

Date: 24<sup>th</sup> November, 2014

**Last date for submission of views/ comments/ suggestions extended upto 10<sup>th</sup> December 2014**

On

**EXPOSURE DRAFT**  
**Guidance Note on Internal Audit of**  
**Engineering Industry**

*The last date to submit the views/ comments/ suggestions has been further extended from 19<sup>th</sup> November 2014 to 10<sup>th</sup> December 2014. Please submit the views/ comments/ suggestions preferably by email at [pd.budhiraja@icmai.in](mailto:pd.budhiraja@icmai.in) or [pd@icmai.in](mailto:pd@icmai.in) latest by **10<sup>th</sup> December 2014**.*

*The comments/ suggestions on any aspect of this Exposure Draft would be most helpful if they indicate the specific paragraph or group of paragraphs including page number to which they relate, also contain a clear rationale and, where applicable, provide a suggestion for alternative wording.*

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Date: 22<sup>nd</sup> October, 2014

**EXPOSURE DRAFT**  
**Guidance Note on Internal Audit of**  
**Engineering Industry**

*The following is the Exposure Draft of Guidance Note on Internal Audit of Engineering Industry issued by the “Professional Development Committee” of the Institute of Cost Accountants of India, for comments and suggestions. The comments/ suggestions on any aspect of this Exposure Draft would be most helpful if they indicate the specific paragraph or group of paragraphs including page number to which they relate, also contain a clear rationale and, where applicable, provide a suggestion for alternative wording.*

*The proposed Guidance Note may be modified in light of comments/ suggestions received before the same is being issued as Guidance Note on Internal Audit of Engineering Industry by the Institute.*

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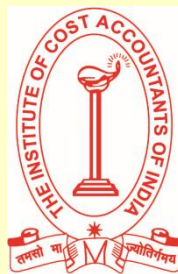
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# GUIDANCE NOTE ON INTERNAL AUDIT OF ENGINEERING INDUSTRY

LAST DATE FOR COMMENTS: NOVEMBER 12, 2014



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## **Chapter 1**

### **Introduction to Internal Audit**

- 1.1 History and Evolution of Internal Audit / Provisions of Internal Audit in Companies Act, 2013**
- 1.2 Definition**
- 1.3 Necessity**
- 1.4 Objectives**
- 1.5 Principles**
- 1.6 Strategy**
- 1.7 Approaches**
- 1.8 Terms of Engagement**
- 1.9 Independence**
- 1.10 Pronouncements**

#### **1.1 History and Evolution of Internal Audit**

The origin of audit may be traced to middle ages but the audit in the present sense can be traced after the introduction of large scale production in consequence of Industrial Revolution during the 18<sup>th</sup> century. As the operations of the organizations increased substantially, the record maintenance did not remain a task to be managed by few individuals. The complexity in the transactions, both in terms of quantity and value demanded the expertise knowledge and also certification by third independent authorities.

The word “Audit” has been defined as “such as examination of the books, accounts and vouchers of a business as will enable the auditors to satisfy himself that the balance sheet is properly drawn so as to have a true and fair view of the state of affairs of the business and the Profit and Loss Account gives a true and fair view of profit or loss for the financial period according to the best of his information and the explanations given to him.

Over a period of years, the necessity of Internal Audit gathered importance as the organizations thought it prudent to verify the transactions before the statutory audit. Subsequently, the scope of the Internal Auditor was extended to various areas viz. all aspects relating to business like stores, consumption, contracts, compliances, productivity, capacity utilization, efficiency in utilization of resources, wastages, pilferages, thefts, frauds etc. Thus, the internal audit mainly aimed at verification of transactions, protective and constructive measures to improve the performance of the organization.

The establishment of Internal Audit can be linked to the need of independent verification with a view of reducing book keeping errors, general misappropriations and fraud. The systematic verification of records and evidence started being called “Internal Audit”. It was felt that external audit at the end of the year needed to be supplemented by more frequent verification and it was equally important to review and upgrade the process and procedure of carrying out Internal Audit.



With the booming growth of business size and structure, it was felt that many businesses did not have appropriate controls in place to permit full achievement of their strategic objectives. The management of these businesses found it impossible to visually supervise all of the operating areas in their respective field of responsibility or to have sufficient personal contact with individuals, who directly or indirectly reported to them. In seeking ways to deal with these new problems, management appointed special staff people to review and report on what was happening and to probe for the “**why**”. These people came to be known as "internal auditors."

The internal audit function varied greatly as to the number of people assigned to perform it and in the scope and nature of the work being done. In some organisations, internal auditors were used to check on routine financial and operational activities with a heavy emphasis on compliance, security, and detection of fraud. In others, internal auditors were given higher levels of status and were asked to analyse and appraise more substantive financial and operational activities.

Gradually, internal auditors also began to exhibit “ industry specialisation” in terms of their domain knowledge of specific industries such as health-care, oil, gas, and energy, defense, financial services, transportation, wholesale and retail, technology, media and entertainment, telecommunications, government, non-profits and education, etc.

Companies worldwide have witnessed rapid and radical change with organization and industry wide significance. The response of company management to such aggressive global competition has led to an increase in multitudes of the quality (efforts such as six sigma) and risk management initiatives, re-engineered structures and procedures, and enhanced responsibility all based on the ever increasing need for more timely, reliable, and relevant management information. This has also led to a rats’ race between global organizations to implement effective and efficient corporate governance processes. Thus, to no one’s amazement the internal audit function is now being viewed as a qualified group of professionals who help with such experimentation with global corporate governance while supporting key governance processes of monitoring control mechanisms and ascertaining operational performance.

However, to facilitate this escalation in the demand for their services, not only do internal auditors need to obtain and display considerably enhanced set of skills and competencies but they also need to exhibit industry specialisation and exposure to a varied operating specialties within the industry. With the recent advents of increase in scope and acceptability Cost Audit and Compliance Report, CMAs are in perfect position to demonstrate the requisite skills and competencies necessary for undertaking successful Internal Audit function including risk evaluation and risk management.

#### **Legal Requirement for Internal Audit**

The compliance with the laws of the home country as well as the laws of the foreign country land for existence of businesses in India and abroad is a critical factor. As per the legal obligation / requirement under different statutes in India and abroad a Company shall have internal audit of its accounts carried out, at such interval and in such manner as may be specified .



**Clause 49 of Listing Agreement: Corporate Governance (SCRA)**

In case of the listed companies as per the Clause 49 of Listing Agreement the audit committee should be reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure, coverage and frequency of internal audit.

**Companies Act 2013**

Section 138(1) of the Companies Act 2013 provides that such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

The class or classes of companies have been defined under the Companies (Accounts) Rules, 2014 issued under Section 138(1) as follows:

**Rule 13. Companies required to appoint internal auditor:** (1) The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

- a. *every listed company;*
- b. *every unlisted public company having-*
  - i. *paid up share capital of fifty crore rupees or more during the preceding financial year; or*
  - ii. *turnover of two hundred crore rupees or more during the preceding financial year; or*
  - iii. *outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or*
  - iv. *outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and*
- c. **every private company having-**
  - i. *turnover of two hundred crore rupees or more during the preceding financial year; or*
  - ii. *outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.*

**Section 134, Sub-section 3, Clause (n)** states that the Board of Directors' Report would include a statement indicating development and implementation of risk management policy for the Company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the Company.

**Section 134, Sub-section 5, Clause (f)** also states, Directors' Responsibility Statement to include the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.



**Under Section 177 of the Companies Act 2013 the internal auditor, if any, shall attend and participate at meetings of the Audit Committee of the company.**

The provisions for constitution of the Audit Committee under Section 292A of the Companies Act 1956 has been replaced by Section 177 of the Companies Act 2013, which are as follows:

177. (1) The Board of Directors of every listed company and such other class or classes of companies, as may be prescribed, shall constitute an Audit Committee.

(2) The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority:

Provided that majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement.

(3) Every Audit Committee of a company existing immediately before the commencement of this Act shall, within one year of such commencement, be reconstituted in accordance with sub-section (2).

(4) Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include,—

- (i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;
- (ii) review and monitor the auditor's independence and performance, and effectiveness of audit process;
- (iii) examination of the financial statement and the auditors' report thereon;
- (iv) approval or any subsequent modification of transactions of the company with related parties;
- (v) scrutiny of inter-corporate loans and investments;
- (vi) valuation of undertakings or assets of the company, wherever it is necessary;
- (vii) evaluation of internal financial controls and risk management systems;
- (viii) monitoring the end use of funds raised through public offers and related matters.

(5) The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

(6) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in sub-section (4) or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.

(7) The auditors of a company and the key managerial personnel shall have a right to be heard in the meetings of the Audit Committee when it considers the auditor's report but shall not have the right to vote.





(8) The Board's report under sub-section (3) of section 134 shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report alongwith the reasons therefor.

(9) Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed.

(10) The vigil mechanism under sub-section (9) shall provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases:

Provided that the details of establishment of such mechanism shall be disclosed by the company on its website, if any, and in the Board's report.

### **1.2 Definition of Internal Audit**

The Chartered Institute of Management Accountants, UK (CIMA) defines Internal Audit as:

'An independent appraisal activity established within an organisation as a service to it. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls; a management tool which analyses the effectiveness of all parts of an organisation's operations and management.'

The Institute of Internal Auditors (IIA) also defines Internal Audit on similar lines as:

'Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.'

These definitions state two clear functions of the Internal Audit activity namely;

**a) Internal Control:** Internal controls direct, monitor, and measures the company's resources and help to detect and prevent fraud from occurring within an organisation. It can be defined as a process which is performed by the employees of the company as well as the information technology systems that are used to assist the company in achieving its objectives. The management of a company is responsible for establishing the system of internal controls within the organisation, but internal auditors test the controls to make sure they are working effectively.

**b) Management Tool:** Internal Audit has been used as a management tool which monitors and evaluates the effectiveness of operational processes and risk management of a company. How an organisation sets their objectives and responds to the risks associated with their objective is part of the risk management process. Risk management is a way for companies to manage uncertainty through risk assessment, to develop strategies to manage risk and to mitigate risk by using managerial resources.

**c) Internal Check:** The term Internal Check is different from Internal Audit. Internal Check implies that the entries passed by one person are automatically checked by another person at the same time. In Internal



Check, the system is so devised that the chances of fraud, misappropriation are minimized unless done by collusion.

Thus, Internal Audit as a function must make recommendations to improve the overall internal control environment including financial and legal compliances, to safeguard assets and to improve the operational performance of the organisation as a whole.

### **1.3 Necessity of Internal Audit**

Internal audits provide a number of important services to company management. These include detecting and preventing fraud, testing internal control, and monitoring compliance with company policy and government regulation. Smaller companies may require these functions even more than large companies. A small business simply cannot afford employee fraud, waste, or a government fine. Establishing an internal audit function provides a vital step in the growth of a small business.

Auditing is a means of evaluating the effectiveness of a company's internal controls. Maintaining an effective system of internal controls is vital for achieving a company's business objectives, obtaining reliable financial reporting on its operations, preventing fraud and misappropriation of its assets, and minimizing its cost of capital. Both internal and independent auditors contribute to a company's audit system in different but important ways. Some of the important benefits are -

#### **Business Objectives**

Having an effective audit system is important for a company because it enables it to pursue and attain its various corporate objectives. Business processes need various forms of internal control to facilitate supervision and monitoring, prevent and detect irregular transactions, measure ongoing performance, maintain adequate business records and to promote operational productivity. Internal auditors review the design of the internal controls and informally propose improvements, and document any material irregularities to enable further investigation by management if it is warranted under the circumstances.

#### **Risk of Misstatement**

Auditors assess the risk of material misstatement in a company's financial reports. Without a system of internal controls or an audit system, a company would not be able to create reliable financial reports for internal or external purposes. Thus, it would not be able to determine how to allocate its resources and would be unable to know which of its segments or product lines are profitable and which are not. Additionally, it could not manage its affairs, as it would not have the ability to tell the status of its assets and liabilities and would be rendered undependable in the marketplace due to its inability to consistently produce its goods and services in a reliable fashion. Accordingly, an audit system is crucial in preventing debilitating misstatements in a company's records and reports.

#### **Fraud Prevention**

Internal audit serves an important role for companies in fraud prevention. Recurring analysis of a company's operations and maintaining rigorous systems of internal controls can prevent and detect various forms of fraud and other accounting irregularities. Audit professionals assist in the design and modification of internal



control systems the purpose of which includes, among other things, fraud prevention. An important part of prevention can be deterrence, and if a company is known to have an active and diligent audit system in place, by reputation alone it may prevent an employee or vendor from attempting a scheme to defraud the company.

### **Cost of Capital**

The cost of capital is important for every company, regardless of its size. Cost of capital is largely comprised of the risk associated with an investment, and if an investment has more risk, an investor will require a higher rate of return to invest. Strong audit systems can reduce various forms of risk in an enterprise, including its information risk (the risk of material misstatement in financial reporting), the risk of fraud and misappropriation of assets, as well the risk of suboptimal management due to insufficient information on its operations.

### **Legal Compliances**

The area of Legal Compliance is an integral and important part of Internal Audit. The purpose of this is to ensure that all the Legal Compliances under various laws viz. Income-tax, various Labour and Industrial Laws, Central Excise, State VAT Act, Environmental Laws, Pollution Control Laws etc. are complied in time. In case of any non-compliance, the Internal Auditor has to report the reasons and also suggest remedial steps for its non-recurrence.

### **Monitoring Controls**

The Internal Audit function must clearly understand the quality and risk management philosophy of the organization before evaluating or reporting on the efficiency and effectiveness of the implementation of management policies.

### **Analyze Operational Performance**

Internal Audit function works closely with lower and middle level managers to review daily operations then report their findings. The strategic objectives of the organization play a significant role in understanding how the operations of any given part of the organization fit into the macro level picture.

In addition to this, business has become more dynamic necessitating regular review of Contribution (Sales Value minus Direct Costs)/ per machine hour or per unit of Key Limiting Factor etc and interpretation of cost data.

It is necessary for every company to continuously ensure authenticity and reliability of data generated and used for decision making and also to avoid duplication of data. It is necessary to verify the source, the quantum and the reliability of all records. The Internal Audit function will primarily concentrate on the system for collection, collation and analysis of data to go into final cost compilation and decision making. The main objective of Internal Audit of Accounts is, to ensure implementation of Control and continuous monitoring of systems being followed.

#### **1.4 Objectives of Internal Audit**

Internal audit is an independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic and effective use of resources.

**The essentials for effective internal auditing are:**

**(a) Independence**

The internal auditor should have the independence in terms of organisational status and personal objectivity which permits the proper performance of his duties.

**(b) Staffing and training**

The internal audit unit should be appropriately staffed in terms of numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditor should be properly trained to fulfil all his responsibilities.

**(c) Relationships**

The internal auditor should seek to foster constructive working relationship and mutual understanding with management, with external auditors, with any other review agencies and, where one exist, the audit committee.

**(d) Due care**

The internal auditor should exercise due care in fulfilling his responsibilities.

**(e) Planning, controlling and recording**

The internal auditor should adequately plan, control and record his work.

**(f) Evaluation of the internal control system**

The internal auditor should identify and evaluate the organisation's internal control system as a basis for reporting upon its adequacy and effectiveness.

**(g) Evidence**

The internal auditor should obtain sufficient, relevant and reliable evidence on which to base reasonable conclusions and recommendations.

**(h) Reporting and Follow-up**

The internal auditor should ensure that findings, conclusions and recommendations arising from each internal audit assignment are communicated promptly to the appropriate level of management and he should actively seek a response. He should ensure that arrangements are made to follow up audit recommendations to monitor what action has been taken on them.

All the above points have been dealt with in details in latter chapters.

### **1.5 Principles of Internal Audit**

The 'Principles of Internal Audit' act as guidelines or standards for undertaking an Internal Audit Function. These principles entail a general list of rules that enable an internal auditor as well as an organisation to not only setup a robust and well-oiled internal audit function but also evaluate gaps in the existing internal audit framework. A detailed note on each of the principles is provided in the ensuing chapters and forms the basis for undertaking an effective and efficient internal audit. The essentials of an internal audit are mentioned as under:

#### **a. Independence and Integrity**

Independence of the internal auditor is vastly different from that of the external auditor. The Internal Auditor may be an Employee of the Organisation heading separate Department or a Third Independent party. In any case, the Internal auditors should be independent in terms of bias or undue influences, organizational status and personal objectivity, which permit the proper performance of duties and provide decision-able recommendations and findings. The reporting framework of internal auditors should also be reminiscent of the individualistic and consultative nature of the activity.

Along with due independence, the internal auditor needs to depict certain personal and professional attributes which shall enhance the integrity and acceptability of the report. These include but are not limited to: honesty, sincerity, impartiality, business acumen, effective communication skills, and should try to maintain arm's length from all organization's members.

#### **b. Terms of engagement**

The Terms of Engagement of an internal audit team means to accept an internal audit assignment for an organization post agreement of the activities to be undertaken and formalizing all preconditions of the internal audit. The Terms of Engagement are a common understanding of the terms of reference for the internal audit between the internal audit team and management of the organization. These common understandings have been specified in further detail later on.

#### **c. Strategy and approach**

The internal audit strategy describes the role of internal audit within the organisation's overall assurance processes and provides an important link between the internal audit charter and the detailed internal audit work plan. It is expected that the strategy will set out:

- 1) the organisation's assurance requirements and the contribution of the internal audit function to that assurance over the period covered by the strategy;
- 2) the broad details of the audit, audit support and non-audit activities that internal audit will undertake; and
- 3) the proportion of resources that will be devoted to the different types of activities that will be undertaken.

The period covered by the strategy can vary, but would normally cover a three to five year period and be reviewed at least annually.

**d. Responsibilities of Internal Audit**

- 1) Develop an audit plan to evaluate the institution's financial, operational and EDP controls.
- 2) Assess the economical and efficient use of resources.
- 3) Determine the level of compliance with established laws, rules, policies and procedures.
- 4) Recommend adoption of desirable policies or changes to existing policies.
- 5) Follow-up on the adequacy of corrective actions.
- 6) Conduct special projects at the request of the Board.
- 7) Investigate cases of misappropriation, misconduct, fraud.
- 8) Establish and maintain professional rapport with external auditors and management.
- 9) Keep Audit Committee and Board fully informed on a timely basis of the activities of the Internal Auditing Department.
- 10) Follow the Standards of the Professional Practice of Internal Auditing and Code of Ethics as promulgated by the Institute of Internal Auditors.

**e. Planning of internal audit**

Internal audit function aligns focus and activities to the organisation's risks. To achieve alignment between the organisation's risks and internal audit coverage, it is imperative that internal audit planning to occur in the context of company-wide assurance mapping, which can be commissioned by the Audit Committee. Within this context, internal audit planning generally involves a detailed work plan, prepared on an annual basis. To provide context, the work plan might be supported by a schedule of potential audits and an indication of previous audit coverage. This document serves the purpose of setting out in strategic and operational terms the broad roles and responsibilities that are included in the internal audit charter and identifying key issues relating to internal audit capability, such as required skills.

**f. Staffing and Training**

The internal audit should be headed by a person who has substantial exposure to the working of the industry that the company is involved in and also possesses the requisite knowledge of compliances to be adhered to. He or she should be able to plan, direct, control, motivate and organize resources and deliver on timelines to ensure the responsibilities of the internal audit unit are met.

It is important to analyse the budget and time constraints along with the scope and audit plan to determine the appropriate background, skills and competencies that would be required by the internal audit team. An internal audit team requires both technical and soft skills to undertake a smooth internal audit function. The team needs to display a variety of skill levels, qualifications and technical know-how.

It is the responsibility of the organisation to ensure that the internal audit team has accurate knowledge of the organisation's structure and peculiarities related to its functioning. If required, the internal audit team may have to undergo specific trainings to meet the basic objectives of the audit and assess operational risks. Just as the external auditors, the internal auditor should keep abreast of current developments, improvements, new techniques and practices in internal auditing to properly equip him for any unique challenge he may encounter during this rigorous audit process.

**g. Evaluation of Internal Systems and Risk assessments**

Internal Audit entails a through systems analysis and audit. Internal audit establishes appropriate criteria to determine whether the controls are adequate and assist in achieving the objectives of the system. The stages of a systems audit would normally be:

1. Identification of systems and procedures
2. Ascertaining control objectives
3. Defining control mechanisms to be implemented
4. Reviewing the changes to be implemented to adhere to controls
5. Implementing new controls and monitoring their performance and adequacy
6. Providing a formal opinion on audit objectives and adequacy of control mechanisms internal Audit establishes standards and provides guidance on obtaining an understanding of the accounting and internal control systems and on audit risk and its components:
  - 1) inherent risk,
  - 2) control risk and
  - 3) detection risk.

The auditor should assess audit risk and to design audit procedures to ensure that the risk is reduced to an acceptably low level.

**h. Evidence and Analytical Procedure**

The recommendations, findings and comments of the internal audit report should all be based on and supported by appropriate and adequate audit evidence. Evidence should cover all activities checked and controlled by the audit plan with specific notes for possible errors, their materiality and risks of occurrence. An internal auditor should obtain the evidence considered necessary for the achievement of the internal audit assignment objectives. The level of detail required for this evidence depends on the objective and scope of the audit, scale of misstatement or level of risk, cost and time involved in obtaining the evidence and finally reliability of the evidence. Reliance on evidence can be satisfied with its nature, extent, adequacy, consistency and relevance to the internal audit assignment and with the methods governing its collection.

**i. Report Writing, Presentation and Follow-up**

The internal audit report must be written after careful review and analysis of the various audit evidences, notes on internal control systems and risk assessments undertaking during the audit. In case internal

auditors come across any fraud or misrepresentations or misappropriations, they have to be reported to the organisation's management or Audit Committee. The internal audit report provides a formal platform to the internal audit team to share its findings, recommendations and comments to the management. The internal audit report should recommend actions for performance improvement and control, and formal records for areas wherein audit was undertaken.

The format and schedule for sharing of the internal audit report presentation should be agreed with the management prior to augment of the assignment. All functional managers should be communicated the audit findings related to their respective areas and final list of actionable decisions must be shared by appropriate management representatives to enable them to take informed decisions. Once, the management has provided for suitable consideration to the internal audit report, the decision points and thereby the recommended actions to be undertaken must be formally recorded along with clear statement of responsibility for completion of assigned tasks.

### **1.6 Strategies to Internal Audit**

As mentioned above, the Internal Audit strategy acts as a link between the internal audit charter and the work plan. An internal audit strategy helps in focusing internal audit effort, where it is most useful and effective. The time and resources involved in developing the internal audit strategy should be commensurate with the size and complexity of the organisation and should also align with the organisation's strategic decision. To analyse the internal audit strategy in further detail, it is necessary to understand its purpose, contents of a good strategy and the methodology for development and selection of internal audit strategy.

#### **a) Purpose of Internal Audit Strategy**

An Internal Audit Strategy is based on the aim and scope of the internal audit. An internal audit strategy helps in:

- a) A bird's eye view of the overall governance, risk management and control system of the organisation,
- b) Focusing the internal audit effort where it is most useful and effective, keeping track of the budgeted time and cost,
- c) Minimising repetition and eliminating duplication of assurance effort,
- d) Ensuring that there are no gaps in the internal audit function and the entire spectrum of control system is analysed,
- e) Identifying the requisite skills, resources and specialisations to deliver an efficient internal audit function,
- f) Providing a reference point and setting up the basic framework for performance appraisal of all functions.
- g) Assessing risk and identifying steps and procedures to mitigate risk.



- h) Introducing a culture of continuous improvement and enhancing feedback by formalizing the communication channel.

**b) Contents of a good of Internal Audit Strategy**

The basic structure of the Internal Audit Strategy will be based on the type of audit being undertaken, expectations of the Audit Committee and management, and finally the size and nature of the Internal Audit function. The precise format and contents would, hence, vary from one organisation to another. However, any internal audit strategy would benefit by incorporating the following:

- i. A brief description of the approach of internal audit selected in developing the strategy and a list of key managers who approved the strategy;
- ii. A short summary on the organisation's prima facie risks (both external and internal);
- iii. A description of the industry that the organisation operates in and positioning of the organisation in comparison to the industry standards;
- iv. A general SWOT analysis of the organisation banks on to deliver commitments and sustain growth;
- v. An estimate of the financial, operational, sales, and human resources budgets and targets over the period of the strategy;
- vi. The parameters of time, effort and costs considered to formulate the internal audit work plan;
- vii. The allocation of resources to the Internal Audit function along with the time lines for delivery;
- viii. The balance of various types of internal audits to be undertaken along with the approved audit scope;
- ix. The frequency, distribution and level of detail in the internal audit report;
- x. The details of function-wise and SBU-wise KPI and KRA (Key result areas);

**C. Development and selection Internal Audit Strategy**

As mentioned above, the time and resources involved in developing the strategy should be commensurate with the size and complexity of the organisation, and have regard to the organisation's risk profile and the maturity of the organisation's risk management processes. The process would also be expected to be consistent with the organisation's usual business planning processes. In developing the strategy, consideration would normally be given to the following factors:

**a) The organisation's Internal Audit objective and business strategy**

The organisation's Internal Audit objective will determine the strategy to be undertaken. The strategy may have to involve multiple and varied expectations of the audit committee and management and helps communicate the direction internal audit intends to pursue over the life of the plan. These expectations or targets may often include staff training and development, analyzing risks and developing mitigation strategies, reviewing the internal control systems, improving audit and other processes, introducing new technologies or enhancing performance measurement and appraisal.

In order to deliver the an effective internal audit report, the strategy must align with the organisation's strategic direction and demonstrate a good understanding of the goals, objectives and priorities of the organisation as set out in corporate and business plans. Such a statement also provides a focus to develop

and prioritize management strategies and tasks designed to achieve those objectives. Business objectives can vary considerably, but often include matters relating to the quality, cost-effectiveness and nature of the audit and other services provided by internal audit designed to meet the organisation's needs. The service delivery model in place will also influence, and be influenced by, the management strategies adopted.

**b) The Internal competencies of the organization**

The Internal Audit Strategy would be largely influenced by the demography and size of the organisation and its resources. The strategy plans will vary for organisations with different levels of financial, operational, and human resource capabilities. The size and skill level of the internal audit team is also to be considered when developing the strategy. The coverage area should be commensurate with the size and ability of the team else meeting deadlines would be difficult and could severely hamper the quality of the final internal audit report.

**c) The external factors affecting the organization**

The internal audit strategy is generally developed after considering government policy, economic and social conditions and the expectations of external stakeholders such as vendors, customers, government, public agencies and competitors. External sources for management information and data collection include reports from Parliamentary Committees, central agencies, industry regulators, independent reviewers; rating agencies and external consultants help ascertain threats and opportunities which should be considered as part of developing the internal audit strategy. The expectations of external stakeholders to whom the organisation has a reporting requirement such as Institutional Investors must also be involved. All of these factors together influence the internal audit strategy and must be continuously monitored to ensure no opportunity is missed and no major risk adversely affects the organization's performance.

**d) The organisation's risk structure and mitigation plan**

The organisation's current and future risk profile will also be an important influence on the internal audit strategy. Provided the company's risk identification process and risk management framework is mature, its risk management plans will be a key source of information in developing the internal audit strategy. In case the organisation does not have a formalised risk assessment and management framework, one of the initial steps incorporated in the strategy would be to formulate and setup the risk management team and plan. The organisation's current and future risk profile would also influence on the types and level of internal audit activity.

In certain situations where the company does not have a mature risk management framework, internal audit will need to develop and modify the existing risk management structure after discussion with the Audit Committee and the senior management of the organisation. The risk management structure will provide a base for mitigation of both internal and external risks.

**e) Assurance and review of internal control systems**

In certain situations where the company does not have a mature risk management framework, internal audit will need to develop and modify the existing risk management structure after discussion with the Audit

Committee and the senior management of the organisation. The risk management structure will provide a base for mitigation of both internal and external risks.

**f) Mapping the Internal Audit coverage**

Organisations are increasingly noticing the benefit in conducting an assurance mapping exercise. This consists of an analysis of the significant risks facing the organisation and the extent to which each of the various assurance elements addresses these risks. Such an exercise can be a very useful way of obtaining a broad organisation-wide perspective of the assurance landscape, assist in demonstrating an alignment between the organisation's risks and the proposed assurance coverage, highlight organisation risks that are not being addressed by the assurance program and assist in identifying any gaps or duplication. The internal auditor uses these assurance maps to develop an overall opinion on the organisation's control environment. Thus, it is important that internal audit coverage complements, rather than duplicates other assurance and review activities. An assurance map assists internal audit to identify any gaps or duplication and to develop its work plan, to develop its work plan and to assist the Audit Committee in undertaking the assurance mapping process.

Examples of possible themes include governance, policy and strategic planning, program and project management, client relationships, financial, human resources and information technology systems.

**g) Budget Consideration**

As a matter of principle, the internal audit strategy should first address all the activities that internal audit, the Audit Committee and other stakeholders consider should be included, before reflecting on the possible budget available. However, in case the expectations far exceed the approved budget, the internal audit function can request for an updated budget.

The size of the investment the company wishes to make in internal audit would normally be determined by the Board on the advice of the Audit Committee and multiple factors would be considered before finalization. The internal audit strategy should outline the issues that will be considered in the development of internal audit work plans and should address the achievement of the appropriate level of coverage and the prioritization of reviews.

