service tax

- Only credits on eligible inputs services claimed
- (the services which contribute to earn taxable revenue)
- Whether proper record of eligible services kept and are
- Duly supported by documents
- If opted for confessional scheme no input credit availed
- Input credit has been adjusted within the quarter

23. Debit Notes & Credit Notes

- In case the company issues debit/credit notes whether these are serially numbered and serially kept.
- The company has recorded all the credit/debit notes in books of account.
- The company have the policy of issue its own debit/credit notes in respect of credit/debit notes received from the party. Or it is simply issuing credit notes and recording debits on the basis of other party credit notes.

24. GP Ratio/NP Ratio

- Is the stock records are maintained or company is working out stock on GP basis?
- Whether the GP ratio and NP ratio of the company is comparable with the previous year and consistent. If not, the reason there of.
- If the company is dealing in different type of products the GP ratio should be separately worked out for each class of products.
- Calculate GP/NPRatio, stock turnover ratio and Material consumption ratio as desired in 3CD form (basis of calculation ?)

25. Comparative Charts of Expenses

- Prepare a chart showing comparative figure of current and previous year
- Work out the differences in % and absolute terms in two separate column and analyze major deviation.
- Justify deviation in terms of increase/decrease of sales other factors like change in pattern or *modus operandi* of business and exceptional factors.

26. Vouching of Expenses to determine personal expense Cash payments, prior period, non-business expense and Verifty:

The vouchers are supported by proper evidence
The evidence pertains to the company
The dates of evidence fall with in the financial year
The heads of account is right
The vouchers are authorized
The revenue stamp affixed wherever applicable
The mark of posting has been in case of manual vouchers

27. Manufacturing Expenses

Salary & Wages – properly classified in Manufacturing & Administrative
Energy – connection wise chart of electricity and month-wise Of other consumption along with production details:
Consumables – Major expenses
Factory Rent – Premises wise/month wise
Fright Inward – Month wise with Purchases figure
Statutory Dues – Pollution Exp etc.

28. Admin & Selling Expenses details:

Salary chart
Rent (Property wise month wise)
Interest (Loanee wise)
Electricity (Connection wise/bill wise)
Generators (Monthwise)
Telephone, Mobile & Internet (connection wise)
Postage & Courier (Month Wise)
Conveyance (employee wise)
Tour & Travelling (tour wise)
Printing & Stationery (major payment)
Business Promotion (major payment)
Vehicle Running (month wise and major payment)
Professional payments (professional wise with cause)
Legal Expenses
Repair & Maintenance (major payments)

29. TDS Compliance on various expenses made

Income-tax

- Whether TDS has been deducted on all the eligible expenses like contractors payment, salary, interest, Professional services, brokerage & commission, Rent, Lease rent of moveable assets etc. List down the case Where no-tax has been deducted at source.
- Whether TDS so deducted has been deposited, list down the cases of TDS not deposited or late deposited
- Whether TDS returns are timely submitted, obtain list of return so submitted with acknowledgement no.

VAT

- Whether TDS has been deducted on all the eligible Payments to contractors.
- Whether TDS so deducted has been deposited
- Whether TDS returns are timely submitted

30. Accounting Policies

Make the disclosure of accounting policy regarding:

- Fixed Assets & Depreciation
- Revenue Recognition
- Inventories
- Investments
- Retirement benefits
- Foreign Exchange Transactions
- Preliminary and DRF write-offs

31. Notes to Accounts
32. Compliance to Accounting standards
33. Tax Audit Report & Annexure
34. CARO.
35. Special matter – Audit Report.
36. Directors Report.