**h) Management Expectations**

It is important to obtain the views of management about their expectations of the internal audit function. Thus, it can be expected that management could have differing expectations of internal audit and its focus and priorities. In these circumstances, it is important for internal audit function to work through the different perspectives and have follow-up discussions, as required, to ensure that the role of internal audit outlined in the internal audit strategy considers the views similar to that of the management. In its consideration of the strategy, the Audit Committee should be made aware, at least in broad terms, of the views of key stakeholders, particularly if they are not reflected in the document presented.

Generally good Internal Audit function will evolve long term strategy to bring in effective Internal Audit by adding new areas and more detailed analysis year after year as, it may not be possible always to implement everything from very first year.

### **1.7 Approaches to Internal Audit**

An internal audit will involve a combination of audit approaches and techniques. These include interviews, document reviews, sampling, testing of controls, and analysis of transaction, processes and management information. The audit approaches selected should be the most time and cost- effective given the objectives and scope of the audit. The aim is to collect sufficient, reliable, relevant and useful evidence to enable the internal auditor to come to well-founded conclusions about the program or activity under review and to make appropriate recommendations. Decisions will have to be made at each stage of the internal audit regarding the need for specific testing, data collection and analysis and the extent that reliance can be placed on work of other internal or external reviewers.

#### **Features of Internal Audit procedures are:**

- (a) The Internal Auditor shall have unrestricted access to all records, personnel, and equipment in carrying out the objectives of an audit.
- (b) All Board members have unrestricted access to the Internal Auditor. The Internal Auditor has unrestricted access to all Board members. This promotes independence.
- (c) The Internal Auditor shall develop an audit plan for review and approval by the Audit committee. The audit plan shall be approved annually. The audit plan is based on audit risk areas identified by Board members, top management, external audit results, and internal auditor experience. The Internal Auditor will develop audit objectives and scopes for each audit on the approved audit plan for the president's review and the Audit Committee's review and approval. The audit plan is sufficiently flexible to cover unanticipated demands on the Internal Auditor given the changing college environment, e.g., unanticipated internal audit areas may surface due to external audit results, or evidence of fraud may surface that requires immediate Internal Auditor attention. The Audit Committee shall review and approve a change in the audit plan.
- (d) The Internal Auditor shall notify the department being audited of the objective and scope of the audit and the timetable for completion of the audit.
- (e) The Internal Auditor shall perform audits in accordance with generally accepted auditing standards.
- (f) The Internal Auditor may perform different types of audits:

#### **Types of Audit:**

There are several types of internal audits. There are financial audit, operational audit, management audit, compliance audit, IS audit, Cost Audit and investigation audit. Each audit has different purpose and characteristic.



**a) Financial Audit**

The purpose of financial audit is to express opinion on financial condition based on analysis, comparisons and test of accuracy. Its scope is on the financial records. The results or comments expected from the audit are to give opinion on the accuracy and reliability of the financial statements.

**b) Operational Audit**

The purpose is to analyse and improve methods of operations and performance of a unit or department. The results or comments expected from the financial audit are to give recommendations to management for the improvement of operations.

**c) Management Audit**

The purpose is to review and evaluate business and management issues to enhance profitability. Its scope is on the business support activities of a unit or the entire organisation. The results or comments expected from the audit are to give opinions on strategic issues and recommendations or solutions.

**d) Compliance Audit**

The purpose is to express opinion as to adherence to internal policies and regulatory rules and requirements and applicable laws relating to the specific aspects of operations and business. The results or comments expected from the audit are to make immediate rectification and compliance thereafter.

**e) IS Audit**

System Audit is a new area of internal audit and the purpose is to audit on the computer systems and the provision and management of information. The purpose of this audit is to analyse the flow of transactions done in the system, mapping of various transactions, missing links in reporting, control measures incorporated in the system, their effectiveness and observance, review etc. Its scope is on the technical reviews on computer systems and their peripherals. The results or comments expected from the audit are to give recommendations on computerization and information systems related.

**f) Investigation**

The purpose is to audit in depth irregularities such as misappropriation of bank's assets or reported fraud or allegations. Its scope is in the area specified to determine modus operandi. The results or comments expected from the audit are to give conclusion to findings with recommendations to prevent recurrence. These types of audits are also undertaken on specific assignment basis by specialized internal audit teams.

**g) Full Audit**

Normally, full audits are required when an area has never been audited before, or significant changes have occurred subsequent to the last audit. A full audit requires completion of all of the following phases:

1. Preliminary Survey and Planning
2. System Documentation
3. Internal Control Evaluation
4. Audit Program
5. Audit Testing

## 6. Reports and Conferences

### **h) General Audit**

A general audit usually does not require the completion of all the phases of a full audit. The topics are usually conducted year after year and tend to require the same testing. There is no need to fully document the system and consider the impact of internal controls again - it is only necessary to ensure that the system has not drastically changed since the prior audit.

### **i) Spot Audit**

A spot audit is a periodic audit of a particular transaction at a particular point in time which gives reasonable assurance that controls in place are still working. Results of spot audits may help determine if a full audit should be scheduled. Examples are: an inventory location test, a surprise cash count, or an unannounced payroll distribution.

### **j) Situational Audit–**

A situational audit is narrower in scope than a full audit. It is usually an unanticipated project that may take priority over a planned audit. The focus is usually based on a previously identified specific control weakness, or the likelihood that a weakness not readily identifiable exists. Examples are: a management or Board requested special project, an integrity or fraud related issue.

### **k) Follow-up Audit**

The focus of a follow-up audit is to contact the audited department to determine if previously agreed to recommendations have been implemented. The follow-up audit may require additional testing to ensure that controls are working and effective as anticipated. An attempt should be made to conduct a timely follow-up audit if a previous audit uncovered serious control issues.

### **l) Opinion**

An opinion may be required regarding a specific issue, procedure, or task. It is part of Internal Audit's responsibilities to provide counsel to management. Providing a professional opinion requires fact-finding research such as reading authoritative texts, holding discussions with key staff, and reviewing results of previous audits as applicable.

In addition to these general approaches, the Institute of Internal Auditor's Research Committee also shortlisted the following five "Value Added Approaches" to internal audit function. These approaches were accepted as basis for identifying emerging focus areas in which internal auditors could add value using non-traditional and innovative approaches. A brief description of each value addition approach follows.

### **m) Project Management**

Project Management Audit is the list of activities performed by the internal audit function for the organisation's project management initiatives. Some organizations do not have a dedicated Project Management Office (PMO) or Project Management (PM) framework. Internal audit's engagement may include the following types of activities:

- i. Plan-Do-Act-Check process determination
- ii. Process information flow
- iii. Monitoring and Controlling project resource allocation process
- iv. Project Risk management

**n) Enterprise Risk management (ERM)**

ERM is generally referred to the methodology implemented by organisations to strategically confront risks and leverage opportunities by implanting risk awareness into the strategy planning and implementation process. ERM is different from internal audit risk assessment as it aims to achieve broader initiatives of connecting risks to strategic objectives, developing risk response mechanisms, and managing risk to within risk taking ability of the enterprise. The Internal audit function is involved in a number of ways in risk management process in line with general guidelines stating the acceptable roles internal audit team can take on with respect to ERM. The figure below helps determine the extent to which internal audit function can support ERM implementation for an organization.

**o) Corporate Governance**

Corporate governance was first formally introduced in England by Kraft Foods Inc founder James L. Kraft. It is defined as the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of the many stakeholders in a company - these include its shareholders, management, customers, suppliers, financiers, government and the community. The Internal audit function plays a significant role in assisting the company's management with corporate governance. The type of activities performed by internal audit can typically be related to the maturity of the Governance Model in the organization.

**p) Social audits**

Social audits include the processes and practices by which an organization integrates its social responsibilities and sustainable business practices in its daily activities and way of working. Social responsibilities of an organization include various activities such as promotion of public interest, charities, and other philanthropic activities. Sustainability includes practices to promote environmentally friendly activities, prevent environmental disasters, or prevent fraudulent selling while maintaining profitability. Social and sustainable growth goals are gaining increasing importance in business in recent times.

**q) Strategy Audits**

Strategy audit generally comprise of two major activities namely; accurately assessing the strategy setting process with control measure and comparing the direction of the business to the planned direction as outlined in the strategic plan. The definition of business strategy is a long term plan of action designed to achieve a particular vision or set of goals or objectives. The internal audit function can add value through strategy audits and emerge as a key consultant who advises the management and the board on the risks and controls that impact achievement of strategic objectives and value creation.

### **1.8 Terms of Engagement**

The internal audit team must have the confidence and trust of the key stakeholders it works with and be seen as a credible source of assurance and advice. This confidence should not be assumed and can only be established and maintained by having effective working relationship, by delivering high-quality and timely advice and internal audit reports that are seen to be contributing directly to assisting the organisation to meet its responsibilities. The key stakeholders of internal audit are:

- i. Chief Executive
- ii. Board of Directors
- iii. Audit Committee
- iv. Senior management
- v. External auditor
- vi. Other reviewers

It is important that details of these relationships are formalised in documents such as the internal audit charter or the Audit Committee charter, good relationships also need to exist at a practical working level to be effective. The importance of these individual relationships is analysed below.

#### **a) Chief Executive**

While internal audit reports functionally to the Audit Committee, it is important that the Head of Internal Audit has direct access, as and when required, to the Chief Executive. Organisations today, recognize the advantages in making the Head of Internal Audit directly accountable to the Chief Executive. This not only sends a clear signal about the importance of the internal audit function, it also facilitates regular contact between the Chief Executive and internal audit. This should not be seen as diminishing the role of the Audit Committee, which still advises the Chief Executive on governance issues, but as ensuring unimpeded communication, when required. This contact should be used as an opportunity for internal audit to gain insights into new and emerging risks and issues facing the organisation and to discuss the role the Chief Executive expects internal audit to fulfill in the company.

#### **b) Board of Directors**

The Head of Internal Audit may formally report to the Board of Directors on the effectiveness of the internal audit function. As the Audit Committee is usually a sub-committee of the Board, this responsibility is often delegated to the Audit Committee. Although the Head of Internal Audit may meet with the Chair and members of the Audit Committee, some Boards periodically meet with the Head of Internal Audit to exchange views and ideas. As a minimum, it is important that the Head of Internal Audit has direct access to the Chair of the Board and the Chief Executive, as and when required.

#### **c) Audit Committee**

Audit Committees play an integral role in the governance framework of organisations. Audit Committees assist Chief Executives and Boards to understand whether key controls are appropriate and operating



effectively. In this respect, the relationship between internal audit and the Audit Committee is crucial and has a number of dimensions which are mentioned below:

- a) Advise the Chief Executive about the internal audit plans of the organisation;
- b) Direct or Coordinate work programs relating to internal and external audits;
- c) Review the content of internal and external audits to identify significant matters of concern, and to advise the Chief Executive on good practice or opportunities for improvement;
- d) Review the adequacy of responses to reports of internal and external audits;
- e) Endorse the internal audit charter and be responsible for either reviewing and approving internal audit plans, or recommending their approval by the Chief Executive/Board of Directors;
- f) Act as the internal audit function's primary client and form a sound professional relationship with the internal audit team as a whole and each of its members;
- g) Utilize internal audit reports and its general interaction with the Internal Audit team, to assess the effectiveness of controls and the performance of the organisation and
- h) Utilize the internal audit function to undertake secretariat compliance

Given this relationship, it is important that both formal and informal lines of communication be maintained between internal audit and the Audit Committee and with individual committee members, particularly the Chair. Audit Committee members should be in a position to be able to openly discuss matters of interest with the Head of Internal Audit. In doing this, committee members must be confident that such discussions will be treated in confidence by internal audit.

It is generally accepted that the Head of Internal Audit, will attend Audit Committee meetings unless there are exceptional circumstances requiring them to be excluded for a particular agenda item. It is also good practice for the Audit Committee to meet privately with the Head of Internal Audit from time to time to ask questions and to seek feedback from internal audit without management being present. This practice also supports the independent role of internal audit.

To assist the Audit Committee in its monitoring responsibilities, internal audit should report to the committee on a regular basis on the status of the internal audit work plan. This report should also provide details of audit activity against planned audits, together with explanations of any significant variations. Internal audit should provide an annual report in an agreed format to the Audit Committee on its achievements and on the use of its resources.

Audit Committees may formally review the performance of internal audit on an annual basis and take an external review of the organisation's internal audit arrangements every five years or so. Internal audit should also report regularly on the status of management's actions to implement agreed internal and external audit report recommendations.

Internal audit functions increasingly are providing Audit Committees and Chief Executives with periodic reports on the patterns, trends and systemic issues identified as a result of internal audit activities.

**d) Senior Management**

To effectively fulfill its responsibilities, it is important that internal audit has a professional and constructive relationship with senior management of the organisation.

Internal auditors should interact on a regular basis with members of the senior management team, and through the delivery of practical, business-focused and useful reports and advice, build a relationship that is based on cooperation, collaboration and mutual respect. Meetings with organisation managers should be used as an opportunity to be briefed on key business developments and associated risks facing the organisation. These meetings should also be used to obtain informal feedback about the performance of internal audit and to assist in identifying ways that internal audit can best assist organisation management. One measure of the effectiveness of internal audit is the extent to which managers seek out internal audit to assist them in managing their business. Thus, internal audit team would encourage managers to seek their advice and assistance on either an informal or formal basis as the need arises.

In interacting with management, internal audit must be privy to information that may affect professional and, at times, personal reputations. It is important that internal audit respect the confidentiality of such information and its communication to others be on a strictly need to know basis. In situations where managers consider that such information is being used inappropriately, the reputation and credibility of internal audit is likely to be damaged.

**e) External Auditors**

External auditors too must help in developing internal audit strategy and internal audit work plan. Both audit teams need to address the key financial and business systems underpinning the company's financial statements and to avoid duplication of compliance and assurance. To avoid such duplication, the external auditor must evaluate the work of internal audit function to determine its adequacy for external audit purposes. The Internal audit function can be made responsible for liaising with external auditor on behalf of the organization. Such a role can be a useful way for internal audit team to be aware of planned and actual external audit coverage. Thus, a constructive relationship between both set of auditors assists in the conduct of external audits. The Internal audit function may also be assigned the role of assisting the Audit Committee to assess the service provided by external audit. Such a role can only be fulfilled when there is health communication between internal and external audit teams. This can be achieved by setting up formally establish meetings between internal and external audit to allow for routine exchange of information.

**f) Other Reviewers**

Internal audit is one of a number of internal and external review and assurance activities that exist as part of an organisation's governance arrangements. The company shall benefit when all these activities, such as those performed by the Ombudsman and regulators, operate in a coordinated and complementary manner to the greatest extent possible. This requires regular formal and informal contact between review bodies to minimize duplication and overlap. Some organisations see benefit in protocols being formalised for such activities: providing, for example, for the regular exchange of views and information and for the reporting of the results of work undertaken in a coordinated manner.

Protocols can be particularly important in situations where internal audit needs to work closely with other entities as a result of inter-agency or other agreements.

### **1.9 Independence of Internal Audit Team**

Independence of an Internal Audit team helps to distinguish it from all other internal controls, systems and procedures. The Internal Audit function is not subject to the authority of the areas of the organization that it audits. Thus, 'operational independence' is ensured and the entire exercise is objective, impartial and free from any conflict of interest, inherent bias or undue external influence. Although the internal audit function is independent in its working, it provides a service to the management, reports to the Audit Committee and is ultimately accountable to the Chief Executive or the Board for the achievement of its set objectives and the utilization of resources.

A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor and the internal audit function. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively. If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment. Impairment of organisational independence and individual objectivity may include, but is not limited to, personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations, such as funding. To ensure operational independence of internal audit function, certain measures need to be undertaken by the management. A general list is given below:

- a) The internal audit function must report directly to the Audit Committee
- b) The lead internal auditor must have direct access to the Chairman of the Audit committee and the Board of Directors
- c) Regular meetings must be held between the lead Internal auditor and the management
- d) Any external consultants approached by the internal audit function must be validated by the management
- e) The internal audit charter should not include any activity which may be or lead to a conflict of interest.

The above mentioned steps helps the internal audit function maintain objectivity and undertake judgment based purely on tangible evidence devoid of influence.

### **1.10 Pronouncements**

One of the primary functions of the internal audit team is to ensure adherence to internal policies and regulatory rules and requirements and applicable laws relating to the specific aspects of operations and business. Internal audit function has to include business improvement reviews, risk management processes, quality assurance arrangements and management control self-assessment arrangements. However, in addition, there is a number of external assurance and review bodies, including external audit, regulators, and the Ombudsman who are submitted various reports and assessments that need to review.



The Internal Audit function must ascertain whether or not the organisation has conducted its operations in accordance with the provisions of laws and regulations including the external reports and statements submitted through financial and cost records. The internal audit must obtain adequate and appropriate evidence to support the compliance or lack of it by the organisation.

This evidence could be shared with the external auditors to ascertain whether or not accurate disclosures and reported amounts of financial statements are correct. The internal audit function has to identify any non-compliance and recommend modification or change to the internal procedure of compliance. In order to facilitate accurate identification of non-compliance, the internal audit team should develop an understanding of various Legal and Regulatory framework.

Certain organisations operate in regulated industries such as pharmaceuticals, banking, electricity, insurance, telecom and others. The internal audit team needs to understand all relevant policies, orders, rules and regulations to be complied with by the company. The Internal Audit function must take into account all aspects of business and compliance.

There are multiple regulatory requirements which need to be addressed and kept track of when undertaking internal audit. The Internal Audit function must have a checklist of all regulations to be followed and it must guide the management regarding the adequacy of compliance or the lack of it.



## **Chapter 2**

### **Documentation and Working Papers**

The Internal Audit Function has to record and share details of all assurances verified, area covered, internal control system checks and process changes recommended. There needs to be hard evidence collected and stored prior to sharing conclusions formed on the evidence. This evidence, observations, status reviews and check points need to be documented to increase reliability and prove effectiveness of the internal audit.

The term 'Documentation' has many meanings but the most relevant is; Documentation is the process of collecting, verifying and storing knowledge, observations, facts and systems in a set of data which may be tangible such as paper, flow charts, SOPs, etc. and intangible such as electronic, audio, video, etc.

The entire internal audit team prepares working papers that record all the information obtained and analyzed that formed the basis for the various observations and recommendations in the internal audit report. These working papers are reviewed by the management and help to:

1. Earmark and support all internal audit communications
2. Facilitate the processes of planning, implementation and review of the internal audit
3. Document all findings and ascertain whether audit objectives were met
4. Aid external assessments of the internal audit process
5. Helps the management ascertain the quality of internal audit and the quantum of work undertaken
6. Ascertain compliance of the internal audit function with the International and domestic rules and regulations.

Thus, when recommending business process improvements, the internal audit team should document both the "As-Is Process" and the "To-Be Process". While many think about it as customary and do it for the same reasons, there are important reasons to the documentation process. Documentation helps the organisation gain long term primary and secondary benefits which have been listed below:

The following are the primary benefits that any organisation seeks to gain by explicitly documenting their processes:

#### **a) No Operational Ambiguity**

The first reason for documenting any process is the fact that it reduces operational ambiguity. Any reoccurrence of confusion regarding who is supposed to do what or what are the best practices following which a task needs to be performed, one can look at the detailed documentation and the dispute can be resolved. These documents act as the store of collective organisational knowledge regarding the processes and can be accessed by anyone in times of need.

**b) Training Material**

The documentation also acts as training material to help new resources move up the learning curve faster. Instead of making resources join on the job and learn tacitly, the documentation can be used to give new resources classroom lessons about the tasks that need to be performed. The documentation acts as the training manual and covers the syllabus as well as provides notes to educate the resources. This can be supplemented with on the job hands on floor visits for better and faster creation of efficient resources.

**c) Marketing and Sales**

Documentation can also be used by the marketing and sales department to truly understand what the capabilities of the organisation are. This knowledge helps them to truly determine what they can promise the customer and what can be fulfilled. With the process knowledge, the marketing department will be able to make promises that the organisation can deliver. There will be no need for over and/or under commitment which helps improve customer satisfaction at a later stage.

Apart from the apparent primary benefits which directly aid in the day to day operations of the organisation, there are certain secondary benefits which help the organization to analyse and improve its process continuously. By documenting process changes, the management can understand the knowledge that was used in designing the best practices that are currently followed. This also helps the management decide whether the best practices followed are indeed relevant in the environment they are operating in and saves both additional time and cost of re-justifying the existing model.

Hence, with detailed documentation in place, process improvements can be tracked version to version. This means that the management will have the previous 3 to 4 processes and their performance along with the current process and performance. They can thus see them together and see what changes are producing what results. This will tell them what they are successful at and they can continue doing so.

The Internal Audit Documentation process begins with the Internal Audit Manual, which documents the policies and procedures for conducting audits and managing the internal audit function is important to:

- a) encourage a consistent approach to achieve a quality result
- b) assist new starters to understand the internal audit process
- c) demonstrate an objective and systematic approach to the conduct of internal audits
- d) provide a basis for review and to improve existing practices

The internal audit manual should be tailored to the needs of the internal audit function and would reflect the strategy and approach chosen. It would generally include policies and procedures for:

- a) planning individual audit assignments;
- b) evidencing compliance with professional standards and methodologies;
- c) internal audit fieldwork and supervision;
- d) reporting audit results and categorizing overall audit findings and audit recommendations;
- e) servicing the Audit Committee;



- f) assessing internal audit performance, including conducting client surveys;
- g) records management and security procedures and
- h) reviewing the manual.

The internal audit manual should provide local procedures consistent with applied standards for using diagrams, flowcharts and checklists that can help to generate a better understanding of the processes involved, while including references to templates and any planning and auditing tools assists in promoting the support available to audit teams. The manual may be an electronic document (for example, on an intranet site) that also includes links to electronic copies of other key documents to facilitate updating and access by internal audit staff as it is an important aid in assisting internal audit to produce high-quality audit reports that meet the expectations of management.

The Internal Audit Protocol is a document intended for general reference by both management and internal audit and therefore ought to be made widely available. The format and content of the internal audit protocol is a matter for the Head of Internal Audit in consultation with entity management. The protocol should outline the respective roles and responsibilities of internal audit and management in the course of an audit and the opportunities for consultation during the audit process. The purpose, responsibilities and authority of the internal auditor are set out in the Internal Audit manual which was approved by the management. Internal auditor prepares an internal audit strategy and a work plan in consultation with the management, and the Audit Committee. The internal audit strategy provides the context for internal audit activity. The various stages to be included in Internal Audit Protocol are:

1. Planning;
2. The examination and evaluation of the adequacy and effectiveness of the system of internal control;
3. The audit procedures performed, the information obtained, and the conclusions reached;
4. Review;
5. Communication and
6. Follow-up.

There are several types of internal audit documents. The internal auditor commonly use flowcharts supplemented by narrative descriptions as a starting point to understand the workings of the organization. Once the operational working of the organization is clear and well defined, the internal audit team often uses risk and control matrices for more specific analysis of areas to be covered and targeted. In addition, internal control questionnaires (ICQs), policy and procedure manuals, and other such official papers constitute the commonly used forms of internal audit documentation.

**Flowcharts** help the internal audit team to describe the flow of activity through a process or function along with the relevant documentation. The main output is a process map — a graphical representation of events performed on a routine basis. These process maps can help the internal audit team better understand



organizational hierarchies; communication channels; identify risks, controls, paucities, and disorganizations; and develop recommendations for improvements, smooth flow of information and utilization of resources.

**Narrative Descriptions** are generally useful supplements to flowcharts and are made by documentation in detail of the existing practices. Thus, they help to minimize potential misinterpretations. However, narrative descriptions on an independent basis cannot serve as an effective tool for process description as they tend to be lengthy and difficult to review.

**ICQs** or internal control questionnaires generally list answers to questions related to the identification and evaluation of internal controls systems and their effectiveness. An effective ICQ document comprises of a carefully structured and logically sequenced series of questions aimed to document processes and to control gaps, strengths, and weaknesses within the organization's control system. All questionnaire results provide a permanent record of the controls at both an entity and process level and are used for future reviews.

**Risk and Control Matrices** are designed to document risks and controls while facilitating evaluation of the design and success of the control mechanism. These matrices help to obtain initial understanding of the requirements for controls in any process. The internal audit team can locate gaps between the current set of controls and the desirable or targeted level of specific controls of the process.

**Policy and Procedure Manuals** generally establish a systematic framework or guidance note for specific functions, processes and activities of any organisation. These operational level manuals are typically incorporated to manage operation risks while keeping a track of relevant internal controls and risks. These manuals also help to communicate how a particular process is to be managed and ensures alignment with performance improvement objectives of the organization.

**The Organizational Chart** is an important graphic diagram that shows the power relationships inside a company. It states who is the manager and his subordinates in a hierarchical and vertical structure. The use of this chart is very useful for all employees because they can see in a very simple graphic of what is their current position inside the company and their ranks according to their position. An organisational chart is also used for showing the relationships between directors in various departments. For large companies like multinationals, these charts are very complicated and also large, so they are divided into smaller ones for each department within the organisation.

Organisational charts can be divided into three categories:

- a) hierarchical charts,
- b) matrix charts and
- c) flat or horizontal charts.

Organisational charts don't show the inter-human relationships that develop inside a company. They only show the formal relationships which help the internal audit team to identify where the responsibility of function lies and who has the appropriate authority to take actionable decisions. This understanding is also very crucial to the efficiency of the internal audit.





**System Reports** are general reports obtained through the existing set of records. These may be maintained manually or electronically through an ERP. System reports are used for and form the basis of all Management Information Systems. These reports are shared with the functional managers and directors from time to time to enable them to be updated with the on goings of the business. There are multiple system reports that the internal auditor has to understand and comment on.

Other Internal Audit Working papers may include, but are not restricted to:

- a) Planning documents and audit programs;
- b) Notes and memoranda resulting from interviews;
- c) Copies of important contracts and agreements;
- d) Information about operating and financial policies;
- e) Results of control evaluations;
- f) Letters of confirmation and representation;
- g) Analysis and tests of transactions, processes, and account balances.
- h) Results of analytical procedures;
- i) The audit's final communications and management's responses and
- j) Audit correspondence if it documents audit conclusions reached.

## Chapter 3

### Planning an Internal Audit and Audit Programme

Planning an internal audit selection of audit coverage, priority of the internal audit and estimating resources of time and costs for the entire internal audit function. The Internal Auditor needs to align its focus and activities to the entity's risks and to achieve this alignment between the entity's risks and internal audit coverage, it is necessary for internal audit planning to occur in the context of entity-wide assurance mapping, which can be commissioned by the management. Thus, internal audit planning generally involves:

- i. The internal audit strategy that relates the role of internal audit to the requirements of the entity by outlining the broad direction of internal audit over the medium term, in the context of all the entity's assurance activities and
- ii. An Internal Audit work plan, generally prepared on an annual basis, supported by a schedule of potential audits and an indication of previous audit coverage.

Together, these documents serve the purpose of setting out in strategic and operational terms the broad roles and responsibilities that are included in the internal audit charter and identifying key issues relating to internal audit capability, such as required skills.

In addition to the internal audit strategy, a detailed internal audit work plan should be prepared specifying the proposed internal audit coverage over the planning cycle. The length of this planning cycle will depend on the nature of the organisation and its current operating environment. Organisations would be benefited by adopting a rolling work plan rather than a fixed term plan to enable flexibility to the Internal Audit function.

**Internal** audit team should share information and coordinate with other assurance activities to ensure proper coverage and minimize duplication of effort. The internal audit work plan facilitates both tasks and helps internal audit to ensure that it supports the management to the maximum extent possible. Generally, the head of the Internal Audit team must provide advice to the management on the internal audit plan and would review the plans to ensure that they are aligned to the entity's risks before recommending approval of the plan by the Chief Executive.

In **developing the internal audit work plan**, it is appropriate to consider that once the broad strategic direction for audit coverage has been determined, a decision needs to be made about the number and scope of specific audit topics to be included in an internal audit work plan. To assist in prioritizing audit topics it is helpful to develop a set of criteria that can be used to assess and rank potential topics. Criteria can vary from industry to industry but would normally include:

- 1) The importance of the program or activity to the entity's objectives;
- 2) The strategic and operational risks identified in the entity's risk management plan or business unit plans or, in the absence of a mature risk management framework, as identified by internal audit;



- 3) The areas covered to support external reporting obligations of the entity;
- 4) The areas covered by other assurance and review functions;
- 5) The potential or expected benefits of an audit and any specific requests from the management;
- 6) The significance of the findings from any previous internal or external audit or review, particularly relevant reports and recommendations from Parliamentary Committees and
- 7) The length of time since any previous internal or external audit.

Some entities see benefit in allocating numerical scores to each of the criteria and aggregating the scores to arrive at an overall audit ranking. Although audit scores can help to rank audit topics, it should be recognized that such a process still involves judgment of the allocation of individual scores. The principles of prioritization should be documented in the internal audit strategy.

The **Coverage of the internal audit work plan** need be comprehensive and definitive to ensure non value added activities are ignored. Such an internal audit work plan would generally include audits of major information technology systems, audits of major projects and all or a majority of the following activities:

- a) Audits of areas where the risk is judged to be high but the controls are considered to be effective in managing the risk. These audits are to provide assurance that the controls are in fact operating as intended;
- b) Advice on new systems, processes and initiatives-these may be referred to as 'systems under development' audits;
- c) Audits of major information technology systems focusing, in particular, on security and access matters, and audits of major projects;
- d) A number of annual (or more frequent) audits to review key areas of financial, operational, human resource or governance matters across different business units and geographical locations or a series of audits that are conducted each year.;
- e) Audits that review particular topics across the whole entity-such as procurement practices, recordkeeping, ethical conduct and compliance with APS and entity values-or that are aimed at addressing systemic risks;
- f) Follow-up audits of areas audited previously where shortcomings have been identified and
- g) A number of reserve audit topics that could be substituted if planned audits do not proceed.

The program may also include an allowance to undertake ad hoc or special request audits, particularly from the management and the Audit Committee. These reviews may prove to be either advisory or quality assurance reviews and should be budgeted as an addition to the routine assurance program.

Developing the internal audit work plan against a background of prior and projected reviews would enable the management to assess whether the full range of risks, especially compliance risks, are covered over an appropriate period. Selection of audit topics should also be confirmed only after careful consideration of the

objectives and scope of individual audits. These factors can have a significant effect on the cost of the internal audit work plan or the number of audits included in the plan. In particular, consideration should be given to whether it is better to have fewer, more in-depth audits, more audits with a narrower focus, or a combination of both.

**Consultation with the external auditor** to gain an understanding of their perspective on the business risks facing the entity is important. This information is necessary to help ensure that potential duplication and gaps in overall audit coverage are known, and to identify opportunities for the external auditor to rely on the work of internal audit. Any significant areas that are not covered or are duplicated should be highlighted to the management.

The **Size and nature** of the Internal Audit Work plan must factor the following:

**a) The risk tolerance and the risk profile of the entity:**

An entity with a low risk tolerance and a substantial number of risks and, by extension, controls designed to assist in managing the risks, could be expected to have a larger internal audit program than an entity with a higher risk tolerance and a smaller risk profile.

**b) The size and complexity of the entity's business:**

The larger and complex size of business entity and also larger number of separate business activities and programs, the size of the internal auditing would also be larger and increased.

**c) The physical characteristics of the entity:**

The larger the employees or geographic locations number of, or the greater the level of distributed control, the larger the internal audit program expected to be.

**d) The nature of the information systems:**

The more complex the Internal Control systems environment, the more internal audit activity is likely to be required.

**e) The stability of the entity:**

Internal audit might be required to do more in times of significant change.

**f) The number of internal assurance functions:**

An entity with well-developed quality assurance, compliance or other internal assurance activities is likely to require less internal audit activity.

**g) Level of Resourcing:**

The size of the internal audit work plan will also be influenced by the level of resourcing of the internal audit function as discussed below.

In preparing the plan, sufficient time and resources should also be allocated to:

- a) Manage the internal audit function;



- b) monitor and report to the Audit Committee on progress in implementing agreed recommendations in internal and external audit reports and other review bodies;
- c) analyse the risk, control and governance issues arising from internal audit work, and/or the work of other assurance providers, with a view to providing periodic reports to the Audit Committee on systemic issues and trends;
- d) support the Audit Committee in discharging its obligations;
- e) provide secretarial support to the management (if specifically defined);
- f) develop and periodically review the internal audit strategy and the internal audit work plan;
- g) provide appropriate professional development to internal audit staff and;
- h) Liaise with the external auditor and other relevant external bodies.

Where some or all services are provided by an external provider, sufficient time should also be allocated to enable the contract, or contracts, to be properly managed. In addition, internal auditor may be tasked to provide direct assistance to external review functions by performing audit or review procedures under the direction and supervision of the external reviewer. Such activity should be regarded as non-audit activity by the entity.

Organizations should focus on assigning accountability and capturing resource utilization for every audit that is conducted. Such in depth tracking of expenditure related to audits aid in estimating the costs of individual reviews during internal audit planning. It must be noted though that there must be parity between the level of administrative and / or financial costs to undertake the audit and the benefits to the operational system.

Any internal audit work plan should be so detailed as to satisfy the Audit Committee and the management that estimated coverage area of the internal audit is adequate to meet the set objectives of the Internal Audit Charter. The internal audit work plan would generally include:

- a) Audit title
- b) Functional and Operational Area to be covered
- c) Director and manager responsible
- d) Type and scope of internal audit
- e) The benefit expected by the audit procedure
- f) Resources allocation for the purpose of the audit
- g) Proposed duration and timelines for completion

The Internal audit work plan is presented to the Audit Committee and the management through mind- maps, executive summary, charts or a mix of such abbreviations of the work plan.

The Internal Audit work plan should be periodically reviewed and any substantive amendments should be approved by the management. Internal audit plans should be prepared and submitted in time to enable



them to be considered and approved prior to the commencement of the period to which they apply. Aligning the timing of the internal audit planning process with that of the entity's business planning processes can assist in internal audit planning being aligned with the objectives and priorities of the entity. There is also value in considering the external audit planning cycle so that work being conducted with a view to external audit reliance can be appropriately scoped.

### **Factors to be kept in mind before commencing a New Audit**

Before commencing a new audit, the auditor must take the following steps:

➤ **Purpose of the audit.**

The auditor must keep in mind the purpose of the audit for which he has been engaged. The primary goal of an internal audit is to verify various aspects such as –

- a) raising or granting a loan;
- b) making an investment in a running business;
- c) valuation of assets liabilities of a business;
- d) determination of the nature and extend of any error or fraud;
- e) filing tax return, Payment of taxes;
- f) compliance with the legal requirements.
- g) verification of accounting records

It is also necessary to ascertain the period to be covered by the audit, particularly in case of a non statutory audit where the client may wish the audit period to be shorter than the financial year, or the examination only to be directed to a particular aspect, e.g. fraud detection, valuation of assets, etc.

➤ **Nature of the enterprise and industry.**

Understanding of the clients business is essential to assess the inherent risk of misstatements in the financial statements, and to identify the problems of a going concern in his lines of business. The auditor should pay particular attention to-

- a) Key product lines of the business;
- b) Important customers and markets
- c) Source of its financing.

The Internal Auditor should also be familiar with the general business and economic trends, competitive environment, technology changes and laws governing the industry to which the enterprise belongs. The main aspects are:

- Organization structure.
- Key personnel.
- Accounting system.
- Instruction to the clients for specific data required for audit.
- Inventory observation.

- Letter of engagement.

### Audit programme

An audit programme is the auditor's plan of action indicating the audit test and procedure to be followed to collect adequate and reliable evidence in support of his opinion as to the truth and fairness of the representation made in financial statement of the enterprise. It is based on the auditor's evaluation of the strengths and weaknesses of that system.

### Types of audit programmes:

Audit programme may be classified as:

- a) Fixed, predetermined, or standardized; and
- b) Flexible, progressive, or special.

**a) Fixed audit programme.** It contains general or standardized instruction and procedures to be followed while conducting the audit examination. It incorporates all conceivable audit procedure respective of their applicability to any particular audit in hand.

### Specimen of fixed Audit Programme

|  | Jan | Feb | March | April | May | June | July | Aug | Sept | Oct | Nov | Dec |
|--|-----|-----|-------|-------|-----|------|------|-----|------|-----|-----|-----|
| Balance Sheet checked                                      |     |     |       |       |     |      |      |     |      |     |     |     |
| P & L Checked  |     |     |       |       |     |      |      |     |      |     |     |     |
| Trial Balance Checked                                      |     |     |       |       |     |      |      |     |      |     |     |     |
| Final Balances of Nominal, Bought and Sales Ledger Checked |     |     |       |       |     |      |      |     |      |     |     |     |
| Observation of Stock-taking                                |     |     |       |       |     |      |      |     |      |     |     |     |
| Scrutiny of Journal  |     |     |       |       |     |      |      |     |      |     |     |     |
| In depth Scrutiny of Selected items in Sales Book          |     |     |       |       |     |      |      |     |      |     |     |     |
| Sales Books:- Casting and totals                           |     |     |       |       |     |      |      |     |      |     |     |     |
| In depth Scrutiny of Selected items in Purchase books      |     |     |       |       |     |      |      |     |      |     |     |     |

|  |  |  |  |  |  |  |  |  |  |  |  |  |
|--|--|--|--|--|--|--|--|--|--|--|--|--|
| Purchase Books:- Posting and totals    |  |  |  |  |  |  |  |  |  |  |  |  |
| Sales Return Book Posting and Addition |  |  |  |  |  |  |  |  |  |  |  |  |
| Sales Ledger Vouched and Checked       |  |  |  |  |  |  |  |  |  |  |  |  |
| Bought ledger checked and Vouched      |  |  |  |  |  |  |  |  |  |  |  |  |
| Petty Cash Book checked and Vouched    |  |  |  |  |  |  |  |  |  |  |  |  |
| Bank Account Checked                   |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash Book Checked, Vouched & Balanced  |  |  |  |  |  |  |  |  |  |  |  |  |

The above table can be suitably modified to suit the specific requirements of industry under audit.

**Flexible audit programme**

The flexible audit programmes is relating to a specific period or a specific purpose. For e.g. verification of records for particular month, review of specific contracts, detection of frauds, misappropriation of funds etc.

**Modification of audit programme**

An audit programme serves as a guide for future. But even in repeat audit, the past years audit programme can not automatically be adopted for audit examination in the current year. It will need to modify in the light of any changes since the last audit.

Before adopting any past audit programme for the current year audit examination, the following point should be carefully followed:

- Change in ownership.
- Organizational re-arrangement.
- Working paper.
- Books and records.
- Internal control.
- Change in business or product-line.

A specimen fixed audit programme relating to sundry debtors can be prepared on the basis of following check list –

**Specimen Fixed Audit Programme: Sundry Debtors**





| Name of client.....   | Period ended..... |         |
|---|-------------------|---------|
|   | Done by           | Remarks |
| <p>1. Examine the relevant replies to internal control Questionnaire and ascertain by test observation whether the procedure indicated therein is being followed.</p> <p>2. Indicate whether, upon evolution of the internal control system, any additional abutting procedures are considered necessary.</p> <p>3. Secure the list of outstanding accounts and compare it with the ledger accounts and general ledger control accounts.</p> <p>4. Select the accounts for confirmation by individual debtors and communicate directly with them.</p> <p>5. Tally the replies to request for confirmation and look into differences, if any.</p> <p>6. Cross-check postings in selected ledger accounts with original records.</p> <p>7. Ascertain the propriety of material transaction in selected accounts for a three-week period.</p> <p>8. Scan the general ledger control account for irregular or unusual transactions and investigate the propriety thereof.</p> <p>9. Discus with responsible officials the prospects of recovery of accounts and adequacy and propriety of the provisions for doubtful and had debts.</p> <p>Indicate your suggestions for modification of this section of the program in the light of your work experience.</p> |                   |         |

## Chapter 4

### Audit Sampling

Internal Audit function does not include verification of all records, entries or transactions. The scope of an internal audit is much broader in comparison to that of statutory audit. The depth of coverage of internal audit, being a management function, would also be much wider. An internal audit function normally is spread beyond checking of financial transactions and is expected to cover comments on internal control systems, risk management, propriety aspect of transactions.

It is very difficult for the Internal Auditor to verify each and every document / transaction recorded in the books of accounts. In normal course, if the organization is having its own internal audit department, the areas of internal audit are pre-determined viz.

- a) Verification of all vouchers, bills or having a monetary limit. These vouchers are checked and approved by the internal auditor prior to booking.
- b) Review of contracts, purchase orders, tenders etc. before these are finalized.

However, if the internal auditor is an external agency, they depute their staff at regular intervals and verify the documents, bills, vouchers either 100% or on sample basis. Normally, the routine transactions are verified on sample basis and critical issues are checked 100%. This is required to have optimum use of resources and for effective control over important transactions.

This process of selecting and verifying less than the entire population is called as “**Sampling**”. The extent and methodology of sampling must to be very clearly mentioned in Internal Audit work plan.

Sampling involves some selection of certain sections of the data or population based on its quantitative or qualitative factors. The Internal Auditor must be wary of the risks associated with sampling. In case the sample size selected is not representative of the entire group, the internal audit team’s conclusions based on the sample may be different from the conclusion they would reach if they examined every item in the population. The risk associated with sampling tends to increase when:

- a. The Estimation of sampling risk is done by using professional judgment rather than statistical techniques.
- b. There is no means of quantifying sampling risk provided.
- c. Sample may be larger than necessary or auditors may unknowingly accept a higher than acceptable degree of sampling risk

Thus, the internal audit team must undertake statistically backed sample selection technique to ensure designing efficient samples, measuring sufficient evidence and evaluating results with objectivity.

**Allowable Risk** is calculated as:

$$AR = IR \times CR \times DR$$



**Where AR** = the allowable audit risk that a material misstatement might remain undetected for the account balance and related assertions.

**IR** = Inherent risk, the risk of a material misstatement in an assertion, assuming there were no related controls.

**CR** = Control risk, the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by internal control.

**DR** = Detection risk, the risk that the auditors' procedures will fail to detect a material misstatement if it exists.

### **Factors determining Scope of Audit Testing or Sampling**

The principle factors which determine the degree of audit testing may be listed as follows:

#### **1. Effectiveness of internal control**

Effectiveness and efficiency of the system of internal control should hold the key to the extent of audit testing. If the enterprise has an effective internal control system, the auditor may place greater reliance on the output generated by the system of accounting in the form of balances. Accordingly, he may reduce the number of transactions chosen for detailed examination. On the other hand, if the internal control system is weak or inefficient, audit testing will not only have to cover a wider area but the auditor will also have to seek other evidence to place a responsible reliance on the figures represented in the financial statements.

#### **2. Materiality or significance**

The materiality or significance of a transaction is to be judged by reference to the effective of that transaction on the financial position results of his business operations. Determination of the sample size on this basis will depend on professional competence, experience and sense of judgments of the auditor and the purpose of his audit assignments.

#### **3. Value and volume**

If a large number of items in the total number are Fairley homogenous , the size of the sample for detailed verification may conveniently be kept small,. For example, if there are a material error is considerably less than when a small numbers of items involve large sums. However, before selecting the sample size, the extent of internal control should be carefully examined in each case.

#### **4. Purpose of audit**

The numbers and types of transactions to be selected for detailed checking will also be influenced by the purpose of audit. For example, in a general purpose audit, the sample will be selected from the entire mass of transaction and accounts. However, where the audit is for a special purpose, such as, purchase of a business, or an intended investment, then both the size and content of the sample will be different.

### **5. Cost of testing**

The cost of sample checking must influence the size of the sample selected for detailed examination. In fact, sample –checking evolved as an answer to the prohibitive cost of all audit procedures, the cost of time and money should also reasonably be the benefits the proof.

### **6. Risk factor**

The probability of risk of irregularity in an account or class of transaction will also determine the extent of sample checking relating thereto e.g. cash receipt and payment offer greater scope for communion of a regularity and therefore require more intensive and extensive sample testing than other accounts, where the degree of risk involved may be relatively low.

### **7. Past experience**

Past experience of the auditor may also serve as a good guide to determining which of the accounts or transactions require greater degree of sampling – checking.

### **8. Irregular and unusual items**

When an item is apparently wrong or questionable, or gives an impression of any irregularity, the auditor must conduct an extensive sample checking in relation to it. The sample treatment should be accord to or items of an unusual nature for which the enterprise may not have an adequate or effective system of internal check.

The different methodologies available for statistically based selection of sample size are as follows:

#### **1) Random Sampling**

In a simple random sample every transaction or data point within the audit population has an equal chance of selection. An easy way of selecting samples would be to use a random number table or random number generator. The Random Number Table is much more effective than manually selecting the random samples as the data in this table portrays the desired properties no matter how chosen from the table: by row, column, diagonal or irregularly. The Random Number Generator undertakes the same function of generating a sequence of numbers or symbols that lack any pattern. Due to random selection there is a reduction in the possibility of any systematic bias that would make the selected group different in character from the overall population.

#### **2) Consecutive Sampling**

Consecutive sampling is often referred to as convenience sampling. It involves choosing the next, or last however many cases, e.g. the next OR the last 50 transactions, or alternatively, all transactions seen over the course of the previous OR next month. Consecutive sampling is an example of non-probability sampling and is often the most practical way of selecting cases for a ‘snapshot’ sample of the population. However, it is important to remember that the sample produced may differ in character from the overall population and therefore the internal audit results may not be representative of the overall nature of all transaction in the database.

#### **3) Quasi Random Sampling**

Quasi random sampling is also referred to as systematic sampling. If the overall audit population is 1000, the representative sample would be 278. Since  $4 \times 278$  is approximately 1000 the internal audit team would select every fourth transaction from the overall database. To ensure that every transaction in your audit population has an equal chance of being selected, the starting point in this method needs to be selected randomly. In this instance the starting number must be between 1 and 4. The start point must be random because if you always started with the first patient, the second patient would never have a chance of being selected. This is an important consideration from a statistical point of view.

#### **4) Haphazard Sampling**

The Haphazard Sampling method means selecting items on an arbitrary basis, but without any conscious bias. This method, though random in nature, may lead to an increase in the sampling risk as there is no statistical methodology for selecting the starting point or the number of samples.

#### **5) Block Sampling**

Block sample consists of all items in a selected time period, numerical sequence or alphabetical sequence. The basis for selecting the sequence or group would determine the level of sampling risk of the data. The selection of the sequence or group should be without any conscious bias and the entire population within the sequence or group must be verified.

#### **6) Stratification Sampling**

Stratification is the technique of dividing the entire population into relatively homogeneous subgroups. Stratified sampling ensures that the proportion of different groupings present in the population is reflected in the sample. The basis for determining the subgroup should be consulted with the management and specifically mentioned in Internal Audit work plan as well as the final report.

The **sample size** selected affects the level of sampling risk of the sample. Every increase in sample size reduces the sampling risk and allowance for sampling risk. The sample size is generally directly proportionate to the characteristics of the population and an increase in the population leads to an increase in the sample size.

In addition, after careful consideration of the methodology of sampling and sample size, the sample selection plan should be based on:

- a) The relevance of the sample to the audit purpose
- b) Level of acceptable risk in the sample
- c) General features of the sample population so as to accurately represent the population
- d) All un-auditable items or samples must be taken as deviations
- e) Deviations should be coupled together and their nature or occurrences must be analyzed

In the rare occurrence, when undertaking audit sampling to test control systems or processes, the following steps need to be followed:



- a) Determine the objective and nature of control system or process
- b) Determine the risk acceptability
- c) Define the sample population
- d) Ascertain the risk of a high tolerable deviation rate
- e) Estimating the sample population deviation rate
- f) Determine the sample size based on acceptable deviation
- g) Selection of the sample
- h) Validation of the sample selected
- i) Evaluation and analysis of the samples
- j) Documentation of the sampling procedure, results and recommendations

## Chapter 5

### Audit Evidence

#### Assertion to be evidenced

The auditor's options as to the financial statements of any enterprise are in the form of an expert opinion. It is an expert opinion because he is expected to possess special knowledge and experience in examination of financial statements, data information etc. It is so, also because it is expected to an independent opinion, quit unbiased and uninfluenced by persons by whom, or under whose directions, the relevant statements, data etc. have been prepared to be able to render an expert and independent opinion, the auditor is required to carefully examine each of the assertions in the financial statements or data, both individually and as part of the overall representation. In the course of such examination, the auditor is required to collect all necessary and available evidence and evaluate it in terms of its sufficiency and appropriateness, keeping in view the materiality and significance of the assertion concerned.

According to Standard Auditing Practice – 5, "audit evidence", issued by the institute of chartered accountants of India, the auditor should obtained sufficient and appropriate evidence by following (a)compliance procedures, and (b)substantive procedures.

**Compliance procedure:** Audit evidence obtained from compliance procedures provides assurance to the auditors in respect of the following assertions in the financial statements:

- a) Existence of the internal control systems.
- b) Effectiveness of the control system as being operated.
- c) Continuity of the control system through the period under review.

**Substantive procedure:** Audit evidence obtained from substantives procedures provides assurance to the auditor in respective of the assertion in the financial statements.

- a) Existence of an asset or liability at a given rate.
- b) **Rights and obligations** i.e. an asset is a right of entity and an obligation is the liability of the entity of the given rate.
- c) **Occurrence** i.e. a transaction or event took place which pretense to the entity during the relevant period.
- d) **Completeness**, i.e., there are no unrecorded assets, liability or transactions.
- e) **Valuation** i.e., an asset or liability has been recorded at an appropriate caring value.
- f) **Measurement**, i.e. a transaction is recorded in the proper amount, and revenue or expense is allocated to the proper period.
- a) **Presentation and disclosure**, i.e., an item is disclosed, classified, and described in accordance with recognized accounting policies and practices and requirements.

#### Stages in opinion formation

In the process of opinion formation, the auditor should proceed as follows:

### **1. Identification of assertions**

The financial statement contains assertions as regards income and expenditure as also assets and liabilities of the business concern to which they relate. The assertions are express and implied, positive as well as negative. For example, cash at bank appearing on the assets side of the Balance Sheet is an express assertion to the effect that the business concern has a certain amount of cash lying with the bank. Unless there is anything to the contrary stated in the Balance Sheet, it is also an implied assertion that the amount is available to the management for expenditure in connection with the business.

### **2. Evolution of material assertion**

After identification of the assertions, the auditor is required to evaluate these Assertions in terms of their materiality or significance. There can be no hard and fast rule about which particular assertions should be regarded as material, because it will depend on the size and nature of the items in connection with which assertion have been made and their effect on the overall representation.

### **3. Collection of evidence**

The auditor is required to collect sufficient appropriate evidence in support of assertions in the financial statement by mean of suitable audit technique or Method such as (a) inception, (b) observation; (c) inquiry and confirmation; (d) computation (e) analytical review etc.

An Internal auditor's judgment as regards sufficient appropriate Evidence will be influenced by factor such as-

- a) the degree of risk of miss-statement as determined by the nature of an Item, adequacy of internal control, nature and size of business, and financial Position of the enterprise;
- b) materiality of the items;
- c) past experience;
- d) result of application of audit procedure;
- e) the type of information; and
- f) the trend indicated by accounting rations and analysis.

During the course of collection of evidence, the auditor will come across several type of evidence and it is for him to evaluate each type on the basis of nature and reliability. Reliability of an evidence will be determine by the Source e.g. internal or external, from which it has been obtained and its nature e.g., documentary or visual. Consistency between evidences as regard any assertion obtained from different source, will also determine reliability of evidence.

### **4. Evaluation of evidence**

The auditor should be through in his efforts to obtain Evidence and objective in its evaluation. Evaluation of evidence should be from the point of view of is sufficiency and appropriateness. This will include factors such as validity, quantum, reliability, and relevance of the evidence. it is useful to remember that on the basis of such evidences, the auditor is required to rendered is opinion as regards the effect of transactions which Have already taken place in the past and to which he has not been a direct observe .



## **5. Formation of opinion**

Formulation as opinion regards the various assertions on the basis of sufficient appropriate evidence, conceived the last stage of audit examination. Opinion has been defined as judgment or appraisal formed in the mind about any particular matter. The auditor opinion implies a conclusion reached by him on the basis of examination of available evidence, though it is open to dispute. To ensure that his opinion is indeed so, he must formulate it only after going through the stages mentioned above. Or else, his opinion will be a mere conjecture, not supported by evidence as to its truth.

### **Types of Evidence**

Evidence collected by the auditor in support of assertions in the financial statements may be as follows:

#### **A. Accounting system**

The system of accounting followed by business constitutes the basic support evidence, business transactions, documents etc are inputs of this system.

#### **B. Physical evidence**

The best evidence in the case of tangible assets e.g., Cash, stock-in-trade, plant and machinery, etc is their physical existence.

#### **C. Documentary evidence**

Documentary evidence in possession of the client may be four kinds, viz.

- a) Evidence originating outside but held by the client;
- b) Evidence originating inside but circulating through third parties;
- c) Evidence originating inside but subject to effective internal control;
- d) Evidence originating inside but not subject to effective internal control.

#### **D. Ledgers and journals**

A ledger contains personal, real and nominal account which is drawn on the basis transaction recorded in the journals. Journals are the books of the original entry to record transactions as and when they take place.

#### **E. Ratio and trend analysis**

Analysis of ratios and trends between different periods of the same company and between the company under audit and other companies will also constitute evidence for the auditors to form his opinion.

#### **F. Oral evidence**

Question-answer sessions with the officers and employees of the company under audit, may sometimes throw up important clues to test the veracity of documentary and other evidence. Oral evidence helps an auditor to satisfy himself as to the reasonableness of the existence of certain procedures and accounts.

#### **G. Subsequent events**

Events subsequent to the preparation of financial statement may also serve as evidence to test the authenticity of the accounting data.

## **H. Circumstantial evidence**

Circumstantial evidence is the evidence that is intended to prove a fact by proving other events or circumstances so as to afford a basis for a reasonable inference of the occurrence of the fact in issue or otherwise. It may be conclusive or presumptive.

## **I. Computerized Records**

There is no change in the basic approach to audit in the case of an enterprise operating computer based accounting system. The main difference is that evidence in such a case is in the form of electronic records. For the examination of which different tests and procedures are called for accordingly the auditor should adapt this test and procedures in conformity with the control techniques in the computer system. He may also use techniques to ensure that the program procedures are operating properly and the tests and procedures are carried out more effectively.

### **Essentials of final output –**

The final output expected from the internal audit is to provide conclusions, recommendations, share findings and comment on the various internal control systems in the final report. All of these should be based on documented evidence which has been appropriately sourced and collected during the internal audit. **Audit evidence** is any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria and to arrive at the conclusions on which the audit opinion is based. The determinants of persuasiveness of evidence are:

- 1) Competence – the range of skill, knowledge, or ability
- 2) Effectiveness – adequate internal controls systems and clear communication channels lead to better information
- 3) External Auditor observations – external auditor's observations are stronger than staff or management comments
- 4) Expert opinions – an expert's opinion is a practical and authorized basis
- 5) Independence – external evidence is considered as a better form of evidence than internal documents or proofs
- 6) Objectivity – objective evidence is stronger than subjective evidence
- 7) Relevance – pertaining to or in support of the audit objective
- 8) Sufficiency – an adequate amount, quality or quantity

The internal audit evidence collected would be dependent on the following:

- a) Audit procedures to use – specific procedures should be spelled out for instruction during the audit.
- b) Sample size – how many items should be tested for each audit procedure.
- c) Items to select – determine which items in the population should be selected.
- d) Timing – timing can vary from beginning of the accounting period to closure of it.



Internal Audit Evidence includes any data, information, process flows, vouchers, bills, memos, contracts or transactions.

The commonly used procedures for sourcing of internal audit evidence are as follows:

**a) Physical examination**

Physical examination means inspection or count of tangible assets. It is different from examining documentation that the asset has inherent value.

**b) Confirmations**

Confirmations mean the receipt of a written or oral response from an independent third party. The Internal Audit team requires a client request for the third party respond directly to the team. Confirmations are usually required when statements or transactions relate to third parties; key examples of third parties include suppliers, banks, attorneys, inventory agents and customers.

**c) Documentation**

Documentation includes both internal and external documents. Internal documents are prepared and used within organisation and do not go outside the company. Whereas external documents have been in hands of a third party to the transaction and are considered more reliable. Documents in general are less reliable than confirmations.

Before recording documents as evidence, proper examination of documents that support a recorded transaction or amount is required; and the direction of testing must be from the item recorded to the supporting document.

**c) Analytical Procedures**

The Internal audit function studies the different relationships among data. Analytical procedures are generally required during the planning and completion phases on all audits. They are necessitated by the existence of unusual fluctuations which occur when significant difference are not expected but do exist or when significant differences are expected but do not exist.

**d) Inquiries of the Client**

The Internal Auditor usually obtains information from the client in response to questions. Although much evidence is obtained through inquiry, it cannot be regarded as conclusive and may be biased in the organisation's favour. To accomplish an unbiased opinion or review, the internal audit team may have to inquire independently with the customers of the organisation.

**e) Re-performance**

Re-performance involves rechecking a sample of the computations and transfers of information. Rechecking of computations consists of testing mathematical accuracy. Rechecking of transfers of information involves ensuring if information is recorded consistently in the accounting records.

**f) Observation**

The Internal audit team should witness the physical activities of the organisation. Observations differ from physical examinations because physical examinations count the assets, while observations focus on organisation's activities and process both.

In the extreme circumstances that the evidence obtained from one source is either in direct conflict or inconsistent with that obtained from another source, the internal audit team must undertake further investigation or additional procedures for resolving the conflict. The Internal Auditor is required to collect appropriate evidence out of the audit process to substantiate their checking and findings.

**Audit Techniques or Method of Collecting Audit Evidence**

Audit techniques, which may be used to collect necessary evidence in support of the auditor opinion, we differ for situation to situation. The principle audit techniques may be described as follows:

**a. Vouching**

Vouching means verification of the authority and authenticity of transaction as recorded in the books of account it is not a mere inspection of receipts and payments with the cash book but includes the examination of receipts and payments with the transactions of business, together with adequate documentary and other evidence of sufficient validity to satisfy the auditor that such transactions are in order, have been properly authorized, and correctly recorded in the books.

**b. Confirmation**

It consists in independently communicating with any outside party to ascertain the correctness and validity of a recorded figure or fact. Under this, written statements and certificates may be obtained from sundry debtors, banks, creditors, and so on. The auditor should ensure that is no tampering by the client's staff with any evidence obtained from independent third parties.

**c. Physical examination and observation**

Physical existence of tangible assets as shown in the books of accounts is established by actual physical inspection, which includes counting, identification and quantitative measurement of the assets as also, in certain cases, evaluation of quality. But evidently, physical examination can be possible only in the case of assets which are easily identifiable.

**d. Reconciliation**

It involves identification and explanation of the items which cause two or more related items to be different. Thus, the amount of rent paid may be verified recording the figure as shown in the books with the product of monthly rent as multiplied by twelve, or the interest paid or payable may be reconciled with the amount that should have been actually paid by multiplying the amount of loan with the percentage of interest.

**e. Audit testing or sampling**

It involves selection of some fairly representative items from a large set of similar items and examining them for drawing a conclusion about characteristics of all the activities. However, it is necessary that the number



and types of transactions and records selected for the purpose of detailed checking should be sufficient representative of most of the transactions and records from among which these have been selected.

**f. Analysis of financial statements**

It would involve the working out of financial ratios between different periods for the enterprise under audit, and between ratios of the enterprise and those of other enterprise of the same type, in order to see whether they bear a logical, reasonable and normal relationship to the others and to the total. The profitability ratio, solvency ratio will prove very helpful in this regard.

**g. Extension verification**

It relates to multiplication of two or more amounts so as to see if the total has been correctly arrived at.

**h. Inquiry**

It helps in obtaining information or explanation with the regard to transactions and their record. The auditors may use this method to collect in-depth information on various matters, particularly as to the operation of internal control system.

**i. Posting verification**

It aims at establishing the propriety and consistency of book-keeping by tracing selected items as recorded in one source to another source. Thus posting from the books of original entry may be traced to individual accounts in the ledger, and a fresh balance sheet may be prepared for each ledger.

**j. Documentary examination**

It is nearly the same as vouching, and equally important. It aims at examining documentary evidence to test its adequacy, appropriateness and reliability. Adequacy means that the documentary evidence must be sufficiently supportive of business transactions to which it relates. Appropriateness means that the transaction to which the documentary evidence relates must be genuine, valid, and related to the nature of the business of the undertaking.

**k. Flow charting**

Flow chart are used to describe graphically the course of transaction through different stages from beginning to end, and the document which are created in the process at each stage.

**l. Electronic data processing records**

Availability of mini-and micro-computer at moderate prize has brought them within the easy reach of even small business houses. The auditor must, therefore, be prepared to audit electronically processed records.

## Chapter 6

### Analytical Procedures

Analytical procedure is nothing but analyzing the various data collected, compare with some benchmarks and understand the variance. The compilation of data is primary step and analyzing the same is subsequent step.

- a) **Substantive tests** (also known as substantive procedures) are procedures designed to test for monetary errors or irregularities directly affecting the correctness of financial statements. The Internal audit performs substantive tests to detect material misstatement at the assertion level. Substantive tests of transactions emphasize the verification of transactions recorded in the journals and then posted in the general ledger.
- b) **Analytical procedures** emphasize the overall reasonableness of transactions and the general ledger balances. Thus, analytical procedures serve as both audit tests and audit procedure.

Analytical procedures refers to the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. The analysis of these deviations may be achieved through the consideration of comparisons of the entity's financial information with:

- a) Comparable information for prior periods
- b) The entity's anticipated results
- c) Similar industry information.

When performing analytical procedures, the internal audit team must examine both financial data and non-financial data relating to the transaction. Before starting their analytical procedures, the internal auditor estimate the expected value (of the ratio/ trend/ account balance/ transaction, etc.) before calculating the actual value so as to avoid the actual value being biased for the auditor's estimate of the expected value. The expected results are estimated based on preliminary discussions with the management.

Analytical procedures may be performed at any or all three stages in the audit process: the planning phase, the testing phase and the completion phase.

During the **planning phase**, analytical procedures can be used as risk assessment procedures. They help auditors identify significant matters requiring special consideration later in the audit engagement to understand the client's industry and business, to assess going concern, to indicate possible misstatements and to reduce detailed tests.

During the **testing phase**, analytical procedures can be used as substantive procedures in collecting appropriate audit evidence. They can be performed together with other substantive procedures and they help to indicate possible misstatements and to reduce detailed tests.



During the **completion phase**, analytical procedures can be used as part of an overall review of the financial statements for the auditors to reach conclusions about the fair presentation of the financial statements. The analytical procedures help the auditors to take a final review of the audited financial statements objectively and help to assess going concern and to indicate possible misstatements.

To ensure the expected effectiveness and efficiency of an analytical procedure, identification of potential for misstatements need to be assessed. These depend on:

- a) The nature of the assertion
- b) The plausibility and predictability of relationship
- c) The availability and reliability of the data used to develop the expectation
- d) The precision of the expectation.

The identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared with expectations and require judgment by the auditors, should be documented using the expectation and factors considered in its development, the results of the comparison of the expectation with the recorded amounts or ratios developed from the recorded amounts and finally, any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedures and the results of such additional procedures.

In practice not all the actual results obtained from analytical procedures will be close to the expected results estimated by internal audit team. As mentioned above, the Internal auditor must then have to investigate and obtain adequate explanations and appropriate corroborative audit evidence. The Internal auditor seldom jumps to the conclusion that fraud exists, but has to at least reveal the suitability and reliability of data adopted in the estimation. If they are confident with their data, they normally start by making inquiries of management. However, if management is unable to provide an explanation or if the explanation is not considered adequate, the internal audit team should consider the need to apply other audit procedures based on the results of their inquiries.

To conclude, Analytical procedure is a powerful tool that has the potential to increase the efficiency of audits since it is a relatively low-cost procedure that seems to have considerable power in identifying errors or irregularities and in guiding audits. Although the calculation of ratios and comparison of trends are relatively easy tasks, the analysis of ratios and trends requires a good understanding of the organisation's business and industry. If, in case, a firm of accountants has undertaken the internal audit assignment, either it should have team consisting of experience Cost Accountants to conduct internal audit, cost records and related systems or alternatively, engage a firm of practicing Cost Accountants with a wide exposure to other companies within the industry.

#### **Ratio Analysis as an Analytical Procedure**

A ratio shows the arithmetical relationship between two figures. Financial ratios, thus, focus attention on the interrelationships between various items of financial information.



An auditor can use ratio analysis to identify anything abnormal or anything which deviates from the expected and the known. The ratio analysis is a simple technique to analyzing the data and it gives clear indication for efficiency or inefficiency of a particular element. E.g. The material consumption ratio for a particular period when compared with previous records or standards, can easily lead to conclude whether the consumption is normal or abnormal for a given period.

Another example is the management of an enterprise may inflate its figure of sales and it may create documentary evidence from which the auditor may not be able to detect the manipulation. However, the other relevant data viz. dispatch of material, duty payment, debtors, production etc. cannot be manipulated simultaneously. The ratio of debtors to sales or the rate of stock turnover or the quantitative ratio of inputs to outputs would indicate that something abnormal has happened. Even if all these are adjusted, the fall in the ratios of expense to sales would put the auditor to enquiry.

To use ratio analysis as an effective tool of audit, an auditor should be capable of:

- a) Identifying and measuring the basic interrelationships in financial data through computation of appropriate ratios; and
- b) Examining and interpreting the ratios and their significance in the light of actual business conditions.

Ratios highlight only symptom and the various symptoms. It is for the auditor to study these symptoms properly, correlate them, and reach definite conclusions or identify areas for further enquiry. Many people have the tendency to view each and every ratio separately. This may often lead to erroneous conclusions. Each ratio reflects a certain symptoms and the various symptoms should be analysed as a whole.

A large number of ratios can be worked out by an auditor while reviewing the financial statements of enterprises. While the choice of particular ratios depends upon the nature of business and the attendant circumstances, an auditor may pay special attention to the discussed below.

#### **Return on Investment (ROI)**

This ratio is the broadest measure of the overall performance of an enterprise. It combines in itself many factors including cost-price relationships of various products, operating efficiently and efficiency with which an enterprise uses its funds thus shows the net effect of various performance ratios.

#### **Capital turnover Rate and its Constituents**

This rate measures the effectiveness with which an enterprise uses the resources at its disposal.

Capital turnover rate is calculated as- ***Sales/Net capital employed***

An auditor should carefully look into the variation in the capital turnover rate. A low rate may indicate that the capital is lying idle or that there is a recession in sales or that the sales have been suppressed or that the value of any of the constituents of the net capital employed (i.e. fixed assets, stocks, debtors, cash, etc.) has been inflated. Similarly, and abnormally high capital turnover rate indicates that either enterprise is over trading to extend that its financial health is in danger or that the figures are manipulated. An auditor should find out whether variations in the capital turnover rate are the result of actual changes in business



circumstances of whether they arise due to manipulation of figures. To point out the reasons for variations in the capital turnover rate, the auditor should work out separately the turnover rates of fixed assets, stock, debtors, cash, etc.

#### **Fixed Assets Turnover Rate**

This rate shows the efficiency with which the fixed assets are utilized. The variations in the utilization of capacity are reflected in this rate. The auditor should find out whether the capacity utilization is actually low or whether the sales or production figures are being suppressed.

#### **Stock Turnover Rate**

This indicates the relationship of finished stocks in hand with sales.<sup>1</sup> If there are no manipulations, a low rate indicates that the sales are low, resulting in accumulation of stocks or that the stock maintained by the enterprise are excessive in relation to sales. This ratio should be worked out in terms of quantity and value

#### **Debtors Turnover Rate**

This indicates the relationship of debtors with credit sales.

#### **Creditors Turnover Rate**

This shows the relationship between creditors for goods and credit purchases.

#### **Ratios of Profit and Loss Account**

**Gross Profit Ratio:** This ratio reflects average mark-up or gross margin on sales.

**Net Profit Ratio:** This ratio indicates the net margin on sales after meeting all cost except interest on long-term loans.

**Material Cost Ratio:** This is the ratio of cost materials consumed to net sales.

**Conversion Cost Ratio:** This is the ratio of labor cost and manufacturing overheads (excluding, of course, direct materials) to sales.

#### **Ratio of Administrative Overheads and Selling and Distribution Overheads to Sales**

This ratio indicates the relationship of administrative, selling and distribution expenses to total sales

#### **Ratios Including Financial Position**

**Current Ratio:** This ratio shows the relationship between the current assets and current liabilities of an enterprise. A high current ratio may be due to an accumulation of stocks or debtors. A low current ratio may indicate that the enterprise over-trading or that it may not be able to meet its short-term liabilities, in all such case, the auditor should conduct a deeper examination. An abnormal current ratio may also indicate that current liabilities are misstated or that here in a manipulation in the values of stocks, debtors, cash or creditors.

**Acid Test Ratio:** This ratio shows the relationship between the liquid assets and the current liabilities. Since the current liabilities can be immediately paid only from liquid assets, this ratio is a good indicator of the liquidity of an enterprise.

**Debit-equity Ratio:** This ratio shows the relationship between the long-term loans and the funds belonging to the shareholders. Thus it shows the relative importance of loan funds and shareholders' funds in the capital structure of an enterprise (i.e. the degree of financial leverage of the enterprise). If an enterprise has an abnormally high debt-equity ratio, its solvency may be in danger particularly when its profitability is low.

**Long-term Ratio:** This ratio shows the relationship between the long-term uses of funds (fixed assets and long-term investment) and the long-term funds. Since it is a cardinal principle of sound financial management that long-term assets and a portion of working capital (core working capital) are acquired only out of long-term funds, this ratio should always be less than one.

#### **Quantitative ratio and Reconciliations**

**Input-Output Ratio:** This ratio shows the relationship between the quantity of input and the quantity produced. The raw materials that are fed into production pass through one or more processes before they are converted into finished products. A standard input-output ratio can be established to show the relationship between the raw materials of a specified quality with the output.

**Stock Reconciliations:** An overall reconciliation of stocks may also be useful for an auditor. He may take the figures of the opening stocks of various products. Add the production during the year as shown by the records and deduct therefrom the total quantities sold. The closing stock so worked out can be compared with the actual closing stock. A significant difference between the two may indicate the possibility of suppression for sales, pilferage, fictitious sales, etc.

**Tracking:** This software enables the auditor to identify which instructions were used in program and in what order. Thus, the auditor can understand the way a program operates.

#### **Comparison of ratios with previous period**

The auditor has to compare all the above ratios with the previous period or with industry related standards. The ratio as such doesn't give any indication unless it is compared with previous period e.g. if the material consumption ratio for a period is high as compared to previous period the auditor should investigate the reasons for high consumption. This analysis may open other areas for further investigation such as viz. poor quality of material, inefficiency of labour, wastage of material, theft of material etc.

After analyzing the ratios the auditor should report the same to the concerned authorities and should ensure that some corrective actions are taken to rectify the situation.

#### **B) Graphical analysis of data**

In case of voluminous data, the same can be represented through Graphs, Tables, charts which are easy to understand. Use of computers is very helpful in this respect. E.g. Area wise sales, Customer-wise sales, Sales



effected by different agencies during a period, product wise sales etc. can be presented and analysed in terms of graphs which can give the idea of performance of various aspects relating to sales.

**C) Data Analysis under ERP environment**

Under ERP environment, the data analysis is very crucial and important. The auditor can get any type of data required for his analysis. The main issue in this respect is what data is demanded by the auditor and how he is analyzing the same. The skill of the auditor lies in raising the appropriate query for verification of data. The feature of ERP environment is that there is no constraint in getting any information from the voluminous data. The exceptions to the normal rule should be identified through different queries raised for Data Analysis. E.g. In HR Department, if the number of employees are say 50000 spread over different parts of the country, the verification of leave records of these employees can be easily compiled by the auditor. However, enjoying normal leave is the privilege of each employee. Hence, instead of analyzing this information, the exception to the rule i.e. persons who have not availed the leave during a given period should be analysed which may lead for further investigation.



## Chapter 7

### Accounting System and Internal Control

An Accounting System is often defined as an organized set of manual and computerized accounting methods, procedures, and controls established to gather, record, classify, analyse, summarize, interpret, and present accurate and timely financial data for management decisions. An accounting system performs the crucial task of accumulating data and providing the management with decision making information. Over the years the process of an accounting system has evolved from being a manual and paper based format to an electronic form. In an electronic financial accounting system, the steps in the accounting cycle are independent in nature, self-reconciliatory and adhering to set rules and controls.

An Integrated Accounting System is an accounting system which involves joint accounting of cost accounts and financial accounts. This system helps set aside the majority of programs, spreadsheets, and other manual systems and replacing them with one, efficient program that can effectively accomplish nearly all of your accounting needs and goals. An integrated accounting system can perform the wide variety of functions and helps to:

- a) Estimate, report on, and monitor all job costs at summary or detailed levels.
- b) Track employee time, and then convert it into payroll that is posted to job costs.
- c) Easily produce customer statements (or create marketing letters)
- d) Reduce data entry time such as converting the estimates into sales orders and/or invoices, and purchase orders into bills.
- e) Handle inventory purchases, assemblies,
- f) and sales

Instead of simultaneously performing all of these different tasks using multiple data collection and analysis points, an integrated accounting system would help incorporate these different activities and correlate their effect on each other. Thus, an integrated accounting system also helps to accurately retain the information needed to access regarding the various activities and components of the business. An integrated accounting system is also cost effective as maintaining several non-integrated systems not only requires duplication of effort, but it's time-consuming and typically yields results that are not useful or accurate. Perhaps the greatest benefit of an integrated system is that it would make reconciliations redundant.

**Internal control**, on the other hand, is the process designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Safeguarding assets against theft and unauthorized use, acquisition, or disposal is also part of internal control.

The management style and expectations, particularly their control policies, determine the **control environment**. An effective control environment helps ensure that established policies and procedures are followed. The control environment includes independent oversight provided by a board of directors and, in publicly held companies, by an audit committee; management's integrity, ethical values, and



philosophy; a defined organisational structure with competent and trustworthy employees; and the assignment of authority and responsibility.

**Control activities** are the specific policies and procedures management uses to achieve its objectives. The most important control activities involve the following:

- a) **Adequacy of documents:** The audit documents must provide adequate and relevant evidence that financial statements are accurate. Controls designed to ensure adequacy of accounting system include the creation of invoices, payment receipts and other documents that are easily available, verifiable by external records and consistently tracked.
- b) **Appropriate authorization** of transactions and activities help ensure compliance of all organizational activities with the established guidelines while keeping a track of deviations through official communications and approvals.
- c) **Independent check** of operational performance of all functions, processes and activities that the organization is involved in helps to ensure the reliability of accounting information along with the efficiency of operations.
- d) **Physical verification of** assets and records helps to protect and ascertain the organization's assets. Physical Verification on a timely basis ensures a complete and accurate Fixed Assets Register.
- e) **Segregation of duties** necessitates that different individuals be assigned responsibility for different elements of related activities of a process to ensure multiple levels of system based checks and controls.

In order to identify and establish effective controls, management must continually assess the risk, monitor control implementation, and modify controls as needed. Top managers of publicly held companies must sign a statement of responsibility for internal controls and include this statement in their annual report to stockholders.

**Internal control of accounting systems involves** a series of procedures designed to promote and protect sound management practices, both general and financial. Following internal accounting control procedures will significantly increase the likelihood that:

- 1) financial information is reliable, so that managers and the board can depend on accurate information to make programmatic and other decisions
- 2) assets and records of the organisation are not stolen, misused, or accidentally destroyed
- 3) the organisation s policies are followed
- 4) Government regulations are met.

The preliminary step in developing an effective internal accounting control system is to identify those areas where abuses or errors are likely to occur. The management can also provide the internal audit function with



a checklist of the areas and the questions to consider when planning this system. The following areas and objectives are generally targeted in developing an effective internal accounting control system:

- i. Cash and cash equivalents
- ii. Cash disbursements
- iii. Cheque issuance
- iv. Grants, gifts, and bequests
- v. Current Assets and Current Liabilities
- vi. Inventories
- vii. Trade Receivable and Trade payable
- viii. Non Current Assets and Non Current Liabilities
- ix. Secured and Non Secured Loan
- x. Deposits
- xi. Transfers
- xii. The annual budget and periodic comparisons of financial statements
- xiii. Personnel policies, and
- xiv. Payroll

The internal auditor's management letter is an important indicator of the adequacy of internal accounting control structure, and the degree to which it is maintained. The management letter, which accompanies the audit, cites significant weaknesses in the system or its execution. By reviewing the management letter with the management, asking for responses to each internal control lapse or recommendation, and comparing management letters from year to year, a useful mechanism for monitoring is created for financial safeguards and adherence to financial policies. The need to periodically review the internal accounting control system which has been established and modify it to include new circumstances and regulations is a continuous and important activity of every Internal Audit.

## Chapter 8

### Control and Risk Assessment

Risk management is the management function used for developing, maintaining and implementing the Risk Management Framework, strategy and policy. Risk management systems help in enhancing the organisation's ability to manage uncertainty by protecting assets whilst ensuring compliance. Many organisations in India and around the world continue to be ignorant of the need and importance of a robust risk management system. The internal auditor should identify the need for a change in behavior and mindset in relation to risk management as and when:

- a) Every function or process does not have one or more well defined risk factors that act as indicators to risk assessments
- b) Risk awareness among staff and management is low
- c) The organization begins to focus on financial control of expenses rather than a broad level internal control through guidelines.
- d) The top level management start believing that risk management is not their concern and agenda in meetings
- e) Internal control system review is viewed as a compliance report rather than a daily activity
- f) There is a lack of clearly defined business objectives in the short term

The process of risk management generally involves:

- a) A clear understanding of the organization's long and short term objectives
- b) Identification of the risks associated with non-performance or deviation from set objectives
- c) Assessment of the probability and potential impact of particular risks factors that are crucial to achieving operational performance
- d) Development of action plans and delivery programs to address the identified risks
- e) Monitoring and evaluating the risks on a continuous basis

Every area of an organization whether it is strategy, operations, accounts, human resources and environment. Examples of such risks are loss of key staff, reductions in financial and other resources, disruptions to the flow of information and communications, fires or other physical disasters, leading to interruptions of business and / or loss of records. Generally, risk should also include issues related to fraud, waste, abuse and mismanagement.

Some of the **types of risks** that may need to be considered are given below, however, this list should not be regarded as exhaustive and it is not industry specific. Actual risks faced by a company are likely to include more industry-specific types of risks and to relate to the particular circumstances of the company.

**A) Business Risks**

- a) Wrong business strategy
- b) Competitive pressure on price / market share
- c) General / regional economic problems
- d) Industry sector in decline
- e) Political risks
- f) Adverse government policy
- g) No attention to information technology (IT) aspects of strategy and implementation
- h) Obsolescence of technology
- i) Substitute products
- j) Takeover target
- k) Inability to obtain further capital
- l) Bad acquisition
- m) Too slow to innovate and reengineering
- n) Too slow to respond to demands from market and customers

**B) Financial Risks**

- a) Market risk
- b) Credit risk
- c) Interest risk
- d) Currency risk
- e) Treasury risk
- f) Liquidity risk
- g) Overtrading
- h) High cost of capital
- i) Misuse of financial resources
- j) Going concern problems
- k) Occurrence of types of fraud to which the business is susceptible
- l) Misstatement risk related to published financial information
- m) Breakdown of accounting system
- n) Unreliable accounting records
- o) Unrecorded liabilities
- p) Penetration and attack of IT systems by hackers
- q) Decisions based on incomplete or faulty information
- r) Too much data and not enough analysis
- s) Unfulfilled promises/pledges to investors



**C) Compliance Risks**

- a) Breach of Listing Rules
- b) Breach of financial regulations
- c) Breach of Companies Ordinance requirements
- d) Breach of competition regulations
- e) Breach of other regulations and laws
- f) Litigation risk
- g) Tax problems
- h) Health and safety risks
- i) Environmental problems

**D) Operations and Other Risks**

- 1) Inefficient / ineffective management process
- 2) Business processes not aligned to customer / market demand and strategic goals
- 3) Loss of entrepreneurial spirit
- 4) Missed or ignored business opportunities
- 5) Other business probity issues
- 6) Other issues giving rise to reputational problems
- 7) Poor brand management
- 8) Failure of major change initiative
- 9) Inability to implement change
- 10) Stock-out of raw materials
- 11) Skills shortage
- 12) Physical disasters (e.g., fire and explosion)
- 13) Computer viruses or other system malfunctions
- 14) Failure to create and exploit intangible assets
- 15) Loss of intangible assets
- 16) Loss of physical assets
- 17) Loss of key people
- 18) Loss of key contracts
- 19) Lack of orders
- 20) Lack of business continuity
- 21) Succession problems
- 22) Inability to reduce cost base
- 23) Over-reliance on key suppliers or customers
- 24) Onerous contract obligations imposed by major customers
- 25) Failure of new products or services
- 26) Failure to satisfy customers

- 27) Poor service levels
- 28) Quality problems
- 29) Product liability
- 30) Failure of major projects
- 31) Failure of big technology related projects
- 32) Failure of outsource providers to deliver
- 33) Lack of employee motivation or efficiency
- 34) Industrial action
- 35) Problems arising from exploiting employees in developing countries
- 36) Inefficient / ineffective processing of documents
- 37) Breach of confidentiality

Risk management is essential for reducing the probability that corporate objectives will be jeopardized by unforeseen events. The board must determine the type and extent of risks that are acceptable to the company, and strive to maintain risk within these levels. Internal control is one of the principal means by which risk is managed.

In the business world, a company's objectives and the environment in which it operates are continually evolving and, as a result, the risks that it faces also change. A sound system of internal control depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. The systems and processes of control need to be sufficiently flexible to be able to change and adapt as the environment and the company's organisation, objectives and activities develop over time. The purpose of internal control is to help manage and control risk appropriately, rather than to eliminate it.

**The basic fundamentals** of a Good Risk management and Internal Control system including but are not limited to:

- a. Risk Awareness
- b. Integrated consultation and business decision making process
- c. Continuous emphasis on internal control and strategy
- d. Focus on Business Objectives
- e. Crash Gates and Early Warning mechanisms to enable quick responses
- f. Reliable and timely business information

Thus, an effective, efficient and progressive risk management system and policy would help the organisation reduce the time management spends "fire-fighting", increase in change initiatives, lower the cost of capital, provide useful feedback and information for strategy setting, achieve and maintain competitive advantages and reduce uncertainty of results and events.

In order to embed the risk management process firmly into the organisation, all employees must be trained and should have the necessary knowledge, skills, information and authority to establish, operate and

monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates and the risks that it faces. In addition, the business process should be so modified that they incorporate risk management as a part of the everyday working. As an elaborate risk management process can be a distraction from the key point, which is that incorporating control within existing processes enables each person in the organisation to become more focused on meeting the business objectives and in managing significant risks that relate to the tasks performed. Reduction of duplicate or repetitive controls within the work environment help increase the empowerment for people within the company to work to satisfy the needs of customers.

**Risk assessment** involves the identification and analysis of risks underlying the achievement of objectives, including risks relating to the changing regulatory and operating environment and business strategy, as a basis for determining how such risks should be mitigated and managed. Risk affects an organisation's ability to survive and successfully compete. However, avoiding risk completely is never possible and thus, the management must decide how much risk can be prudently accepted and strive to maintain risk within this level. Setting objectives is a pre-condition to risk assessment and management. It is a prerequisite for and enabler of internal controls, although not a component as such. These should be expressed around the future rather than the past or present and should be focused on achievable goals. The management should consider whether any existing objectives are able to meet the challenges that it is likely to face over, at least, the next two to three years. By setting high level objectives at the entity level and more specific objectives at the activity level, an entity can identify factors that are critical to the achievement of goals.

The biggest concern whenever setting objectives should be "SALY". This stands for "Same as Last Year" and can hamper even the most prudent risk management systems. The management should be cautious of the "SALY" approach to risk assessment and care diligence is required to avoid the same.

There are various techniques used to identify risks including the periodic reviews of economic and industry factors affecting the business, senior management conferences and meetings with industry analysts. Whatever method be adopted, the management needs to consider carefully the factors that contribute to or increase risk, including issues such as past experience of failure to meet objectives; quality of personnel; significant changes, such as increased competition; legislative, regulatory and personnel changes; market developments, and the significance of particular activities to the entity and their complexity.

Risk should also be identified at the activity level, which can help to focus risk assessment on major business units or functions and also contribute to maintaining acceptable levels at the entity-wide level. Following the initial identification of the significant risks to the company achieving its objectives, it may be useful to consult throughout the company on issues such as:

- a) awareness of the company's business objectives, business strategy and related significant risks;
- b) the company's risk management policy;
- c) whether the control strategies adopted are effective and what needs to be done to put them into effect;

- d) the fundamentals of good risk management and internal control and
- e) ways in which improvements can be made in order to mitigate the significant risks affecting the ability of the company to achieve its business objectives;

This consultation can help to identify whether the management has identified all the significant risks relevant to the objectives. It can also provide the management with a solid foundation for its review of the effectiveness of internal control and for its reporting on control. Following the identification of entity-wide and activity risks, a risk analysis should be performed. Once the significance and likelihood of risk have been assessed, the management needs to consider how the risk should be managed. Fundamental to risk assessment is a process to identify changed conditions and take action as necessary. Mechanisms to identify relevant and important changes should, as far as possible, be forward looking and early warning systems should be in place to identify data signals of new risks.

The final step in the process is that of prioritizing risk. Risks may be prioritized according to their impact and likelihood.

- a) Require immediate action;
- b) Consider action and have a contingency plan;
- c) Consider action and
- d) Keep under periodic review.

The impact should be considered not merely in financial terms, but more importantly, in terms of potential effect on the achievement of the company's objectives. Not all risks will be identified as significant. Non-significant risks should be reviewed regularly, particularly in the light of changing external events, to check that they remain non-significant.

Having identified and then prioritized the significant risks in gross terms, it is then helpful to determine for each of these,

- a) do the directors wish to accept this risk?
- b) what is the control strategy to avoid or mitigate the gross risk?
- c) who is accountable for managing the risk and maintaining and monitoring the controls?
- d) what is the residual risk, that is the risk remaining after the application of the control processes? and
- e) What is the early warning mechanism?

It should be noted that, while risk assessment is a part of the internal audit function, the plans, programs and other actions deemed necessary to address the risks are an essential part of the overall management process but are not regarded as an element of the internal audit.

### **Risk Analysis Techniques**

A risk analysis involves identifying the most probable threats to an organization and analyzing the related vulnerabilities of the organization to these threats. A risk assessment involves evaluating existing physical and environmental security and controls, and assessing their adequacy relative to the potential threats of the organization.

The types of criteria that can be used to evaluate the risk include:

- a) Customer service,
- b) Internal operations,
- c) Legal/statutory,
- d) Financial.

Most businesses depend heavily on technology and automated systems, and their disruption for even a few days could cause severe financial loss and threaten survival. The risk analysis process provides the foundation for the entire recovery planning effort.

### **A) Risk analysis Process**

Regardless of the prevention techniques employed, possible threats that could arise inside or outside the organization need to be assessed. Although the exact nature of potential disasters or their resulting consequences are difficult to determine, it is beneficial to perform an organization. Regardless of the type of all threats that can realistically occur to the organization, Regardless of the type of threat, the goals of business recovery planning are to ensure the safety of customers, employees and other personnel during and following a disaster. The relative probability of a disaster occurring should be determined. Items to consider in determining the probability of a specific disaster should include, but not be limited to geographic location, topography of the area, proximity to major sources of power, bodies of water and airports, degree of accessibility to facilities within the organization, history of local utility companies in providing uninterrupted services, history of local utility companies in providing uninterrupted services, history of the area's susceptibility to natural threats, proximity to major highways which transport hazardous waste and combustible products. Potential exposures may be classified as natural, technical, or human threats. Examples include:

- a) **Natural Threats:** internal flooding, external flooding, internal fire, external fire, seismic activity, high winds, snow and ice storms, volcanic eruption, tornado, hurricane, epidemic, tidal wave, typhoon.
- b) **Technical Threats:** power failure/fluctuation, heating, ventilation or air conditioning failure, malfunction or failure of CPU, failure of system software, failure of application software, telecommunications failure, gas leaks, communications failure, nuclear fallout.
- c) **Human Threats:** robbery, bomb threats, embezzlement, extortion, burglary, vandalism, terrorism, civil disorder, chemical spill, sabotage, explosion, war, biological contamination, radiation contamination, hazardous waste, vehicle crash, airport proximity, work stoppage(Internal/External), computer crime.

All locations and facilities should be included in the risk analysis. Rather than attempting to determine exact probabilities of each disaster, a general relational rating system of high, medium and low can be used initially to identify the probability of the threat occurring. The risk analysis also should determine the impact of each type of the threat occurring. The risk analysis also should determine the impact of each type of potential threat on various functions or departments within the organization. The functions or departments will vary by type of organization.

The planning process should identify and measure the likelihood of the potential risks and the impact on the organization of that threat occurred. To do this, each department should be analyzed separately. Although the main computer system may be the single greatest risk, it is not the only important concern. Even in the most automated organizations, some departments may not be computerized or automated at all.

**Following are typical assumptions that can be used during the risk assessment process:**

1. Although impact ratings could range between 1 and 3 for any facility given a specific set of circumstances, ratings applied should reflect anticipated, likely or expected impact on each area;
2. Each potential threat should be assumed to be “localized” to the facility being rated;
3. Although one potential threat could lead to another potential threat, no domino effect should be assumed;
4. If the result of the threat would not warrant movement to an alternate site(s), the impact should be rated no higher than
5. The risk assessment should be performed by facility. To measure the potential risks, a weighted point rating system can be used. Each level of probability can be assigned points as follows:

| <b>Probability</b> | <b>Points</b> |
|--------------------|---------------|
| High               | 10            |
| Medium             | 5             |
| Low                | 1             |

1. Considerations in analyzing risk include:
  - a) Investigating the frequency of particular types of disasters (often versus seldom);
  - b) Determining the degree of predictability of the disaster;
  - c) Analyzing the speed of onset of the disaster (sudden versus gradual);
  - d) Determining the amount of forewarning associated with the disaster;
  - e) Estimating the duration of the disaster;
  - f) Considering the impact of a disaster based on two scenarios, namely;
    - (i) Vital records are destroyed,
    - (ii) Vital records are not destroyed;

- g) Identifying the consequences of a disaster, such as: Personnel availability, personal injuries, Loss of operating capability. Loss of assets, Facility damage.
2. Determining the existing and required redundancy levels throughout the organization to accommodate critical systems and functions, including: Hardware, Information, Communication, Personnel, Services;
3. Estimating potential financial loss such as: Increased operating costs, Loss of business opportunities, Loss of financial management capability, Loss of assets, Negative media coverage, Loss of stockholder confidence, Loss of goodwill, Loss of income, Loss of competitive edge, Legal actions;
4. Estimating potential losses for each business function based on the financial and service impact and the length of time the organization can operate without this business function. The impact of a disaster related to a business function depends on the type of outage that occurs and the time that elapses before normal operations can be resumed.

#### **B) Disaster prevention**

Disaster prevention techniques include two categories-

##### **1. Procedural prevention**

Procedural prevention relates to activities performed on a day-to-day, month-to-month, or annual basis, relating to security and recovery. Procedural prevention begins with assigning responsibility for overall security of the organization to an individual with adequate competence and authority to meet the challenges.

##### **2. Physical prevention**

Physical prevention and preparedness for disaster begins when a site is constructed. It includes special requirements for building construction, as well as fire protection for various equipment components. Special considerations include: computer area, fire detection and extinguishing systems, record(s) protection, air conditioning, heating and ventilation, electrical supply and UPS systems, emergency procedures, vault storage area(s), archival systems.

#### **C) Security and Control Considerations**

Security and controls refer to all the measures adopted within an organization to safeguard assets, ensure the accuracy and reliability of records, and encourage operational efficiency and adherence to prescribed procedures. The system of internal controls also includes the measure adopted to safeguard the computer system.

#### **Fraud Risk Assessment**

Every organization faces some risk of fraud from within. Fraud exposure can be classified into three broad categories-

- a) Asset misappropriation,
- b) Corruption
- c) Fraudulent financial statements.



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The auditor should approach logically to investigate the above matters. The auditor should prepare a questionnaire asking- Who, When, Why, How etc. relating to the specific issue. This will enable him to analyse the problem and conclude his observations.



## Chapter 9

### Internal Audit in ERP Environment and Systems Audit

#### **Introduction:**

Enterprise resources planning (ERP) systems were first seen utilized in for accounting in early 1990s. These systems, which are essentially vendor defined enterprise wide accounting systems, promised fully integrated applications built upon common, centrally defined databases. The benefits of these systems were supposed to be manifold. An ERP system would eliminate the need to manage information flows manually by allowing the effect of every business transaction to be disseminated throughout the enterprise via update to a common database. It would provide real-time information to support operational and managerial decision activities as every application would be working with the current version of the operational database rather than working with slightly stale data as was the case in old fragmented systems. An adopting organisation would be able to reduce the time to close accounts and create financial reports in real time, as the data in databases is current all the time.

In the initial period of computerization, the computer department was commonly known as “Electronic Data Processing (EDP)” Department and with this, EDP Audit gained momentum. With the advent and growth of computer network systems, Computer Systems are now “Information Systems”. EDP Audit got replaced with terms such as “Information Technology Audit” and “Information Systems Audit”. As the recording of business transactions shifted from manual system to high-tech ERP systems, it simultaneously necessitated the Internal Auditor to change his methods of verification and evaluation of data.

#### **Essentials of Implementation of ERP system**

Enterprise Resource Planning (ERP) System implementation is both an art and science that consists of planning, implementation, and ongoing maintenance. This methodology is designed to automate the laborious work of implementation and provide organized approaches to problem solving by listing, diagramming, and documenting all steps. Structured methodologies help to standardize and systemize ERP implementation and maintenance by approaching them as an engineering discipline rather than as whims of individual software developers. It is essential to understand structured methodologies in the implementation of ERP systems.

The basic steps of structured methodologies are:

- a) **Project Definition and Requirement Analysis:** Defining the terms of reference, determining user needs and system constraints, generating a functional specification and a logical model for the best solutions.
- b) **External Design:** Detailing the design for a selected solution, including diagrams relating all programs, subroutines, and data flow.

#### **ERP System Implementation Overview**

- a) Internal Design - Building, testing, installing, and tuning software.

- b) Pre-implementation - Evaluation and acceptance
- c) Implementing systems.
- d) Post-implementation - Evaluation of controls and debugging.

When an organization purchases an ERP system, the intent is that the purchased ERP system provides specific functions and benefits. These functions and benefits need to be articulated to ensure that the ERP system performs as desired. This process is called conducting a feasibility analysis. The purpose of the feasibility study is to provide:

- a) An analysis of the objectives, requirements, and system concepts.
- b) An evaluation of different approaches for reasonably achieving the objectives.
- c) Identification of a proposed approach.

**The feasibility analysis normally covers:**

1. **Current working practice:** These are examined in depth, revealing areas in the business where there is duplication of effort, or where procedures instituted in the distant past are carried out even though there is no longer any need for them.
2. **Channels of information:** These are examined because the feasibility study is concerned primarily with the input and output information of each internal system. Such a study ignores departmental boundaries and prejudices. When the true information patterns within a business are exposed, it is often possible to reorganize resources so that all relevant data is captured at the point where it can be used for decision. In a manufacturing firm, data relating to a product is typically kept by many different departments in the organization:
  - a) A record showing product inventory balance is kept by the Inventory Control Department.
  - b) It's cost and/or standard cost is shown on a record in the Costing Department.
  - c) A record kept by the incentives department shows bonus percentages to be paid to employees for given levels of production.
  - d) In the Finance/Accounting Department, a record of inventory values is kept for manufacturing account purposes.
  - e) Shipping and Receiving maintains records of quantities shipped to customers and receipts of raw material.

ERPs have substantially altered the method by which administrative processes, such as payroll, accounts payable, inventory, sales and accounts receivable, operate, are controlled and audited. Opportunities for personal review and clerical checking have declined as the collection and subsequent uses of data have changed. The changes are the result of moving from manual procedures performed by individuals familiar with both the data and the accounting process; to high volume, automated processes performed by individuals unfamiliar with either the data or the accounting practices. The audit of operational ERP systems evaluates the results of the automated processes. It is normally a data-oriented audit, looking at processed

transactions. The adequacy and effectiveness of the system controls can be evaluated by examining the results of operation (i.e., did the application produce the anticipated outcome).

### **Risks in an ERP Environment**

Various risks involved in ERP environment are discussed below, including many of the conditions that cause the risks to occur.

- **Improper use of technology:**

The conditions that lead to the improper use of technology include:

- a) Premature user of new hardware technology.
- b) Early user of new software technology.
- c) Minimal planning for the installation of new hardware and software technology.
- d) Systems analyst/programmer improperly skilled in the use of technology.
- e) Inability to control technology.

- **Uncontrolled technology:**

The conditions that result in uncontrolled technology include:

- a) Selection of vendor-offered system control capabilities by systems programmers without considering audit needs.
- b) Too many control trade-offs for operational efficiency.
- c) Inadequate restart/recovery procedures.
- d) Inadequate control over different versions of programs.
- e) Inadequate control over schedulers, system operators, tape librarians, print capabilities, and data transmission capabilities.
- f) Inadequate review of outputs.

- **Inability to translate user needs into technical requirements:**

Conditions that can lead to the inability to translate user needs into technical requirements include:

- a) Users without technical IT skills.
- b) Technical people without sufficient understanding of user requirements.
- c) User's inability to specify requirements in sufficient detail.
- d) Multi-user systems with no user in charge of the system.
- e) Illogical processing.

- **Illogical Process:**

Conditions that can result in illogical processing include:

- a) Failure to check for unusually large amounts on output documents.
- b) Fields that are either too small or too large, thereby impacting the completeness, accuracy, or efficiency of the data being processed.

- c) Failure to scan output documents.

• **Inability to react quickly (to stop processing):**

The conditions that make ERP applications unable to react quickly include:

- a) Computer time is unavailable to satisfy the request, or computer terminals/microcomputers are not readily accessible to users.
- b) The structure of the computer files is inconsistent with the information requested.
- c) General-purpose extract programs are not available to satisfy the desired request.
- d) The cost of processing exceeds the value of the information requested.
- e) Cascading of errors.

**Cascading of errors:**

The types of conditions that lead to cascading of errors include:

- a) Inadequately tested applications.
- b) Failure to communicate the type and date of changes being implemented.
- c) Limited testing of program changes.
- d) Repetition of errors.

**Repetition of errors:**

The conditions that cause repetition of errors include:

- a) Insufficient program testing.
- b) Inadequate checks on entry of master information.
- c) Failure to monitor the results of processing.
- d) Incorrect entry of data.

**Incorrect entry of data:**

Conditions that can cause incorrect entry of data include:

- a) Human errors in keying data.
- b) Mechanical failure of hardware devices.
- c) Misinterpretation of characters or meaning of manually recorded input.
- d) Misunderstanding of data entry procedures.
- e) Inadequate data verification procedures.
- f) Concentration of data

**Concentration of data:**

The conditions that can create problems due to the concentration of data in ERP applications include:

- a) Erroneous data and its impact on multiple users of that data.
- b) Impact of hardware and software failures that ordinarily make the data available to multiple users.
- c) Inadequate access controls enabling unauthorized access to data.

- d) Inefficient use of system for data storage and/or retrieval, which may impact response time or computer capacity.
- e) Inability to substantiate processing

**Inability to substantiate processing:**

Conditions that may cause the inability to substantiate processing include:

- a) Evidence is not retained long enough.
- b) The evidence from intermediate processing is not retained.
- c) Evidence is not independently reviewed for quality assurance and/or data integrity.
- d) Concentration of responsibilities

**Concentration of responsibilities:**

Conditions that cause the concentration of responsibilities in an ERP environment include:

- a) Establishment of a data processing programming and systems group to develop ERP applications for an organization.
- b) Centralized processing of ERP applications.
- c) Establishment of a database administration function.
- d) Lack of adequate standards and enforcement of those standards.
- e) Lack of adequate quality assurance and systems or applications testing.

**Role of Internal Auditor in ERP Environment–**

Once the business risk for the ERP systems is defined, it is possible for the auditor to determine how these risks will be contained. Control objectives can be defined as “the purpose or justification for having internal controls.” The organization’s internal control structure must meet several control objectives to prevent, detect and correct errors, omissions and irregularities in business transactions and processes, and to assure continuity of business operations. They are a link between the risks and internal controls. Control objectives may differ, depending upon the type, scope, and purpose of the audit. There could be several internal control objectives for a given business risk, so that the risk is adequately addressed. Some of the common internal control objectives that an auditor should look for are:

- I. Transactions are properly authorized (**Authorized**).
- II. Transactions are recorded on a timely basis (**Timeliness**).
- III. Transactions are accurately processed (**Accuracy**).
- IV. All existing transactions are recorded (**Completeness**).
- V. All recorded transactions are valid (**Validity**).
- VI. Transactions are properly valued (**Valuation**).
- VII. Transactions are properly classified and posted to proper accounts and subsidiary records (**Classification**).
- VIII. Transactions are properly summarized and reported (**Reporting**).

- IX. Assets, including software programs, data, human resources, computer facilities, etc. are safeguarded against damage, theft, and so forth (**Security**).
- X. System and data integrity is maintained (**Integrity**).
- XI. System availability is assured (**Availability**).
- XII. System controllability and audit ability is maintained (**Controllability and Audit ability**).
- XIII. System maintainability is assured (**Maintainability**).
- XIV. System usability is assured (**Usability**).
- XV. System economy and efficiency are maintained (**Efficiency**).

### **Information System Audit**

An **information technology audit**, or **information systems audit**, is an examination of the management controls within an Information technology (IT) infrastructure. The evaluation of obtained evidence determines if the information systems are safeguarding assets, maintaining data integrity, and operating effectively to achieve the organization's goals or objectives. These reviews may be performed in conjunction with a financial statement audit, internal audit, or other form of attestation engagement.

### **Types of IT audits:**

- a) **Systems and Applications:** An audit to verify that systems and applications are appropriate, are efficient, and are adequately controlled to ensure valid, reliable, timely, and secure input, processing, and output at all levels of a system's activity.
- b) **Information Processing Facilities:** An audit to verify that the processing facility is controlled to ensure timely, accurate, and efficient processing of applications under normal and potentially disruptive conditions.
- c) **Systems Development:** An audit to verify that the systems under development meet the objectives of the organization and to ensure that the systems are developed in accordance with generally accepted standards for systems development.
- d) **Management of IT and Enterprise Architecture:** An audit to verify that IT management has developed an organizational structure and procedures to ensure a controlled and efficient environment for information processing.
- e) **Client/Server, Telecommunications, Intranets, and Extranets:** An audit to verify that telecommunications controls are in place on the client (computer receiving services), server, and on the network connecting the clients and servers.

### **Control Points in IT Audit**

Irrespective of type of audit under consideration, the IT auditor has to see for three basic control points in any system. These are –



- a) Security Control.
- b) Access Control.
- c) Information Assurance Control.

IS auditing considers all the potential hazards and controls in information systems. It focuses on issues like operations, data, integrity, software applications, security, privacy, budgets and expenditures, cost control, and productivity.

## **Chapter 10**

### **Relying on External Opinion and Reference of Auditor Expert**

The 21<sup>st</sup> Century business conditions are very complex demanding total expertise in each and every field. The Internal Auditors have a basic and professional qualification mainly pertaining to accounting and other related matters. Simultaneously, the internal auditor has to look into various legal matters varying from Tax Laws, Labour Laws, Industrial Law, and Environmental Laws and so on. The auditor can have some basic knowledge in all these areas but he may not have expertise in all these areas except some laws where he has his own specialization.

Since the Internal Auditor is expected to cover all these areas pertaining to business activities, situations arise where he can visualize or understand that a specific activity is not as per the legal provisions or he may have some different opinion than that of the auditee. However, he may not be 100% sure about the specific legal issue. In such cases, the specific issue is referred to the concerned expert in the field and his opinion is obtained and auditor is relying on such opinion while forming his opinion.

E.g. If the auditor is given an assignment of detecting inferior quality of a construction and financial loss due to such poor quality, the auditor has to take external help from Architects, Civil engineers to ascertain the quality of material and based on their reports he can form his opinion. Similarly, in Information Technology Audits, the auditor has to take expert external opinion from IT engineers. Similarly, in IT Audits, the auditor has to take help from computer experts to understand the programmes and system installed.

Recent developments in businesses around the globe require specializations in addition to the internal audit competences which are offered by experts and these experts are increasingly being involved throughout the entire internal audit function. The organisation or the head of the internal audit function may opt for an auditor's expert or an external opinion is as follows:

- a) Risk may increase when other expertise is needed to assess the processes, activities or risks
- b) Utilize competence and capabilities which are specialized in nature
- c) Keep the situation under review as the audit progresses – circumstances may change
- d) Nature, significance and complexity of the subject is highly sensitive to the organisation's performance

The key to success areas in managing external providers or auditors' experts, involve but are not limited to:

- a) Defining the objectives of the assignment
- b) Resources of time, effort and money available for the assignment
- c) Considering the experts' experience and knowledge in providing internal audit support service
- d) Selection of the expert with appropriate experience, knowledge and value addition basis



- e) Monitoring expert's technique of working and evaluating the results
- f) Nature, importance and complexity of the assignment

At times there is a well-defined and extensive audit plan wherein a broad range of skills are required to meet the audit objectives. In such a case, it would be appropriate to establish a panel of service providers to facilitate the internal audit team. Such a panel allows additional skills and flexibility at the disposal of the internal audit team. Where the expert is assigned to perform a small parcel of work, there is limited opportunity for the expert to develop the required understanding of the entity and its business needs. This lays further importance on establishing clear deliverables and as an added safeguard, service delivery requirements should be outlined in a contract with the expert.

Another key safeguard in ensuring that the expert delivers a quality internal audit service is that the expert allocates sufficient time and effort to audit assignments and has in place effective supervision arrangements, including sufficient review by the internal audit team. It is preferable to include a clause in the contract nominating the expert who will provide the audit services and to may require the organization to be consulted before such assignment is shared

Generally, internal auditors are not part a of large service firms, which may also be seeking to provide other services to the company as this can generate a conflict of interest and limit the ability of the internal audit function to review parts of the organisation. Organization also engage more than one internal audit service provider, so as to ensure work undertaken by a firm is not reviewed by the same firm. It should also be noted that a firm engaged as an internal auditor must retain the key responsibility of objectivity and independence even if a different part of the same firm is engaged in consultancy work within the organization.

Even though the internal audit function may be completely outsourced, responsibility for the overall efficiency and effectiveness of the internal audit function remains with the organization. It is therefore important for the management retains control of the internal audit strategic direction and to actively monitor the performance against the internal audit work plan and manual.

## **Chapter 11**

### **Audit Conclusion and Corrective Measures**

The ability to identify audit findings, communicate them and determine the internal audit conclusions adds the most value to the internal audit function. Internal Audit Findings are the combination of observations, recommendations and results that the internal audit team collects in the course of audit and by the conclusion of the investigation and audit.

The preliminary step is to evaluate all the evidence and observations that the internal audit team has collected against the internal audit objective and criteria. Internal audit evidence includes any factual information or data collected while pursuing the internal audit. The internal audit objectives and criteria as mentioned in the internal audit charter must include the standards, procedures, rules and regulations of the organization that must be considered during the internal audit. Such criteria state the requirements that the organization must confirm to and the limits that the internal auditor must work within. The internal audit findings help to identify conformance or otherwise with the internal audit criteria. The Internal audit function must provide data and evidence of both conformance and non-conformance.

Where the internal auditor has to identify areas or opportunities for cost reductions and/or improvements in productivity, the audit findings must also include observations or inefficiencies and ineffectiveness. The Internal audit findings of all stages must be summarized along with the conformity requirements and should also include details of areas, functions or processes that were covered under audit.

The management of organizations usually focuses on nonconformities or inadequacies of control. They are more interested in knowing what needs to be corrected or fixed than what is being done correctly and need no change. Thus, all evidence supporting nonconformities should be well documented and recorded. All irregularities may also be grouped based on the level of impact to the organization such as minor, major or potentially risky. However, at times the management takes the onus of defining the severity of the nonconformity as well as the corrective action plan.

Even though the management may be in a better position than the internal audit team to determine the appropriate action plan, the internal audit team can accurately gauge the significance of the irregularity with their multi company and industry exposure. Thus, the management and internal audit team must work closely to assure all nonconformities are well documented, assessed and corrective action plans are implemented.

Although nonconformities form an important part of the internal audit findings, they may not be the intended final objective of the internal audit. Certain other internal audit objectives include determination of project status, gaps in control systems and creating action plans for business challenges.

Internal audit findings are recognized at every stage during the course of the audit. But, conclusions are only determined at the end of the entire audit exercise. All observations and information meeting the qualitative and quantitative criteria as determined in the internal audit charter form the basis for these audit

conclusions. An in-depth review of all audit findings leads to a comparison between the inputs to achieve a progressive output.

After considering the inherent uncertainties of the internal audit process such as test checks, the internal audit team should first internally agree on the audit conclusions and forward the same to the management via the head internal auditor. Usually, the head internal auditor chairs this meeting and decides on any conflicting views to finalize the audit conclusions all the while seeking consensus of the entire internal audit team. The audit conclusions must be finalized only after considering and evaluating all options and recommendations

Audit conclusions can address several issues and given below are common issues that conclusions address:

- a) Audit conclusions aid to ascertain the effectiveness of control exercised by the management system when compared to the audit criteria
- b) Audit conclusions must have a detailed assessment of the effectiveness of implementation, maintenance and improvement of the control system. The internal audit function must note the procedure for deployment of the organization's control system along with whether the system maintenance based on adhering to requirements, correcting irregularities and taking corrective action. Any prospects for improvement must be incorporated as the audit conclusion through preventive and innovative actions.
- c) Audit conclusions may also assess the capability of the management data collection and review process. The management must be able to assure continuing suitability, adequacy, effectiveness and improvement of the control system and operational effectiveness.

The Corrective Action Process is the final step of the Internal Audit Process and is used wherever corrective action is warranted. As findings are identified through the internal audit process, the Internal Audit Team will discuss the findings with the management and confirm with an understanding of both the data and the process, and validate that the facts of the finding are correct.

Throughout this process, the managers responsible for change or corrective measure implementations are identified, and provide a recommendation on how to resolve the finding appropriately. Once the internal audit report is shared, the finding may be loaded into a Corrective Action Database and followed-up on. Quarterly meetings may be held with the management to communicate the status and provide updates for each open finding. A general checklist of corrective action would include:

- a) The first step to undertake corrective actions is to ensure the internal audit function accurately understands the finding that has been identified. The Management must work with the internal auditor to understand the source of the data, the significance of the risks identified. The main goal of this step is to identify risk and proceed to fixing it appropriately.
- b) The employee or manager in charge of the area of concern or at risk must be shared the authority to lead the action plan to revise the present practice. Ideally, the assigned manager must be able to

understand how the process works, and provide informed ideas, make empowered decisions and be involved with the internal audit function during identification of the finding.

- c) Control systems can be defined as a set of processes intended to ensure an expected outcome with minimal variances. The extent to which these control systems should be implemented would be based on the relative risk of failure and the significance of the risk. There are different types of control systems and depending on the desired action, the appropriate control system is selected. Different controls could be:
- i. **Preventative control** is designed in such a way that a predefined corrective action is undertaken prior to the commencement of the process.
  - ii. **Detective control** is designed to identify and highlight any deviations or variances from the set tolerance levels.
  - iii. **Directive control** is designed to guide the staff to follow the established rules and regulations which supports the ultimate objective.
- d) Wherever deemed necessary, new control systems are setup and post evaluation of the steps for new controls, the next step is to develop timelines and crash gates for submission of the process audit and evaluation report. This report which is to be compiled by the internal audit function provides the first review to management of the estimated period required to resolve the nonconformity.
- e) Post completion of these steps, a summary of the corrective actions is provided for the final report in the corrective action worksheet. This summary must include the “Action Planned v/s Taken” for each finding reported. The Corrective Action Worksheet is a document which not only helps document the corrective action process for each finding but also helps in tracking the follow up of actions implemented.

Thus, the Corrective Action process is the key to an effective control environment within an organization, and the Internal Audit Team will help to identify the right changes to be made in order to improve the organization’s operational success and maintain sustainability.

## Chapter 12

### Report Writing and Audit Report

Internal Audit reports should be accurate, objective, constructive, clear, concise, and timely. The Audit Report is the principal means by which audit findings are communicated to management and the Audit Committee for the purpose of reporting on the scope of the audit performed and the audit results.

Basic elements of Audit Report are – Title, Period of audit, introduction / Purpose of audit, Executive summary, detailed report and Action Taken Report. The report should contain the details of discussion held on draft audit report, outcome of exit meeting, formal draft and final draft report. The report is useful to the management to understand the issue and take corrective actions. The reports are also useful to the other stakeholders viz. Departmental Heads, Statutory auditors, regulators or employees of the Company.

Each audit finding should be classified as a major control weakness, minor control weakness, exception, observation, or a violation of law, rule or regulation.

The Internal Audit Report's findings summary should be of sufficient detail to identify the control weaknesses, exceptions, observations or violations of law, rule, or regulation, and should include supporting facts to the extent considered necessary. The risk exposure presented by a control weakness should be identified. A recommendation for corrective action should be included for each control weakness, exception, observation and violation of law, rule, or regulation. The various types of findings are as follows:

- a) **Major Control Weakness:** Identifies a control weakness that presents a high risk exposure or risk of loss, or that has a significant adverse effect on the achievement of an important operating objective related to a core business process, key business activity, or critical business function. Major control weaknesses generally require prompt corrective action to reduce the risk exposure.
- b) **Minor Control Weakness:** Identifies a control weakness that presents a low to moderate risk exposure or risk of loss, or that has a minor adverse effect on the achievement of an operating objective related to a business process, business activity, or business function. Minor control weaknesses generally require timely corrective action to reduce the risk exposure.
- c) **Exception:** Identifies an error or occurrence (event) which did not conform to established policy or an established control procedure, or a condition which does not conform to generally accepted control principles or business practices, however, it does not constitute a control weakness. A related control weakness may exist, depending on the nature and pervasiveness of the exceptions. Exceptions generally require corrective action to remedy the exception.
- d) **Observation:** Identifies a condition such as an operating policy, operating procedure, or operating practice that is not efficient or effective, however, the condition does not constitute a control weakness. Observations merit management consideration to realize improved efficiency or effectiveness.

- e) **Violations of Laws, Rules and Regulations:** Identifies violations of laws, rules, or regulations. Each Audit Report should include an overall internal control rating based on the audit findings.

Commonly accepted ratings are as follows:

- 1) **Satisfactory:** The internal control system is effective. Established control procedures reasonably assure the achievement of operating and control objectives. If control weaknesses exist, they are only minor control weaknesses. Risk exposure or risk of loss is low.
- 2) **Needs Improvement:** The internal control system is generally effective. Only minor control weaknesses exist, however, their effect on the internal control system is more pervasive and the achievement of important operating or control objectives is not reasonably assured. Risk exposure or risk of loss is moderate.
- 3) **Unsatisfactory:** The internal control system is ineffective. One or more major control weaknesses exist that have a significant adverse effect on the achievement of important operating or control objectives. Risk exposure or risk of loss is high.

A Draft Internal Audit Report should be issued to the process owners and any other individuals (i.e. executive management) included on the Distribution List. Draft Internal Audit Reports should be issued on a timely basis following the completion of each audit.

A written management response should be provided for each major control weakness, minor control weakness, exception, observation or violation of a law, rule, or regulation included in a Draft Internal Audit Report. As applicable, the management response to any finding should identify corrective action taken or planned and include a completion date for corrective action taken, or a target completion date for planned corrective action. Each management response should designate one comment owner. Management has responsibility for establishing comment ownership.

All written management responses to audit findings noted in Draft Internal Audit Reports should be submitted to the Internal Auditor within a reasonable period of time (i.e. 10 calendar days) of the issuance date of the Draft Internal Audit Report. Reasonable deviations from this time requirement may be allowed for valid reasons such as illness, vacation, or unexpected demands on time to meet the operating needs of the department or organisation.

In the event that the management does not concur with audit findings, conclusions, recommendations, or the internal control rating, identified in the Draft Internal Audit Report, management should, at its discretion, indicate the reason(s) in its written management response. Following receipt of management's written response to a Draft Internal Audit Report and prior to the issuance of a Preliminary Audit Report, the Internal Audit team should discuss with management and attempt to resolve any differences of opinion with regard to the Draft Audit Report audit findings, conclusions, recommendations, internal control rating or adequacy of a management response in terms of proposed corrective action.

Following receipt of a written management response to each audit finding noted in a Draft Internal Audit Report, the Internal Auditor should issue a Preliminary Audit Report that incorporates the written management responses. The Preliminary Audit Report should be issued to the individuals identified on the Distribution List. Management should have additional time (i.e. 5 calendar days) from the issuance date of the Preliminary Audit Report to review the Report and provide any additional or revised management response.

After expiration of the allowable time for management's written response, a Final Audit Report, incorporating management's written responses or non-responses to audit findings and any corrective action taken or planned, should be issued to the Audit Committee.

Any unresolved difference of opinion with regard to audit findings, conclusions, recommendations, internal control rating, or adequacy of a management response in terms of proposed corrective action should be arbitrated and resolved by the Audit Committee at their discretion. The Audit Committee's determination should function to resolve the difference of opinion and bind all parties to the resulting determination. In the event the Audit Committee is unable to arrive at a determination, for whatever reason, the matter should be resolved by the Board of Directors at their discretion.

An Internal Audit Report should ideally include the following:

- I. Audit Name and Report Issuance Date;
- II. Audit Report Addressee(s): Identifies the process owners to whom the Audit Report is directed;
- III. Report Distribution List: Identifies all parties to whom the Audit Report is distributed;
- IV. Scope and Objective of the Audit: Identifies the major activities, processes and functions reviewed and identifies the time period the audit is meant to review (dates of sample tested documents and procedures);
- V. Auditor's Conclusions and Internal Control Rating: Identifies the auditor's opinion regarding the
- VI. adequacy and effectiveness of internal controls to include an internal control rating;
- VII. Narrative overview of the business activity and its associated internal controls;
- VIII. List and detailed explanation of the Major Control Weaknesses, Minor Control Weaknesses, Exceptions, Observations and violations of Law, Rules and Regulations noted during the audit;
- IX. Internal Auditor's Recommendation: recommendation for corrective action as it applies to each audit finding;
- X. Management Response: A section for management to include its written response to the audit finding and state any corrective action taken or planned;
- XI. Target Completion Date: Identifies the date corrective action will be completed by
- XII. management and
- XIII. Comment Owner: Identifies the manager responsible for ensuring corrective action is taken as it applies to the audit finding.

## Chapter 13

### Introduction to Engineering Industry

The Engineering industry forms the basis of all major industries across the world. Important industries such as infrastructure, manufacturing, processing, and metallurgical are heavily dependent on the engineering industry for their growth. Engineering is by far the largest segment in the Indian industry. It is a diverse industry with a number of segments, and can be broadly categorized into two segments, namely, heavy engineering and light engineering. Engineering research & design (ER&D) revenues are projected to increase to US\$ 45 billion in 2020 from US\$ 11.2 billion in 2012. The turnover of engineering services firms is also likely to touch US\$ 37 billion by 2020.

Engineering exports from the country stood at US\$ 61.61 billion in 2013–14, registering a growth of 8.49 per cent compared to the previous year. During April 2014, the overseas sales of engineering products rose 21.3 per cent to US\$ 5.7 billion. The foreign direct investment (FDI) inflows in miscellaneous mechanical and engineering industries during April 2000 to March 2014 stood at US\$ 2,606.83 million, as per data released by Department of Industrial Policy and Promotion (DIPP).

The industry currently employs over 4 million people, both skilled and semi-skilled professional through direct and indirect processes. The Engineering industry contributes 3 per cent to the country's gross domestic product (GDP). India's engineering industry accounts for 27 per cent of the total factories in the industrial sector and represents 63 per cent of the overall foreign collaborations. Since the heavy engineering goods segment chiefly consists of the capital goods industry, the latter contributes almost 12 percent of the manufacturing activities.

The engineering sector is showing positive sign and moving toward high-end engineering and manufacturing with the Government announcing multiple reforms and policies in these sectors. Unlike the past, where these sectors were driven by low cost labour, inadequate land laws and reasonable cost of capital, India is fast moving up the value chain and is increasingly adopting global standards in manpower training, technologies used, processes adopted and overall quality of goods and services produced.

India is also fast emerging as a major destination for high-end engineering, research and development (R&D), and product/service/process innovation for most companies across the globe.

#### Key Growth Drivers of Indian Engineering Sector

The engineering sector in India has been growing on the back of growth in the user industries and several new projects being undertaken in various core industries such as railways, power, infrastructure, etc. Capacity creation in sectors such as infrastructure, oil & gas, power, mining, automobiles, auto components, steel, refinery, consumer durables, etc, is driving growth of the engineering industry.

- Growth of the key user-industries
- Government's thrust on the power and construction industries



- India being preferred by global companies as an outsourcing destination as it enjoys lower labour cost and better designing capabilities.

### **Roadblocks on the way**

The engineering sector has been on a growth mode even in the most difficult times. But there are certain challenges the industry faces and needs to overcome. The key challenges faced by these industries include increased global competition, availability of skilled workforce and access to uninterrupted energy supplies and developed public infrastructure. To overcome these challenges, the engineering sector must have continued focus toward innovation, operational excellence, productivity improvements and talent development.

Indian engineering sector demands huge capital investment and regulation of policies by regulatory bodies to maximize the profit. The evolving trends at the economic and technological front demand a lot of changes to suit the needs of engineering environment.

### **A Bright Future Ahead**

The Indian engineering industry has witnessed an unprecedented growth in the past few years and it plays a significant role in the development of other industrial sectors of the economy. With a rapidly growing middle class and millions of underserved customers, these industries offer significant opportunities for growth. Fuelled by innovation, growing entrepreneurial culture and availability of skilled workforce, these industries have the potential to bring about sustained development and progress in all walks of life. The future looks healthy with promising opportunities and there is always a new emerging space that brings reason for growth and excitement. There are lots of innovations happening across multiple spheres such as transportation, education, retail that will potentially change the way we live, eat, shop and interact with each other.

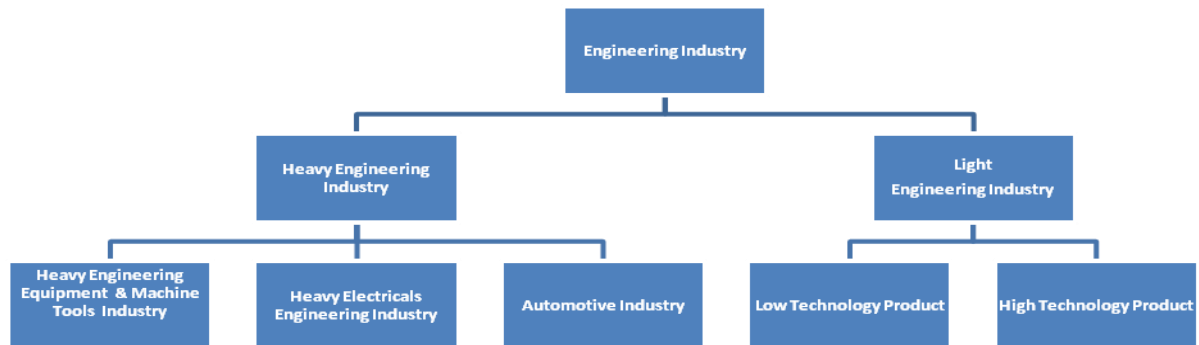
### **Classification of Engineering Industry**

The Engineering sector is the largest in the overall industrial sectors in India. It is a diverse industry with a number of segments, and can be broadly categorized into two segments, namely, heavy engineering and light engineering. The engineering sector is relatively less fragmented at the top, as the competencies required are high, while it is highly fragmented at the lower end (e.g. unbranded transformers for the retail segment) and is dominated by smaller players.

The engineering industry in India manufactures a wide range of products, with heavy engineering goods accounting for bulk of the production. Most of the leading players are engaged in the production of heavy engineering goods and mainly produces high-value products using high-end technology. Requirement of high level of capital investment poses as a major entry barrier. Consequently, the small and unorganized firms have a small market presence.

The light engineering goods segment, on the other hand, uses medium to low-end technology. Entry barrier is low on account of the comparatively lower requirement of capital and technology. This segment is characterized by the dominance of small and unorganized players which manufacture low-value added

products. However, there are few medium and large scale firms which manufacture high-value added products. This segment is also characterized by small capacities and high level of competition among the players.



## 1. Heavy Industry

Heavy Industry in India comprises of the heavy engineering industry, machine tool industry, heavy electrical industry, industrial machinery and auto-industry. These industries provide goods and services for almost all sectors of the economy, including power, rail and road transport. The heavy engineering segment includes machinery used in power, oil refining, mining, metallurgy, oil and gas extraction, cement production, textile production, and such like. The machine building industry caters the requirements of equipment for basic industries such as steel, non-ferrous metals, fertilizers, refineries, petrochemicals, shipping, paper, cement, sugar, etc.

### Sub-Sectors of Heavy Industry

Heavy Industry deals with the following 19 Industrial Sub-sector:

- a) Boilers
- b) Cement Machinery
- c) Dairy Machinery
- d) Electrical Furnace
- e) Freight Containers
- f) Material Handling Equipment
- g) Metallurgical Machinery
- h) Mining Machinery
- i) Machine Tools
- j) Oil Field Equipment
- k) Printing Machinery
- l) Pulp and Paper Machinery

- m) Rubber Machinery
- n) Switchgear and Control Gear
- o) Shunting Locomotive
- p) Sugar Machinery
- q) Turbines & Generator Set
- r) Transformers
- s) Textile Machinery

### **Light Engineering Industry**

The Indian light engineering industry is highly diversified, comprising of a number of distinctive sectors and sub-sectors. The product range in this industry varies from highly sophisticated microprocessor based process control equipment and diagnostic medical instruments to low-tech items such as castings, forgings, and fasteners, among others. The sector also includes products such as bearings, steel pipes and tubes, etc. Most of the products in the light engineering industry serve as inputs for the capital goods industry. The health of the light engineering industry is therefore dictated by the demand for capital goods.

The major sub-segments within this industry are:

1. Medical and Surgical Instruments
2. Process Control Instruments
3. Bearings
4. Industrial Fasteners
5. Ferrous Castings
6. Steel Forgings
7. Seamless Steel Pipes & Tubes
8. Electrical Resistance Welded (ERW) Steel Pipes & Tubes
9. Submerged-Arc Welded (SAW) Pipes
10. Bicycle Industry
11. Sewing Machines
12. Plain Paper Copier

From the above detailed analysis of various types of industries covered under Caption “Engineering Industry”, one can understand that it covers a wide range of products. The nature of products differs substantially from one to other demanding different types of raw material, processes, requirement of skilled labour and unskilled labour, end users etc. These peculiar differences demand that the approach of Internal Auditor for these varied types of industries should be different. A uniform approach towards all these industries cannot be the same. Keeping in mind the Generally Accepted Principles of Accounting and Auditing, the auditor has to prepare the audit plan and decide procedures to be adopted for conducting the audit. These issues are dealt with in details in subsequent chapters.



## Chapter 14

### Applicable Government Policies and Rules

#### Background

The Indian industrial policy made a major transition towards liberalization in the mid-1980s with the proponents of liberalization expecting not only a general increase in the efficiency of Indian industry but also improvement terms of innovative performance. Extensive industrial studies, as well as macro level data, suggest that liberalization in the field of industrial licensing and foreign technological collaborations has resulted in large scale entry of new firms across different segments of the economy. In this context, the Engineering industries development from 1950-51 onwards should be reviewed. There were mainly two breaks during this period, one in 1965-66 and the other in 1984-85. A review of policies suggests that these breaks were associated with major shifts in policies of the government. The study indicates that the first break came through industrial policies of the government with a focus on the heavy industries during the initial phases, while the other break came during 1984-85 which could be attributed to changes in policies from a restrictive one in the mid 60s and 70s to a liberalized one in this sector in the 80s.

Although engineering industry gained its importance with a rigorous planning regime since 1951. Based on the soviet experience in 1930s, Indian policy makers started believing that the indigenous technological capacity and self-sustaining economy would go hand in hand. Therefore, one of the objectives of the Indian planning was to promote heavy machinery building industry. In India increasing the per-capita income through income redistribution was impossible, so the only option left open for increasing per-capita income, employment and through these consumption, was to substantially increase in the level of output. Nevertheless, the big question was why the levels of output were low in the initial period? From the planners' view, the reasons were low level of investment and poor quality of capital goods. There is an important distinction made between two types of capital goods, i.e., (a) those that produce consumer goods, and (b) those that produce capital goods. As the objective of the planners was to achieve long term growth, more weightage was given to the second category, i.e., 'machines producing machines.'

However, since the late 1980s, the government of India shifted its focus from the macro-economic policy towards growth promotion in the sense that it moved away from the state intervention and import substitution to one of a liberalized industry. In view of the rapid liberalization and the subsequent integration with the world economy, Indian firms are facing strong competitive pressures from within the country as well as from outside economy. In India the reform process was initiated in the mid 1980s which gained momentum in the 1990s with major changes effected in trade and industrial policies, leading to a significant change in the Indian market.

A number of empirical studies have examined the impact of liberalization on the Indian firms in general and the performance of capital goods sector in particular. The engineering industry is part of the capital goods industry. Many of the earlier studies, which focused on the capital goods industry, conclude that

this industry has been severely affected since mid 1980s due to liberalization policies like reduction in the tariff rates and liberal trade policy or import of second hand machinery. The reason for such an apprehension relates to the competitiveness from the domestic market given that growth of this industry in India is dependent on in protected market (monopolistic/ Oligopolistic) with a predominant presence of the public sector. The specific characteristics of technology in this industry also raise doubts about its growth because of liberalization.

The engineering industry (electrical and non-electrical) produces a range of products (durable machinery, equipment, etc.) used by a wide number of end-users in agriculture, chemical, automobile, petrochemical, fertilizer, textile, mining, power, defence sectors, etc. To compete in international markets, the engineering industry needs to focus on product design and development as producing for a foreign market requires more technological capabilities for meeting the international standards than the domestic market. Hence, technological development is very important in developing export competitiveness. It has been argued that, the incentive to technological development in the domestic industry locked in the initial phases of import substituting industrialization regime. It is expected that after the liberalization, due to competitive pressures the industry would try to access and adopt new technology.

#### **Regulatory Policies for Engineering Industries**

The Engineering industry does not have a specific regulatory policy. There are no price control policies for the engineering products. Hence the industries covered under the Caption “Engineering Industry” are governed by general laws applicable to industries.

The Engineering Industries are required to comply with the general laws viz. Central Excise Act, Income tax Act, Finance Act relating to Service tax, Industrial Law, Factories Act, Pollution Control Act, Labour Laws, Value Added Tax etc. Some products attract Cess for the goods products manufactured e.g. Rubber Cess, Automobile Cess etc. The engineering industries enjoys exemptions from taxes and duties if operated in defined areas. E.g. excise duty exemption for industries in North-East Region, Jammu & Kashmir etc. Certain Tax exemptions / benefits are also given to such industries. Also, excise duty is exempt for specified goods if used for specific purpose like Defence, are exempt from excise duty.

## Chapter 15

### Legal and Regulatory Framework

As stated in the earlier chapter, the Engineering Industry does not have a Regulatory Policy or specific Law as such. Hence all the general laws are applicable for Engineering Industry. The Internal Auditor is expected to exercise due care in verifying the compliances under all the applicable laws. The Auditor should prepare a detailed compliance list covering all the laws and various compliances under respective laws and should verify whether these have been complied in time or not.

#### Importance of Legal Compliance:

The compliances whether it is payment of tax or filing of return or filing of form / declaration, if not done within stipulated time, the consequences are severe. The Company is liable to pay the dues with interest and also liable for penal action. Further, the Directors, Company Secretary and other officials face prosecution under these laws. Hence, the Directors need to have a confirmation from Auditor stating that the compliances under applicable laws have been made or not. In case of non compliances under any law, what remedial actions have been taken are also mentioned in the audit report.

#### Role of Internal Auditor in Legal Compliance:

The general applicable laws and their compliances should be listed out for the purpose of audit. The check list should cover:

- I. The various procedural compliances under the Act viz. filing of timely declarations, returns, payment of taxes, levies etc.
- II. Supportive documentation viz. validity of Bonds, permissions, amendment to registration certificates etc.
- III. Compliances with various provisions in Rules and conditions in exemption notification.
- IV. Benefits entitled to the organization under various schemes viz. Drawback, EPCG, DEPB etc.

#### Approach for audit of Legal Compliances

As stated above, the auditor shall verify the legal compliances under various laws. A list of various laws applicable to an Engineering Industry and general compliances under these acts is given below-

(The list and compliances are illustrative only):

| S.NO. | Name of the Law            | Nature of compliance   | Remarks |
|-------|----------------------------|--|---------|
| 1     | Income tax Act, 1961       | Payment of Income tax, Advance tax, filing of returns              |         |
| 2     | Income tax Act, 1961 – TDS | TDS deduction and payment to Government account, filing of returns |         |
| 3     | Central Excise Act, 1944   | Payment of excise duty, filing of returns,                         |         |

|    |  |   |  |
|----|--|---|--|
|    |  | CENVAT Credit, Valuation aspect etc.  |  |
| 4  | Finance Act, 1994 – Service tax provisions           | Payment of service tax, filing of returns, payment of service tax under Reverse Charge, CENVAT Credit etc.  |  |
| 5  | Central Excise Tariff Act, 1985                      | Classification of products.   |  |
| 6  | Central Sales Tax Act, 1956                          | Payment of CST, C-Form transactions.  |  |
| 7  | Payment of Value Added Tax as per the State Law      | Payment of tax, filing of returns.  |  |
| 8  | Customs Act, 1962                                    | Duty Drawback rules, Import & Export procedure.   |  |
| 9  | Foreign Exchange Management Act, 1999                | Provisions relating to dealings in Foreign Exchange to be complied by the industrial undertaking.<br><br>Non-fulfillment of compliances of RBI envisages stringent penalty.     |  |
| 10 | Wealth Tax Act,                                      | Payment of Tax & filing of returns.   |  |
| 11 | Local Body Tax (Or Octroi)                           | Registration for LBT.   |  |
| 12 | Sale of Goods Act, 1930                              | Implied condition as to quality. Contract of sale. Payment & Delivery.  |  |
| 13 | Factories Act  | Registration of factories. Health & Cleanliness. Disposal of Waste & effluent. Facility of Drinking Water, Latrines & Urinals.  |  |
| 14 | Industrial Disputes Act, 1947                        | Provision regarding Retrenchment, Lock-outs, Strikes.   |  |
| 15 | Industries (Development & Regulations) Act, 1951     | The owner has to abide by the regulations contained for Registrations, Licensing and its renewal.<br><br>The Undertaking also has to obtain license for producing new articles. |  |
| 16 | Legal Metrology Act (earlier Weights & Measures Act) | Manufacturers are required to maintain Records and registers pertaining to the weights and measures applied.  |  |
| 17 | Dangerous Machines (Regulations) Act, 1983           | Licensing of Manufacturers & ensure that every part of dangerous machine conforms to prescribed standard.   |  |
| 18 | Waste Disposal Act, 1988                             | Central Competent Authority shall   |  |

|    |   |   |  |
|----|---|---|--|
|    |   | <p>register and report recycling and disposal volumes.</p> <p>Responsible Enterprises and recycling and disposal enterprises may apply to the Resource Recycling Management Fund.</p>   |  |
| 19 | Hazardous Waste (Management & Handling) Rules, 1989   | Hazardous waste shall be collected, treated, stored & disposed of only in such facilities as may be authorised for this purpose.  |  |
| 20 | Air (Preventions and Control of Pollution) Act, 1981  | Declaring Air Pollution Control Areas, restrictions on use of certain industrial plants, disallowing of emission beyond prescribed standards, furnishing of information to the Boards, Entry and Inspection, power to take samples of Air or emission, penalties for certain offences, Returns to be filed. |  |
| 21 | Environment (Protection) Act, 1986                    | <p>Emission or Discharge of Environmental Pollutants in Excess of the Standards.</p> <p>Persons Handling Hazardous Substances to Comply with Procedural Safeguards. Furnishing of Information to Authorities and Agencies in Certain Cases.</p>   |  |
| 22 | Water (Prevention and control of pollution) act, 1974 | Certain Emergency Measures to be observed by an Industry In Case of Pollution of Stream or Well.  |  |
| 23 | Labour Laws – Minimum wages Act, 1948                 | Minimum wages payable. Govt. can authorize supply of essential commodities at concessional rate.  |  |
| 24 | Apprentices Act, 1961, 1962                           | Registration of contract of Apprenticeship. To provide with training in his trade.  |  |
| 25 | Contract Labour (Regulation and Abolition) Act, 1970  | Register of contractor & employees employed by contractor. Maintain the muster roll, wage register.   |  |
| 26 | Employees Pension Scheme,                             | Employers' contribution not exceeding   |  |



|    |  |  |  |
|----|--|--|--|
|    | 1995   | 8.33% of Basic Wages, DA, Retaining allowance if any of the concerned employee.  |  |
| 27 | Employees' Provident Funds & Miscellaneous Provisions Act, 1952                          | The contribution which shall be paid by the employer to the fund & employee's contribution shall be equal to the contribution payable by the employer. |  |
| 28 | Employees State Insurance Act, 1948  | The employer should get his factory registered with ESI corporation within 15 days after the act becomes applicable. Half yearly return.               |  |
| 29 | Employment of Children Act, 1938   | Maintenance of register by every employer.   |  |
| 30 | Equal Remuneration Act, 1976   | This aims to provide for the payment of equal remuneration to men & women & for the prevention of discrimination. Maintenance of register.             |  |
| 31 | Inter-State Migrant Workmen Regulation of Employment and Conditions of Service Act, 1979 | Registration must obtained by the employer. Licensing of contractors. Registers to be maintained.  |  |
| 32 | Payment of Bonus Act, 1965   | Pay the minimum bonus. Maintenance of registers & returns.   |  |
| 33 | Payment of Gratuity Act, 1972  | To determine the amount of gratuity & give notice in writing to the person to whom gratuity is payable & to the controlling authority.                 |  |
| 34 | Payment of Wages Act, 1936   | Wages must be paid in currency note or cheque or crediting in bank account. Fix the wage period & time limit for payment of wages.                     |  |
| 35 | Provident Funds Act, 1925  | Payment to be made to PF Authorities. Submission of Return. Settlement.  |  |
| 36 | Workmen's Compensation Act, 1923   | Employer is liable to report & pay compensation as per chapter II in case of personal injury by accident arising out of & in the course of employment. |  |
| 37 | Maternity Benefits Act, 1961   | Payment of maternity benefits. Provide leave for that period.  |  |

|    |   |  |  |
|----|---|--|--|
| 38 | Trade Unions Act, 1926                              | Registration of trade union. Filing of annual return.  |  |
| 39 | Payment of Profession Tax on employees and employer | Regular payment of Profession Tax and filing of returns.   |  |
| 40 | Bureau of Indian Standards Act, 1986                | The goods manufactured must meet the criteria of standardization set by BIS.   |  |
| 41 | Companies Act, 1956 (Now Companies Act, 2013)       | As per Listing Agreement under clause 49, Company has to disclose its quarterly & yearly result to Stock Exchange. Related Party disclosure. |  |
| 42 | Contract Act, 1872                                  | Review of Purchase, Sales Contracts, Technology Transfer contracts etc.  |  |
| 43 | Copyright Act, 1957                                 | Registration of Copyright & Follow up.   |  |
| 44 | Electricity Act, 2003                               |  |  |
| 45 | Patents Act, 1970                                   | Registration of Patent with patent office.   |  |
| 46 | Trade Marks Act, 1999                               | Registration of Trademark with Trademark Registry. Penalties prescribed for Infringement of Trademarks.                                      |  |
| 47 | Transfer of Property Act, 1882                      | Registration of various proprietary rights. Relating to agreements of Immovable properties.  |  |
| 48 | Boilers Act, 1923                                   | To provide all reasonable facilities & information during the examination. Report of accident in writing to the inspector.                   |  |
| 49 | Indian Stamp Act, 1899                              | Payment of Stamp Duty on various deeds, agreements relating to property.   |  |
| 50 | Securities & Exchange Board of India Act, 1992      | Compliance with various clauses of Listing Agreement. Full & transparent disclosure of financial information.                                |  |

The above list is only representative. There are various other laws and regulations which need to be complied viz. In case of Diesel, the Storage facility needs to be approved from the State authorities. In case of use of Ethanol in the plant, proper licence from State Excise Authorities needs to be obtained and compliances regarding duty payment, filing of returns needs to be done.



The internal auditor must be in a position to identify the various legal compliances applicable to various types of engineering industries it is dealing with. E.g. In case of Pollution Control legislations, the auditor must take into account –

- i. the permissions granted by the controlling authorities while granting consent to operate.
- ii. The exact emission of the various elements viz. Gas, Water, Smoke, Waste Oil, Effluents generated in the manufacturing process.
- iii. Measures exercised by the Company to control the norms.
- iv. Methods of Disposal of waste, oils, effluents – whether these are as per the prescribed norms or not.

On the same lines, the Internal Auditor has to review the existing schemes, policies, specific notifications issued for industries located in rural areas etc. under various laws and should prepare the check list for compliance with such laws.

## Chapter 16

### Peculiarities of Engineering Industries

#### The peculiarities of Engineering Industry are:

The Engineering industry is technology oriented and the manufacturers in this sector belong to Small Scale, Medium Scale and Large Scale organization. The Manufacturers are manufacturing a variety of products which can be categorized as -

- i. Base Metal and articles of Base Metal (Foundries and Forgings)
- ii. Machining Centres dealing in parts of various machines, equipments, automobiles.
- iii. Various Assemblies and Sub-assemblies required in end products.
- iv. Original Equipment Manufacturers (OEM)

Majority of the engineering industries follow a common model for manufacture which is either

- i. In House manufacture of parts and finished goods or
  - ii. Sub-contract operations demanding lesser skills or
  - iii. Purchase Assemblies / Sub-assemblies and assemble the Finished Goods in plant.
- a) The technical knowhow required by these models varies from industry to industry. In many cases, the production process is normal conventional method demanding basic engineering knowledge whereas in case of OEM there is a demand for technical knowhow.
  - b) The requirement of labour varies from industry to industry. Some industries operate with contract labour and some industries require highly skilled labour.
  - c) Some industries are highly labour intensive and some are highly sophisticated with minimum labour.
  - d) The end customers of these industries are different. Some industries cater to the demand of OEMs whereas some industries supply the products for Spares Market. Some industries manufacture the products as capital goods to the various industries or for personal consumption of people at large.
  - e) **Capital Investment:** As the manufacturers in this sector are varied, the effectiveness of capital employed has to be assessed. If the manufacturer has not invested large amounts in machineries, then efficiency of labour, quality of goods manufactured by the labour, cost of labour become critical factors in determining the cost of the product. On the other hand, if the manufacturer has invested huge amount in machineries, equipments, then the efficiency of machinery installed, its impact on quality of products, utilization of machine capacity etc. are the factors which need to be focused.

- f) The basic material requirement also varies to a large extent. In case of industries dealing in metals and metal products, the requirement is for ferrous or non ferrous metal viz. Cast Iron, Steel, Aluminum, Copper, and Nickel and so on. The material cost constitutes a major portion of the total cost ranging from approximately 60% to 70%. Even, in the case of industries dealing in Assembly manufacture have a major material portion.
- g) **Technology Upgradation:** After globalization, all these industries face stiff competition from foreign companies. The goods manufactured by the competitors are price competitive and also technically advanced. Hence, to remain in the market, the Indian Engineering Industries are compelled to upgrade their technologies and also supply the goods are competitive rates. Continuous change in the product design is a special feature of engineering industry. Hence the manufacturers have to keep their plans flexible so as to meet this requirement. Technology upgradation demands capital investment. As a result of this feature, the manufacturers often require to change the tooling, equipments, carry out trials for new design etc. Thus the machinery, equipment or tooling may not be used for its full life and the manufacturer is compelled to incur idle cost of such machines. Thus the auditor has to analyse the impact of such transactions while auditing the capacity utilization and idle capacity.
- h) The market of Engineering Industries is driven by consumers. As various alternative products are available in the market, the customers are having wide option for purchasing a particular product. The manufacturers have to keep this fact in mind and accordingly price their products.
- i) **Working Capital Requirements:** The Engineering Industry is mainly dealing with capital goods and consumer goods. The customers are required to give credit period. Delay in Recovery of debtors is a common phenomenon of this Industry. On the other hand, the suppliers are not in a position to offer a longer credit period. In some cases, involving supply of basic metals, credit period is not granted by the suppliers. Thus the manufacturers are trapped in a situation where suppliers are required to be paid immediately and the customers are required to grant a longer credit period. Thus, the working capital requirements are very high.

#### **Role of Internal Auditor in Engineering Industries**

Since the nature of Engineering Industry is multi-fold, the auditor must be well acquainted with the manufacturing process, specific method of working of the industry under audit, applicable laws and policies for the specific industry. The auditor must obtain this knowledge before he commences the audit. As an internal auditor, the auditor has to look into all aspects irrespective of the set up. Hence the profession demands a clear vision and understanding of the product before initiating the audit process. Depending upon the types and peculiarities of the industry, the auditor has to verify:

- a) the consumption of material,
- b) efficiency of labour,
- c) input-output ratio



- d) Capacity utilization
- e) Efficiency of labour / Idle Labour
- f) Efficiency of Machines / Idle Machine capacity
- g) Efficiency of capital employed
- h) Cost reduction measures
- i) Profitability of products – Cost Vs Selling price.

## Chapter 17

### Special transactions peculiar to the industry

As stated in the earlier chapter, material cost followed by Labour Cost constitutes a major portion in any Engineering Industry. Since the material requirement is specific and has a tremendous impact on the final product, change in the material composition is not acceptable to the industry. A thorough R&D can only implement such change with consent from OEMs. Hence, majority of industries prefer Job work / Outsourcing as a measure for cost reduction.

The special transactions peculiar to Engineering Industry are:–

#### 1) Job Work

This is an industry where outsourcing from other manufacturer is usual thing and significant portion of industry is involved into it in one way or the other. Instead of manufacturing the various components in house, the industries prefer to procure the parts from other manufacturers. This gives advantage of reduced cost, effective utilization of space, skilled labour etc. The auditor has to work out a plan to verify the outsourcing activity with following aspects –

1. Record of Material Accounting – Material sent to the job workers and received back.
2. Time limit within which the material was received back.
3. Documents generated in this activity.
4. Accounting of waste, scrap generated in the process – whether received back or not.
5. Method and justification of Rate fixation to the sub-contractors.
6. Treatment of scrap generated in at Job worker's end and its valuation.
7. Compliance with Legal provisions viz. Rule 4(5) (a) of CENVAT Credit Rules, 2004.

Along with job work operations, the Engineering Industries also outsource their routine type of activities viz. Bill Booking, Stores function, Accounting entries, Routine record maintenance etc. The Internal auditor should review such activities and must ensure that as a result of Outsourcing the Company has not exposed itself to major risks, confidentiality, legal compliances etc. The control measures must be put in place in these activities and the internal auditor must cover this area in his audit.

#### 2) Pricing

The pricing of the products manufactured by Engineering Industries is a peculiar feature of this industry. The OEMs can fix / modify their prices of final products as per their policy. However, a majority of other manufacturers who are supplying their products to OEMs cannot be enjoying this facility. These manufacturers cannot earn high profits for their products. The revision of prices is very lengthy process. The manufacturers have to approach their customers / OEMs for revision in prices. Even when the basic raw material prices are increased, the manufacturers cannot revise the prices of their products immediately. Increase in Labour cost is not always compensated by their OEMs. Under such circumstances, the manufacturers have to increase the production to maintain their profitability. In case of constraints in

increasing production, the manufacturers have to adopt measures of cost reduction so that they can survive in adverse conditions.

The internal auditor has to take into account these aspects and conduct the audit of various aspects affecting the industry. The role of auditor becomes critical from this point.

### **3) Volatile Market Condition**

The basic raw material of engineering industries is Iron / Steel or other base metals. The raw material manufacturers in this segment dictate the terms and conditions of supply of raw material. The buyers or component manufacturers who buy the basic raw material are compelled to accept the terms and conditions laid down by the Steel Mills.

On the other hand, the component manufacturer is not in a position to dictate his terms and conditions over their customers. For them, the market is very competitive and driven by customers. Hence, they have to face stiff competition from other manufacturers. The OEMs generally dictate the terms to the component manufacturers.

This typical feature of industry thus makes the market very volatile. The base raw material manufacturers and OEMs are placed at strategic positions whereas the small and medium scale manufacturers who are placed in the middle stage are exploited by both the segments as explained above. Hence, these manufacturers have to work hard to remain in business and earn profits. There are tremendous pressures on bottom line of these manufacturers.

The Internal Auditor has to understand these peculiar features and accordingly work out a plan which will be useful to the industry under audit. Any suggestion without understanding these problems will not be meaningful and workable.

### **4) Captive Consumption**

In Engineering Industries, manufacture of goods for captive consumption is a common feature. The unit is having a well set up of machines, fabrication shop and knowhow for manufacturing various parts, components for its captive consumption. Such parts are either used in the manufacturing process or for maintenance of machines or any other purpose.

Another feature of captive consumption is Inter-Unit transfer of semi-finished goods. If the unit is having more than one unit at different locations, Inter-Unit transfer is a common feature in Engineering Industry.

The Internal Auditor should verify the documents, records for such captive consumption parts and ensure that the material consumption is properly recorded, the quantity is shown in the monthly excise returns and exemption for captive consumption is claimed. In both these situations, the auditor should ensure that Cost Accounting Standard – 4 issued by the Institute of Cost Accountants of India are followed properly. In case of payment of duty for inter unit transfers, the duty should be paid as per certificates issued by the Cost Accountant and differential duty, if any, should be paid. This should be the check point in the Internal Auditor's check list.



### **5) Tools / Dies / Moulds / Fixtures**

In an Engineering Industry, use of Dies / Moulds / Fixtures is required for manufacturing process. In Foundries, Press Shops, Machine Shops use of Dies, Moulds and Fixtures is done for manufacturing parts. These are very critical components and the quality of the product depends on the accuracy of the Die / Mould. Hence, the cost of Dies / Moulds is very high and the manufacturers of parts are not in a position to invest in manufacturing the Die / Mould / Fixture.

Hence, generally, the Dies / Moulds / Fixtures are supplied by the customers to the manufacturers free of cost. These transactions are typically done in two ways:

- i. The customer supplying the Dies / Moulds / Fixtures to the manufacturers free of cost. The dies / moulds are owned by the Customer and they supply the same for manufacture of parts required by the customer.
- ii. Alternatively, the customer, places order on the manufacturer to supply the Die / Mould which is either manufactured by the manufacturer or he gets is manufactured from third party. The customer is paying the cost of the Die / Mould to the manufacturer.

In both these cases, ultimately, the die becomes the property of the customer. The role of the Internal Auditor is to understand the mode of transactions and the how the die is received by the manufacturer. He should ensure that the excise duty benefits, if any, are availed by the manufacturer properly and the most important part is that the Amortization of Dies / Moulds is done on the parts manufactured by using such Dies / Moulds.

**Guidelines as per Cost Accounting Standard – 16 issued by the Institute of Cost Accountants of India should be followed in this respect.**

## **Chapter 18**

### **Activities/ Services of the industry**

The Engineering Industries provide variety of services which are listed below:

- 1) End-to-end design and engineering solutions ranging from new product development and introduction, technical documentation, and engineering design and analysis, to support for technical infrastructure such as product lifecycle management (PLM) and computer aided design (CAD) tool customization.
- 2) Product offerings to cut material costs, manufacturing times and costs, and overall program management timelines and expenses. From tool design to reverse engineering, augment institutional knowledge, speed development, and drive savings from end-to-end of the development process.
- 3) Product design and development (mechanical, integration engineering), Tool design and development, Programmable logic controller design/Supervisory control and data acquisition, Product development management, Technical marketing, Program management.
- 4) Provide support to clients with a variety of engineering documentation in aerospace, energy, and industrial. Assist with all areas of documentation from regulatory compliance to certification support.
- 5) Advice on best practices to reduce product development time and cost, and ensure ongoing compliance.
- 6) Bill of Material Management.
- 7) Plant / Process Layouts,
- 8) Certification programme, Testing & Analysis reports.
- 9) Manufacturing Engineering Support - supporting clients with years of experience in manufacturing engineering support, applying diverse industry knowledge to help to reduce product development time and management costs.
- 10) Engineering IT (CAD – CAM )- Help provided to clients to reduce product management costs with CAD / CAM customization, design automation, , reducing product design time and cost and speeding time to market.

#### **Role of Internal auditor**

The role of the auditor is to be understood in this respect. The Engineering industry is providing various types of services as enumerated above. There could be still more specific to the industry. The auditor has to verify whether the costs involved in the providing the services are recovered or not. Often, the services provided are sub-ordinate activities of the unit. Hence, much attention is not paid towards the profitability aspect.

The auditor can play an important role by working out the profitability of services. Many times, the services like Engineering drawings, technical specifications of products etc. are very much valuable and the customers get tremendous benefits from such consultation. Hence, the charges for such services should be appropriate. The auditor can bring on record, this otherwise, neglected aspect of profitability of services provided.

**Note: Guidelines as per Cost Accounting Standard – 13 should be taken into account while dealing with such transactions.**



## **Chapter 19**

### **Audit of Operational Activities**

In this chapter, audit of operational activities viz. Material cost, Labour Cost, Utilities etc. is discussed in details.

#### **1) Material cost**

As discussed in the earlier chapters, material cost constitutes a major portion in the cost of production for Engineering Industries. Naturally, the Internal Auditor must concentrate his attention in verifying the stores records. The auditor has to focus on two main aspects –

1. Quantitative records.
2. Value aspect.

#### **A) Quantitative records**

The auditor needs to check the stock records maintained in stores. The complete cycle of record maintenance from the receipt of material to closing stock should be critically viewed. The normal check points are:

- 1) Receipt of material and documentation.
- 2) Storing of material.
- 3) Issue of material against proper authorized requisition.
- 4) Updating closing stock.
- 5) Internal checks for receipt of material at factory gate.
- 6) Checking Record of receipts at gate.
- 7) Checking procedure for physical receipt and counting and weighing of material.
- 8) Checking procedure for testing, acceptance, rejection of material.
- 9) Checking procedure for returning of rejected materials.
- 10) Checking of procedure for Forwarding Material Receipt Note (MRN) and Test Report to Stores Department along with party's Challan, packing slip, Railway/Road Receipt and documents for octroi/local body tax etc. Thereafter forward these documents to Accounts Dept. for payments,

Regarding proper usage of material, the auditor must work out the standard consumption and should compare with actual consumption. Due to multiplicity of variety of products involving common raw material, this may be a difficult task. But with the help of Bill of Materials and with computerized records, this can be worked out with some pains. This will give an overall idea of effective usage of material. Abnormal wastages, thefts of material, misuse of material etc. will be identified only with comparison of standard consumption vs. actual consumption.

The auditor should be acquainted with normal process loss, normal rejection percentage, input-output ratio, normal yield and other technical matters so that his analysis is appropriate and not too theoretical.



**B) Value aspect**

The Internal Auditor should also verify the value aspect in material cost. The normal check points are:

- i. Checking of Procurement procedure including number of quotations/ tender called for.
  - ii. Checking of procedure and controls for finalization and acceptance of quotation/tender after comparative analysis of quantity, quality, delivery period, credit period, excise duty, VAT, octroi and service tax implication as also supplier suitability/desirability.
  - iii. Checking of Landed cost register showing:
    - a. Date of Receipt.
    - b. Material Receipt Note.
    - c. Supplier Code
    - d. Specification of material received.
    - e. Material code.
    - f. Purchased within country/ imported.
    - g. Quantity billed.
    - h. Quantity received.
    - i. Basic rate of material.
    - j. Excise Duty rate and amount,
    - k. VAT rate and amount,
    - l. Transport cost.
    - m. Transit insurance if paid by purchaser.
    - n. Loading and unloading charges.
    - o. Octroi duty/ local body tax (rate and amount);
    - p. Total cost for domestic purchase.
    - q. For import custom duty payable/ paid (rate and amount).
    - r. Clearing and forwarding charges.
    - s. Loading/ unloading charges.
    - t. Local transport cost to factory.
    - u. Loss in transit/ evaporation in quantity.
    - v. Value of quantity rejected and returned.
    - w. Net quantity received.
    - x. Total cost (total and per Kg)
    - y. Less credit for returnable containers
    - z. Less Cenvat and VAT credit.
    - aa. Net cost to company.
    - bb. Cost per Kg/ unit item 'aa' divided by item 'w'.
- 4) If the same material is procured from different sources, what is the landed cost of material from each source and any variation in the rate should be analysed.

**C) Inventory Valuation :**

To check the method of inventory valuation and its impact on profitability of a particular accounting period.

In an Engineering Industry, inventory valuation is generally done as per conventional methods of valuation – viz. LIFO, FIFO, Weighted Average etc. The auditor has to ensure that the any method adopted should be consistently adopted.

The auditor should pay more attention towards:

1. ABC Analysis of inventory items.
2. Non Moving Items.
3. Valuation of items having shorter shelf life – viz. rubber parts,
4. Rejected parts, scrapped parts.
5. Differences in actual stock and book stock with proper analysis of shortage.
6. Possibility of thefts.
7. Treatment for shortages noticed and authorization thereof.
8. How the minimum level and maximum levels of inventory items are fixed.

In Engineering industry, if the raw material is imported, the theoretical levels of inventory cannot be maintained as various aspects compel the manufacturer to built stocks. The issues which are taken into account are:

- i. Continuous fluctuations in exchange rates.
- ii. Economies of bulk purchases.
- iii. Scarcity of raw material.
- iv. Lead time between the time when order is placed and actual receipt of material.

Guidelines as per Cost Accounting Standard – 6 issued by the Institute of Cost Accountants of India relating to Material Cost should be followed by the Internal Auditor in this respect.

**2) Capacity Utilization:**

Capacity utilization is an economics concept which refers to the extent to which an enterprise or a nation actually uses its installed productive capacity. Thus, it refers to the relationship between actual output produced and potential output that could be produced with installed equipment, if capacity was fully used.

Production capacity is defined in terms of:

- Factors of production that is used in production activities of company,
- Product which is obtained as result of utilization of production factors,
- Being of the whole occupations and efforts of production within a certain period of time

Consequently, the production capacity is said that business will bring about the amount of production by using the factors of production in a rational manner in a certain period of time.

Manufacturing capacity in Engineering Industry has special features. The Production Capacity can be defined in some industries whereas in some cases it is very complex. E.g. In case of Rolling Mills, Foundries or industries involving use of machines, the capacity can be defined with basic manufacturing facilities. However, in case of industries involving Assembly of parts, the capacity cannot be defined easily if there are multiple products. With change in product mix, the production levels also differ widely. Also, the analysis of capacity utilization cannot be properly done in such situation. The manufacturing facility is common for variety of products demanding but the cycle time is different for various products. Hence, the production capacity cannot be easily determined for all the products under different situations.

Also, the auditor should consider following aspects in this respect:

1. Does the company have capacity constraint for any of its product line and if yes, does company outsource some of the operations.
2. Are there instances that company has idle production capacity available within plant.
3. Whether the various machines installed are utilized upto the maximum extent. Whether the plant is running in all shifts or in parts.
4. Instances wherein the machines, equipments have remained idle resulting in loss of production and the reasons for such idle time.
5. Is generation of utilities like power, steam, DM water, RO water, air conditioning, air compressor are efficient, and how many percentage of the capacity is utilised.
6. Power factor.
7. Installed capacity as shown in the Excise return ER-7 by the Company and compare the same with actual capacity.
8. Guidelines as per Cost Accounting Standard – 2 issued by the Institute of Cost Accountants of India should be followed.

3) **Manpower:**

In an Engineering Industry, Labour Cost is the second influential factor after Material cost. Some units are labour intensive and some are highly automated. The auditor has to understand this situation and accordingly has to be developed his audit plan and take into account following aspects:

- a) What is the total requirement of manpower- skilled, semi-skilled, unskilled and helper/ own and contract labor for achieving given level of production?
- b) Is employment of manpower close to the budgeted manpower comparable to the production levels achieved?
- c) What is the Labour efficiency?
- d) Cost of Idle Labour.
- e) What percent of manpower is met through contract labour?
- f) What is the ratio between skilled and other labour?
- g) What is the output achieved against labor deployed?



**Guidelines as per Cost Accounting Standard – 7 on Employee Cost issued by the Institute of Cost Accountants of India should be followed in this respect.**

#### **4) Power Consumption**

The Engineering Industry is power intensive and power being a scarce input, power consumption has to be efficient. Electrical Furnaces, Air Conditioning Plants, Highly automated machining centers, Compressors etc. consume substantial part of power. The auditor has to verify that the power is consumed appropriately. The auditor has to analyse the standard consumption of power as against actual consumption. If power meters are not installed at respective cost centers, the actual center wise power consumption is difficult to calculate. In any case, the auditor has to estimate the standard power consumption with technical specifications.

Along with consumption of power in manufacturing areas, the auditor should study the consumption in other areas also where wastage of power, misuse of power is normally done. E.g. administration office, street lights, excess light points than required, possible use of natural sunlight etc. Various techniques of power saving have been established by industries and the auditor should try to verify whether techniques are implemented or not.

#### **5) Other Utilities**

This includes consumption of diesel, furnace oil, compressors, Air conditioning, Water Treatment plants etc. wherein excess consumption is normally observed if not controlled strictly. The Internal Auditor has to check the consumption of such items and see that these consumptions are normal and justified. The main aspect to be kept in mind that these items have no direct relation with actual production.

**Guidelines as per Cost Accounting Standard – 8 issued by the Institute of Cost Accountants of India should be followed in this respect.**

#### **6) Verification of Assets**

The Internal Auditor has to ensure that the Assets of the Company are well protected and are in good / working condition. The machineries / equipments which are capitalized are normally used in the company for 10 – 15 years or even for more than this period. However, some assets are required to be discarded for various technical, marketing reasons. Hence, physical verification of assets is done regularly and it is confirmed which assets are –

- a. physically available and are in use
- b. physically available but are not in use
- c. physically available but are in scrapped condition
- d. not physically available

The company can take appropriate action on the basis of such verification. The Internal auditor has to ensure that physical verification is done at regular intervals either by the Company staff or by independent agency.

## Chapter 20

### Audit of Special Areas with reference to peculiar transactions

As explained in the earlier chapter, material cost constitutes a major portion in an Engineering Industry. The nature of engineering industries is varied and hence the material accounting and control procedures also differ from industry to industry. This aspect is dealt with in detail with reference to three types of engineering industries –

1. Industries dealing with base metals – Foundries, Forgings, Stamping etc.
2. Industries dealing with components manufacture – Machining centers
3. Industries dealing with Assemblies and sub-assemblies.

#### 1. Industries dealing with Base Metals:

- A) Industries dealing in Foundries, Forgings, Stamping use C.I. Scrap, Steel Scrap, M. S. Sheets etc. as their raw material. Units dealing with Aluminum, Nickel, copper products, use such ingots of base metal as their input. The cost of such special alloy metals is high and hence the material consumption needs to be monitored carefully. The factors for consideration are:
- I. The standard weight of a casting can be technically ascertained. But the actual weight differs due to moulding process.
  - II. There is difficulty in weighing actual weight of a batch of castings manufactured. Hence, in majority of cases, the weight is calculated on standard basis.
  - III. Accurate consumption of raw material for a period is difficult as actual weights of material on floor; scrap stock on floor is not possible.
  - IV. The yield – Input and Output ratio varies from batch to batch as various factors affect the yield viz. quality of material.
  - V. Material going into the furnace cannot be measured accurately for each heat.
  - VI. The customer pricing is fixed on standard weights. Hence, extra weight of castings, forgings results in loss to the company. E.g. the price of a casting is fixed considering 10 kgs. as standard weight. If the actual weight of casting is 10.5 kg., customer pays only agreed price and 0.5 kg. is a loss to the company.
  - VII. **Rejection of materials** – In case of foundries, forgings, the rejection is at different stages – at Plant, during machining and finally at customer end. All these rejection are required to be considered for determining the material cost of the product.
  - VIII. **Value of scrap** – The castings once rejected, the value of such rejected castings is not more than the scrap value. All the costs incurred in manufacturing, realizes nothing but a scrap value. Hence, the rejection percentages of the parts are required to be monitored closely for controlling the material cost.



- a) **Methods of controlling Material Cost-** The prices of the base metals are volatile and change with variations in international markets. However, there is a constraint in increasing the price of casting at every stage. Hence, absorbing the increase in material cost is also a feature of these industries. In view of this fact, material consumption needs to be controlled.

**B)** Considering the peculiar aspects of this industry, the material cost is controlled as under –

**Comparison with Standard consumption –**

- i. Working out the actual consumption of raw material for a period – say month.
- ii. The consumption is calculated as – Opening stock of raw material + scrap On floor + Fresh Receipts from Stores – Closing stock of raw material and Scrap on floor = Consumption of raw material for the period.
- iii. Calculate the weight of castings / forgings produced during the period.(standard weight X qty. produced)
- iv. Compare the standard consumption with actual.
- v. If the actual consumption is more than standard consumption, it will indicate that casting weights are higher than standard. This needs to be corrected by identifying such parts and correcting the pattern design or such other steps.
- vi. If the weight of the casting cannot be reduced for various technical reasons, steps should be taken to revise the price by negotiations with customers.

**1. Checking the Yield – Input / Output ratio**

For controlling the material cost, the Input / Output ratio should be monitored regularly. e.g. if the yield is 97%, it will indicate that the metal loss / heating loss is around 3%. This should be compared with the technical parameters.

**2. Rejection at all levels**

The rejection of different parts at different levels should be analysed properly so that parts with low rejection and parts with high rejection can be identified. Efforts should be done to reduce the rejection percentage as low as possible. The technical persons should be involved for analyzing the reasons for rejection and identifying remedial actions.

**C) Industries dealing in manufacture of components**

The types of industries that are covered under this segment are the Machine Shops or Machining Centers doing machining for various raw / semi finished components. The peculiar feature of this segment is the capital employed. Some units invest in conventional machines where the capital investment is not too much and some invest in high-tech CNC Machining centers which involve high capital investment.

The material cost involved in these industries is the cost of tools, gauges, fixtures. The tools have short life but the cost is high. Hence it is to be ensured that proper consumption of tools is done and no wastage or

misuse is done. For controlling the material cost average consumption of tools should be compared with actual consumption. In ERP system, the consumption of tools as per individual machines can be maintained and any abnormal consumption for a particular machine can be identified. Quality of tools and availability of skilled labour is also important for efficient consumption of material.

The scrap generated in the process is disposed at scrap value. Hence the quantity of scrap generated in the process should also be compared with standard. This aspects needs to be checked as any negligence may lead of misappropriation scrap which is a monetary loss to the organization.

#### **D) Industries dealing in Assembly and Sub-assembly of parts –**

These industries procure various components from market and do the assembly or sub-assembly of main component. E.g. unit manufacturing Bearings, Diesel Engines for various applications, Various components of automobiles viz. Clutch Assembly, Gear Box Assembly, Break Assembly, Compressors / Radiators for various applications, Electrical / Electronic equipments etc.

The raw material for such industries is the various components / base parts required for Assembly. The number of components required in one assembly various from product to product. Normally, there is no high percentage of rejection in the process. However, the material consumption has to be controlled by way of:

1. Comparison of Standard Consumption as per Bill of Material (BOM) and actual consumption.
2. Analysing reasons of rejection – whether the rejection is due to defective material or due to negligence of own staff.
3. Taking appropriate action to minimize the rejection loss.
4. The feature of this type of industry is that the parts involved in assembly could be from minimum to maximum depending upon nature of product. Hence, the control of material consumption has to be well planned by the Auditor.

For controlling the material cost in these types of Industries, effective use of ERP system can be done. If the BOM of all Assemblies / sub-assemblies if properly defined, the standard and actual consumption of various components involved in BOM can be worked out.

In case of industries not having ERP system, have to depend on record maintained in stores, standard consumption of major inputs (since all inputs cannot be analysed without ERP). Data can be analysed with Excel formats or such other techniques.

#### **Labour Cost:**

Labour Cost is another factor influencing the cost of product. The peculiarities of this Account Head are that some industries are Labour intensive or some are highly modernized involving minimum labour. The foundry / forging industry is highly labour oriented whereas the Machining Centers or Assembly type of industries are technology oriented. Skill of labour is also a vital factor in determining the labour cost.

The Internal Auditor should compare the Productivity of labour for a particular period and compare the same with standard productivity. The Industrial Engineer can determine the standard productivity of labour under the given conditions – viz. types of machines used, availability of skilled labour, quality of material etc. This should be studied and as against this the actual productivity should be compared. Any variation should be analysed properly and cases of idle labour hours, stoppage of work due to unforeseen factors viz. breakdown of machines hours' loss due to defective material, loss due to non availability of power, material etc. can be identified and appropriate action can be taken. The Internal Auditor has to look into all these aspects and report to the management.

### **Power Cost**

Engineering Industries are largely depending on power. Foundries / Forging Industries need power for Induction Furnaces, Heat Treatment, and Press Machines etc. Even the Machining Centers also consume high power. Hence, the power consumption is also important element which needs to be controlled.

Main features of this element for consideration are –

- a. Power cannot be stored and powers consumed without proper use is wastage and directly adds to the cost of the product.
- b. Install sub-meters for measuring consumption of various process centers viz. furnaces, machining centers, Air conditioning Plant, Administration office etc. This helps in identifying the power consumption at these centers and this can be compared with standard consumption. E.g. Standard consumption of Induction Furnace for melting one ton of metal can be established with the help of Industrial Engineer. The actual consumption of power for a given period can be worked out from meter readings and any variation can be compared. “Energy saved is Energy Produced”. Hence, any saving in power consumption directly results in reducing cost. The Internal Auditor can play a very important role in this analysis.
- c. The Internal Auditor can identify the areas where power is wasted and can be easily controlled.
- d. The Technical staff can take various energy saving measures to reduce the power consumption on the basis of analysis done by the auditor.
- e. In case of power shut down, industries use Generators for which diesel is commonly used. The auditor can also study the consumption of diesel, areas where Generators are used and where there is scope for cost reduction.

### **Make or Buy decision**

This is a peculiar feature of engineering industry. As a measure of cost reduction and also for effective utilization of available resources, the Company has to take a decision as to – whether a product / part should be manufactured in House or should be procured directly from outside sources.

The Internal Auditor can study this aspect from different angles viz. capacity released by procuring material from outside, effective utilization of released space, cost benefit etc. Generally, the parts which can be easily



procured and which involve simple technology are purchased from outside and only critical parts requiring highly skilled labour are manufactured in house.

### **Technology Upgradation**

Any engineering industry, whether Heavy or Light, has to often update the technology for producing the parts. For this purpose, the industry has to invest in technical knowhow, Research and Development and also in highly qualified technical staff. Due to Globalization, the competition from foreign players has seriously affected the domestic industry. In order to remain in Competition, the Engineering Industry has to be constantly upgrade the technology and introduce quality products in the market. The customers also demand new technology at every stage. Hence, upgrading the technology, providing the funds for such investment is a challenge before the industry.

The most formidable problem faced by the Engineering Industries in India has been in accessing technology and maintaining competitiveness. The reasons are:

- Poor financial situation and low levels of R&D
- Poor adaptability to changing trade trends
- Desire to avoid risk
- Non-availability of technically trained human resources
- Emphasis on production and not on production costs
- Lack of management skills
- Lack of access to technological information and consultancy services
- Isolation from technology hubs

To overcome the above problems, the Internal Auditor can play a vital role in this respect. He can suggest the areas of improvement, cost reduction and make Cost – Benefit analysis of any technology under consideration.

Specimen Check lists for guidance are given in separate chapter for reference.

## Chapter 21

### Audit of Functional Areas

Engineering companies need internal audits regularly. Internal auditor must conduct internal audit according to an audit plan, so that all important aspects of the company will be audited. Internal Auditor has to meet with all department heads before undertaking an audit to discuss the important Areas/aspects that should be audited and according make an audit plan. Audit plan of an engineering company can be divided into two parts:

#### I) Project Auditing Plan

Every project of an engineering Company must have an auditing plan. The internal auditor should start with project balance sheets to determine the cost-effectiveness of the engineering project. Areas to evaluate include accuracy of job bid, engineer wages as a percentage of income from the project, unexpected expenses, risk management procedures and effectiveness, and operating management oversight practices and their effect on the profitability of the project.

#### II) General Audit Plan

General audit plan of an engineering company is more comprehensive than the project auditing plan. The general audit plan identify what are the areas internal auditor should review, whether the risk-management controls are in place in the company and audit of the functional areas i.e. Purchase, Administration, Finance & Accounts, Marketing, Research and Development, Quality Control, EDP etc. The internal Auditor has to focus on following aspects while auditing the Functional Areas.

##### 1. Purchase Department - Material Management:

The main objective of purchase management is to procure raw materials, supplies, and stores of the requisite quality at a reasonable cost and at the right time. The Internal Auditor has to go through the various aspects of Purchase Department. Some of the major activities are –

- i. How is the purchase function organized? Whether there are separate purchase departments for various units or is purchasing a centralised function.
- ii. What is the purchase policy? Whether it take into account the uncertainties in availability of materials consequent to the changes in market conditions.
- iii. Whether the purchase requirements related to production schedules and dependent upon level of inventories.
- iv. Whether the organisation developed links with suppliers to ensure regular and dependable supplies.
- v. What is the system of purchase authorization in the company?
- vi. How are the suppliers selected? Is there a list of suppliers with whom running contracts have

- been executed?
- vii. Whether there is a system of eliminating unreliable suppliers.
  - viii. What is the system of executing emergency purchases?
  - ix. Whether there an information system whereby the latest market information regarding new products, spare parts, and machinery items useful for the organisation is automatically collected and considered.
  - x. Whether the studies are conducted periodically to analyse the price trends in order to form an opinion about the future prices of major raw materials in use.
  - xi. Whether regular comparisons made between the average purchase prices paid by the organisation and the average market prices.
  - xii. What are the built -in controls against mis-utilization of purchasing powers and how effective is the system of follow-up of orders.
  - xiii. Review of Purchase Contracts / Purchase Orders and other agreements viz. Price revision contracts, minutes of meetings dealing with quality of material and accepting sub-standard material under special circumstances etc.
  - xiv. Internal auditor has check the purpose of contract, terms and conditions, period, legal provisions, financial impact, procedure of awarding contract to a vendor, approvals from appropriate authorities etc.
  - xv. For comparison of Tender/Quotation/Bid the following format of quotation needs to be followed and the lowest eligible supplier needs to be identified. The term lowest eligible supplier pre-supposes following conditions:
    - a. Goods are of acceptable quality.
    - b. Technical and financial capacity is satisfactory to supply the size of order.
    - c. Financial capability to procure requisite Working Capital and execute the order within the time frame.
    - d. Tax benefits / discounts offered by the vendor
    - e. Other locational advantages available by procuring from a specific vendor.

### **Inventory Management**

Inventory management aims at keeping an adequate stock of raw materials and other items at the minimum carrying cost. Apart from controlling material cost, the internal auditor has to go through other aspects of inventory:

- i. How is inventory management organized? Whether there is a separate department looking after this function or is it a part of production or purchase department.



- ii. Whether the storekeepers well equipped to grasp the fundamentals of the inventory control system and to apply it intelligently in practice.
- iii. Whether there is a well-defined policy regarding inventories. Whether inventory levels are worked out keeping in view factors like availability of funds, future price projections, consumption rates, etc.
- iv. What is the system of maintaining stores records? Whether perpetual inventory records are maintained and records are up-to-date.
- v. What is the system of receipt and inspection of stores?
- vi. What is the system of physical stocktaking? Whether the physical stocks are verified on a continuing basis by the internal audit department. Whether periodic stocktaking is conducted, are the cut-off arrangements effective? How are the discrepancies between actual stocks and book stocks dealt with?
- vii. Whether there is a system of ABC analysis so that management by exception is possible.
- viii. Whether there is adequate control over obsolescence of materials. Whether stocks reviewed periodically to identify slow-moving, dormant, or obsolete items? How is the investment in various items of stores controlled?
- ix. What is the procedure of fixation of Minimum Quantity, Maximum Quantity, Re-order Quantity levels?
- x. What is the system of material issues and whether the system followed consistently?
- xi. How effective is the management information system regarding inventories?
- xii. Whether actual losses during storage computed periodically and compared with the standards. What is the system regarding writing-off of stocks.
- xiii. Non Moving Inventory and inventory written off due to expiry of shelf life.
- xiv. Analysis and Rating of Vendors.
- xv. Methods adopted for valuation of inventory including WIP and finished goods.
- xvi. Check the Insurance coverage of Inventory and its adequacy.
- xvii. What is the Inventory Turnover Ratio?
- xviii. Transport cost, Local Body Taxes paid.
- xix. Set off of Excise duty / Value Added Tax and other tax benefits.

### **Production Management**

The main objective of production management is to turn out finished goods of requisite quality by making an optimum use of men, machines, materials and services. The Internal auditor can evaluate

this function by asking the following questions.

- i. Whether there an adequate system of production planning. Whether the production schedules drawn up to optimize various factors like plant capacity, raw materials, skilled labour, availability of funds, machine hours, and availability of power.
- ii. Whether there is a close coordination with sales department to ensure acceptability of the finished products by customers. How effective is the quality control on production. How are the customer complaints regarding manufacturing defects, etc., dealt with?
- iii. Whether the inputs and outputs of each process or department linked up periodically and the actual input-output ratios compared with the standard ratios.
- iv. What is the system of reviewing delays in production?
- v. What is the frequency of accidents? Are safety measures adequate?
- vi. Whether there is a system of incentives linked up with the production output. Whether the incentive systems been designed on the basis of scientific studies.
- vii. How effective is the control over idle time?
- viii. Whether each production process is reviewed periodically to explore the possibility of having more efficient production methods.
- ix. Whether the performances of equipment/machinery appraised periodically. Whether standard efficiency factors been worked out and they are compared with actual efficiency ratios.
- x. How effective is the management information system regarding the production function as a whole.

### **Accounting and Finance**

This is an important area of verification for the Auditors. As the finance is the life blood of any organization all the activities will ultimately reflect in finance, it is very essential that the Finance and Accounts Department is having all the requisite controls and proper systems are established and maintained. If the organization is having any Finance Manual, it is required to be considered for identifying the procedures. Further the delegation of financial powers also should be considered for identifying whether the authorization of the expenditure was done at the appropriate level with authority. The main objectives of this function are to provide economic information for decision-making at the various levels of management, to account for assets and liabilities, and to manage the sources and applications of funds.

Internal auditor to check:

- i. What is the role of accounting and finance department in the overall management structure? Whether it is properly staffed with qualified people? What is its relationship with other departments?
- ii. Whether the organisation have a proper system of financial accounts and cost accounts and whether these two are integrated or separate.





- iii. Whether the financial accounting system is efficient and how regularly is the trial balance prepared.
- iv. How much time does it take to prepare the final accounts after the annual closing?
- v. How effective are the internal checks in the accounting department?
- vi. Have the systems and procedures been designed to minimize the possibility of errors, frauds and misappropriations. What are the controls on the flow of cash, goods, and documents?
- vii. Do manuals and flow charts exist describing the various accounting procedures? Whether these are reviewed periodically.
- viii. Whether an internal audit department exist to examine various transactions and procedures and to ensure that actual decisions adhere to the managerial policy. How are the reports of internal auditors dealt with?
- ix. Whether the costing system is suited to the needs of the organization. Whether standard costs been determined and are developed on the basis of time, motion and work studies.
- x. Whether cost statements are prepared in time and they are geared to meet the requirements of the management and reviewed periodically.
- xi. Whether there exist a system of budgetary control and how are the variances between actual figures and budgets dealt with. What are the bases of allocation, apportionment and absorption of overheads.
- xii. Whether the costs are classified by their nature? Does the cost department use the technique of marginal costing for profit planning?
- xiii. Whether the future requirements of funds are estimated periodically and the projections related to the planned levels of activity.
- xiv. Whether the capital structure is designed keeping cost and risk factors in mind.
- xv. What is the cost of capital and how does it compare with that of other similar units.
- xvi. Is a detailed financial analysis conducted before funds are committed for capital expenditure?
- xvii. Whether the working capital requirements properly analysed and they are related to the changes in the level of activity.
- xviii. Whether the policies regarding credit, stocks, cash, etc., reviewed periodically to keep working capital at the optimum level.
- xix. How is working capital financed?
- xx. How is cash management organized whether it is centralized? How do various segments of the organisation receive adequate cash?



- xxi. Whether a constant watch kept on the solvency and liquidity of the organization. Whether the ratios are computed periodically to ensure that the organisation earns an optimum return on investment while maintaining a sound financial health.
- xxii. How does the return on investment of the organisation compare with that of other similar organizations?
- xxiii. What is the system of financial control? Whether the various divisions are appraised on the basis of their financial results.
- xxiv. Whether proper account codes have been given to all the Head of Accounts which is regularly used or otherwise for the purpose of bringing all expenses and Income broken down to material, labour and expenses within the Trail Balance for systematic and easy preparation of Financials.
- xxv. To check up the financial delegation of authority and FC in operation.
- xxvi. To check up un-used, or abandoned machinery lying in the company which has a bearing on the cost
- xxvii. To check whether proper accounting control exists for accounting and identifying the non-cost items
- xxviii. To collect and check the internal audit reports of the previous year's which may have a bearing in the current period
- xxix. To check any cases instituted by the tax authorities and pending before any judicial authorities
- xxx. To check whether the statutory payments/taxes have been made by the company within the prescribed time and no penalties has been paid.

### **Personnel Management**

The main objective of this function is to create such conditions in the organisation that the employees can give their best performance. The personnel manager has to assess manpower requirements, select, recruit, train and develop staff, ensure industrial peace, redress grievances of the workers, maintain discipline, keep various personnel records, and negotiate wage settlements. Verification of policy documents on the HRD and Manpower would be helpful for the internal auditor to identify the system lapses if any. In many large sized organizations it happens in such a way that SAP would have been implemented and at the time of implementation, certain group of employees would have been shown under a particular branch or department or cost centre. Subsequently, from time to time, periodical changes that happen, would not take place in the SAP, resulting into continuance of the old practices. Unless adequate care is taken for the segregation of the labour and identify the employees whether they are working in the same department/cost centre as their pay bills have been debited or not. Any deviation in this would result in under/overcharging of labour to that particular department or cost centre.

- i. What is the organisation of the personnel department? Whether it is adequately staffed.
- ii. What is the personnel policy whether it is the organisation production-oriented or people-oriented?
- iii. How is the future manpower requirements assessed? Whether long-term projections relate



- manpower with the estimated levels of activity. Whether the manpower requirements defined clearly in respect of different kinds of skills required.
- iv. What is the recruitment policy? Whether the qualifications for each job specified clearly and the recruitment procedure well-designed.
  - v. What is the internal promotion policy? Whether the employees are given a chance to grow in the organisation itself through an objective assessment of their qualifications and performance.
  - vi. How does the organisation scout for talent at both the managerial and other levels? Whether it regularly keep in touch with institutions, which develop technical, managerial and other skills.
  - vii. Whether training programmes conducted regularly. Whether they effective in updating the knowledge and skills of the employees. Whether the opportunities are for training adequate.
  - viii. Whether the training methods modern and scientific and they are suited to the needs of the organization.
  - ix. Whether proper records maintained for all workers.
  - x. What is the procedure for dealing with the grievances of the employees? How is discipline maintained? How are the erring workers dealt with? Whether there is a uniform and consistent policy of dealing with indiscipline and misconduct on the part of all the employees.
  - xi. Whether various employee costs properly analysed. Whether the cost of labour turnover and absenteeism worked out periodically and what are the efforts made to reduce labour turnover to an optimum level.
  - xii. How effectively are the labour welfare activities in the organization?
  - xiii. What is the extent of man-hours lost due to strikes and lockouts and how do these losses compare with man-hours lost by similar organisations in the area.
  - xiv. the employee's ids are matching with the labour booked at the respective cost centre
  - xv. the correct wages have been booked to the respective cost centres.
  - xvi. to check the allocation of the salaries of the managers and others in the administrative offices as well corporate office and proper accounting for the same.
  - xvii. to check the basis for the apportionment of the Directors/Managing Director and other corporate personnel to the cost of production.

**STATUTORY MATTERS:**

Legal compliances under various laws viz. Labour Laws, Tax Laws, Factory Act, Companies Act etc. Verify whether the Company has availed the benefit of all eligible schemes viz. EPCG, Drawback etc. Any non



compliance is seriously reviewed. The report on Legal Compliance is also helpful for the Directors of the Company as they can ensure the compliance with all applicable laws only on the basis of this report.

**Company Law and other statutory compliances:**

- (i) **Tax Laws (Excise, Agricultural tax, VAT, CST, Income tax, Service tax):** Review the administration of taxes, duties, cess etc., whether the tax liabilities are being calculated correctly, payments are being made in time to avoid penalties, claim for refunds/rebates have been lodged in time and follow up is being done, various tax returns are being filled properly and submitted in time and whether tax proceedings are followed up with effective representation.
- (ii) **Companies Act:** Review the functioning of the secretarial department regarding maintenance of statutory records, filing of returns with appropriate authorities, arranging for meetings mandated by the statute and other activities, to form a judgment about the functioning of the secretarial department. In this connection, the internal auditor shall also refer to the report of the secretarial audit if there is any.
- (iii) **Export and Import laws:** Review compliance with export and import laws, whether documentation has been done properly and records maintained, whether claims for export subsidy has been made in time and followed up.
- (iv) **Factories Act:** Review the maintenance of statutory records and filing of statutory returns. Whether an order issued by the authority based on inspection/query made, has been complied with or contested at the proper forum and being followed up properly.
- (v) **Labour laws:** Review the maintenance of statutory records and filing of statutory returns. Whether an order issued under any of the labour laws, based on inspection/query made, has been complied with or contested at the proper forum and being followed up properly.

**Deposit of Statutory Dues:**

- i. Whether the following statutory liabilities are paid within the due dates –
  - a) Employers' contribution to PF and Employees' contribution to PF deducted from their wages;
  - b) PF Administration Charges;
  - c) Tax deducted at Source and Tax collected at Source as per Income Tax Act;
  - d) Service Tax
  - e) Professional Tax/ Employment Tax deducted from the employees
  - f) State Level Value Added Tax/ Sales Tax and Central Sales Tax;
- ii. Whether the contribution to Deposit Linked Insurance deducted from Salaries & Wages are deposited with the Insurance Company in time.

**Submission of Returns:**

- i. Whether quarterly TDS Returns (Form 26-Q) are submitted regularly within due date;
- ii. To check quarterly Service Tax Return (Form ST-3) are submitted regularly within due date;



**Provident Fund:**

- i. To review the compliance with the provisions of Employees' Provident Fund & Miscellaneous Provisions Act, 1952 and Rules made there under.
- ii. To check the status of submission PF Annual Return;
- iii. To review the cases of pending Provident Fund Settlement – Whether proper follow-up is being made with the Local Provident Fund authorities for settlement of the cases;
- iv. To check the reasons for long pending cases of PF settlement and to report thereon.
- v. To check the status of filling the nomination forms by the employees, specifically by the new recruits.

**Excise Records**

**VAT/ Sales Tax:**

**Check that State VAT/ Central Sales Tax Returns** are submitted regularly and report in case of any irregularities found;

Scrutinize the assessment orders where the assessment is complete and to report on the additional demand, if any, imposed by the respective Sales Tax authority;

Whether appeals have been filed with the Appellate Authority within the time specified in the Act against the demands, if any, made in the Assessment Orders;

Examine the status of receipt of Sales Tax Declaration Forms from the customers; it should also be checked that appropriate recoveries have been made from the customers where the customers have failed to provide with the valid Sales Tax Declaration Forms for which the Company has to pay additional tax to the authority;

Examine the status of receipt 'F' forms in case of inter-state transfer of finished goods (this is particularly applicable in respect of transfer of Tea to the Auction Centres in other States or to C&F Agents );

Verify that no Input Tax Credit has been failed to be availed.

**Licenses & Certificates:**

- a. To examine the period of validity of following licenses / certificates:
  - i) Air & Water Pollution Certificates;
  - ii) Factory License;
  - iii) Explosive License in case of HSD if stored in tanks;
  - iv) Fire Extinguishment Equipment License;
- b. Licences & Pollution Control Certificates pertaining to all the vehicles
- c. Whether the validity of the licenses or certificates have expired or going to be expired within a short span of time;
- d. Check the record of the number and locations of Fire Extinguishers placed in the factory;



- e. Examine that records are maintained for periodical refilling of Fire Extinguishers on expiry of their validity;
- f. Test check physically that content of the Fire Extinguishers has not expired.

**Marketing Department:**

The main objective of this function is to create and develop customers and retain the position of the organisation in the market. In respect of Marketing Department, the Internal Auditor has to go through the various contracts and see that the terms of contract are well defined and supply of finished goods is done as per terms of contract. He should also measure the risk factors, legal issues etc. and ensure that these are as per the Company's pre-determined policies. In case of new orders, the auditor is expected to go through the Costing of such products and should report if the sale price is accepted below the cost and the circumstances for such decision.

The other terms like delivery terms, escalation clauses, Dealers contracts and their performance, after sales contracts and cost of warranty etc. All these elements have a long standing impact on the financial performance of the Company. The following questions would be of help in evaluating the marketing function of an engineering Company.

- i. Whether market forecasts developed regularly. What is the method of preparing them? Whether they are reliable.
- ii. How does the growth in sales during the last five years or so compare with the growth in the sales of the industry as a whole.
- iii. What are the steps taken to increase the market share of the organization.
- iv. Whether the system of appraising the performance of marketing divisions and salesmen objective and fair and performance is linked with rewards.
- v. What controls exist on the expenses incurred by the salesmen?
- vi. What is the percentage of sales returns and allowances?
- vii. Is there a constant review of the status of the order book?
- viii. Whether there is a proper budget for advertising and sales promotion and the advertising campaigns well planned.
- ix. Whether the credit policy been framed after considering factors like growth in sales, availability of finance and the nature of customers and it is reviewed periodically.
- x. What are the overall controls on outstanding? Are they analysed periodically?
- xi. Whether ageing schedules prepared regularly and what is the procedure of writing-off bad debts.
- xii. Whether distribution channels are properly selected. Whether there an efficient system of after-sales service. What is the frequency of customer complaints? How are these complaints dealt with?



**Administrative Expenses, Selling & Distribution Expenses:**

Expenditure incurred on – Travelling, welfare, Medical expenses, entertainment, Repairs and Maintenance, Communication, Rates and Taxes, Printing and Stationery, Discounts etc. The purpose of such expenditure along with approving authority should be checked. Whether the policy laid down in this respect is followed or not has to be checked. Whether the expenses incurred are as per budgets.

In case of out of budget expenses, whether such expenses are approved by competent authority or not. In case of administrative expenses, if the budgeted expenditure is over-run, the auditor should exercise due care in reporting these matters and also reviewing the budgets with prior approval from competent authorities.

In some units, Integrated Business Plan (IBP) for long term is prepared and then it is broken down into smaller periods like year, quarter or month to achieve short term and long term goals and the same has to be monitored consistently. The overall performance of the company and setting up and achieving long term goal is the activities of Administration Department. The expenses in current period under the heading Administration, Selling & Distribution etc. are controlled through this measure. The Internal Auditor should concentrate on major expense heads covered under this caption and shall monitor these with reference to budgets fixed. The auditor should also go through the policy and procedure prepared for approving budgets, actual expenses, and financial limits for individuals approving expenses, authorities for approving unplanned expenditure etc.

The Auditor must verify that such process is followed as defined and any deviation should be reported appropriately to the higher management. If such policy is not in existence, the Auditor should recommend for this.

***Guidelines as per Cost Accounting Standards – 10, 11 and 15 issued by the Institute of Cost Accountants of India on Direct Expenses, Administrative Overheads and Selling & Distribution Overheads respectively should be followed in this respect.***

**Interest Charge:**

The Internal Auditor should analyse the interest expenditure for determining effective deployment of funds. He should study how the working capital limits are utilized and what are the areas for reducing the interest cost.

- i. Whether Debtors are realized properly or not which may put pressure on working capital.
- ii. Whether the capital expenditure is properly financed through funds or not.
- iii. Whether the capital expenditure is justified during actual operations or not.

All these factors should be taken into account so that the Management can be assured of the best utilization of funds. If not, corrective measures can be immediately taken.

***Guidelines as per Cost Accounting Standard – 17 issued by the Institute of Cost Accountants of India on Interest and Finance Cost should be followed in this respect.***



**Capital Expenditure:**

Capital expenditure incurred on Plant & Machinery, Building, office equipments – Terms and conditions of procurement, Tax benefits availed / not availed, source of finance, whether it is a planned and approved expenditure or not etc. The auditor should also go through whether the payback period has been worked out and that capital expenditure is appropriately made.

**Research & Development Expenditure-**

The expenditure incurred on Research and Development needs to be scrutinized by the auditor carefully. This expenditure is very essential for continuous process improvement, cost reduction, new product development etc. The survival of the business is ensured with a strong team of R&D. Simultaneously, there is every possibility that projects are required to be cancelled after substantial expenditure. The entity has to take this business risk. But, the auditor should continuously monitor such expenditure, developments, progress etc. and should ensure that the financial risks are controlled properly. The auditor should ensure that the expenditure on R&D is planned, budgeted and approved by senior management.

***Guidelines as per Cost Accounting Standard – 18 issued by the Institute of Cost Accountants of India on Research and Development Cost should be followed in this respect.***

**Repairs and Maintenance Cost**

In an Engineering Industry, Repairs and Maintenance cost of Machineries, Equipments constitutes a substantial portion of Factory Overheads. Replacements of parts, consumption of lubricants, hydraulic oils, bearings, belts etc. is required to be done on regular basis. In order to have a continuous flow of production, it is essential that the machinery should be in good and workable condition. Hence the Company has to follow the Preventive Maintenance Policy. If the production cannot be done due to breakdown of machinery, it is a direct loss to the Company, as the machine hours lost is a permanent loss.

Hence the Internal Auditor has to go through the Maintenance Schedules prepared by the Maintenance Department and should see that schedule is rigorously followed. The maintenance expenditure is booked as per the specific machines so that machines prone for continuous repairs can be identified and a decision on their replacement can be taken.

Being an unavoidable expenditure, the Internal Auditor should ensure that the expenditure is properly done and is justified. Guidelines as per Cost Accounting Standard – 12 issued by the Institute of Cost Accountants of India should be followed in this respect.

**Pollution Control Expenses**

In Engineering Industries, due to use of Furnaces, Cuploas, Paint shops, Press shops etc. air pollution, noise pollution and water pollution is done. To safeguard these areas, the Company has to take various steps and incur expenditure on Pollution Control. Disposal of waste as per statutory provisions, installing Effluent Treatment Plants, Installing Chimneys of standard height, measures of control noise etc. are some of the steps taken in this respect.





The internal auditor should go through such expenditure and should ensure that the expenditure has been incurred for specific cause and is justified. The expenditure should be approved by Top Management as they are directly involved in such matters. If any of the standards are not met as per the Consent to Operate or under any other legislation, the auditor should bring it to the notice of the Top Management immediately and ensure that corrective steps are taken on priority.

***Guidelines as per Cost Accounting Standard – 14 issued by the Institute of Cost Accountants of India on Pollution Control Cost should be followed in this respect.***

## Chapter 22

### Maintenance of Cost Records and Cost Audit Specific to Engineering Industry

Engineering Industry first time was covered under Cost Accounting Records (Engineering Industries) Rules, 1984 published vide G.S.R. 688 dated 25th June, 1984 issued under Section 209(1) (d) of the Companies Act, 1956 and subsequently amended vide G.S.R. 279(E) dated 24th April, 2001.

Till year 2010, the Companies were covered under Cost Audit by specific orders issued by Central Government to a Company/Industry. The Ministry of Corporate Affairs, notified the Companies (Cost Accounting Records) Rules, 2011 vide GSR 429(E) dated 3<sup>rd</sup> June 2011 and engineering industry fulfilling the threshold limits as per these rules were required to maintain the cost records as per the provisions contained therein. Those Engineering Companies fulfilling the criteria of conducting the cost audit as per Cost Audit Orders No. 52/10/CAB-2010 dated 24<sup>th</sup> January 2012/ 6<sup>th</sup> November 2012 are required to conduct the cost audit as per the provisions of these Cost Audit Orders and required to e-file the cost audit report in XBRL Format as per the provisions of Companies (Cost Audit Report) Rules 2011 issued by Ministry of Corporate Affairs vide GSR 430(E) dated 3<sup>rd</sup> June 2011.

The Ministry of Corporate Affairs, Government of India has again revised the above rules pursuant to provisions contained in the Companies Act 2013 relating to maintenance of cost records and cost audit vide Section 148(1) and (2) and notified "Companies (Cost Records and Audit) Rules 2014 vide GSR 425(E) dated 1<sup>st</sup> July 2014. As per these Rules Engineering Industry is covered for maintenance of cost records and cost audit under two places, the provisions as per the said Rules are given below:

**Application of cost records:** As per **Rule 3(A) (a) (i) and (ii)** the Companies engaged in the production of goods in strategic sectors, such as: (i) machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items; (*Explanation: - For the purposes of this sub-clause, any company which is engaged in any item or items supplied exclusively for use under this clause, shall be deemed to be covered under these rules*) and (ii) turbo jets and turbo propellers, are required to maintain the cost records as per Rule 3(A)(b), **if the net worth of the company is rupees five hundred crore or more or the turnover is rupees five hundred crore or more.**

The cost records are to be maintained in the Form-CRA-1 of the said Rules by the companies on which these rules are applicable. Extract of Form-CRA-1 is given at Annexure I.

- (1) The gist of the details required to be maintained under Form CRA-1 by the companies are as follows:
  - (i) Input Material(s)/ Service(s)
  - (ii) Salaries and Wages
  - (iii) Utilities



- (iv) Service Department Expenses
  - (v) Repairs and Maintenance
  - (vi) Fixed Assets, Depreciation and Lease Charges
  - (vii) Overheads
  - (viii) Royalty and Technical Knowhow
  - (ix) Research & Development Expenses
  - (x) Quality Control Expenses
  - (xi) Work-in-Progress and Finished Stock
  - (xii) Captive Consumption
  - (xiii) By-Products
  - (xiv) Joints Products/ Services
  - (xv) Packing Expenses
  - (xvi) Interest and Other Borrowing Costs
  - (xvii) Expenses or Incentives on Exports
  - (xviii) Pollution Control
  - (xix) Production Records
  - (xx) Sales Records
  - (xxi) Any other Items of cost
  - (xxii) Adjustment of cost variances
  - (xxiii) Cost Statements
  - (xxiv) Reconciliation of Cost and Financial Accounts
  - (xxv) Statistical Reports
  - (xxvi) Records of Physical Verifications
  - (xxvii) Related Party Transactions
- (2) The cost records referred to in sub-rule (1) shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.



- (3) The cost records shall be maintained in such manner so as to enable the company to exercise, as far as possible, control over the various operations and costs to achieve optimum economies in utilization of resources and these records shall also provide necessary data which is required to be furnished under these rules.
- i. **Cost Audit:** The Companies engaged in “strategic industry” who are required to maintain the cost records as per **Rule 3(A) (b)** are also required to conduct the cost audit of the records so maintained.
- ii. **Cost Audit Report:** Every cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in **form CRA-3** along with Annexure to the Cost Audit Report as prescribed **under Companies (Cost Records and Audit) Rules 2014**.

Twenty Four Annexures have been prescribed under the rules. The following are the Annexures:

1. General Information
2. Cost Accounting Policy
3. Process of Manufacture of Good(s)/Delivery of Service(s)
4. Good(s)/Service(s) Details (For the company as a whole)
5. Quantitative Information for Each Good(S)/Service(S) separately
6. Details of the major input materials/service used for good(s) manufactured/service(s) rendered under reference
- 6(A). Standard/ Actual Consumption of Input Material(S)/Service(S) Per Unit
- 6(B). Break-Up of Cost of Input Material(S)/Service(S) imported during the Year
7. Utilities
8. Salaries and wages – for the good(s)/service(s) covered (For company as a whole)
9. Repairs and Maintenance (For company as a whole)
10. Net fixed assets and depreciation (For company as a whole)
11. Net block, depreciation and lease rent (For good(s)/ service(s) covered)
12. Overheads (For company as a whole)
13. Research and development expenses
14. Royalty and Technical Know-how Charges
15. Abnormal/Non-Recurring Cost
16. Non-Moving Stock (good-wise/ service-wise details of non-moving stock may be provided)



17. Written Off Stock /Forfeited Services (good-wise/ service-wise details may be provided)
18. Inventory Valuation (at the end of the year)
19. Sales/Revenue of the good(s)/service(s) covered
20. Margin per Unit of Output/service rendered
21. Related Party Transaction
22. Central Excise/Service Tax Reconciliation for the Good(s)/service(s) under reference
23. Profit Reconciliation
24. Cost Statement (for each good(s)/service(s) separately
  - i. **Submission of Cost Audit Report to Central Government:** Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in **form CRA-4** alongwith fees specified in the Companies (Registration Offices and Fees) Rules, 2014.
  - ii. **Exemption of certain companies from applicability of Rules:** The requirement for cost audit under these rules shall not be applicable to the following companies:
    - (i) whose revenue from exports, in foreign exchange, exceeds seventy five per cent of its total revenue or
    - (ii) which is operating from a special economic zone.

## **Chapter 23**

### **Audit follow-up**

The audit report is the key deliverable of the audit. It reflects the quality of the audit work performed and the judgment and integrity of the role of audit in the organization. There is no lack of guidance on what an audit report should include.

An audit organization's efficiency, effectiveness and accountability in audit reporting must start with the establishment of metrics. The starting point is the establishment of criteria for assessing the audit. The next step is the development and establishment of criteria for assessing auditors and their performance. Both are critical ingredients to supporting the audit process within any organization. These two steps are the basics that anyone entering the audit profession must understand.

#### **Conclusions, Findings and Recommendations**

The audit must present appropriate conclusions and findings that lead to recommendations reflecting cost-conscious, workable and timely solutions to audit objectives. The content of this final report and its results should not be a surprise but a result of interim reports provided to the auditee and management throughout the audit engagement. Whether through midpoint briefings or preliminary findings, auditees should be given the opportunity to provide the basis for their actions or provide their response to interim findings before they become final. Such reports can be given as an oral or written presentation and labeled as "preliminary findings." As mentioned previously, communication skills play a critical role in the dissemination of such information. Also, auditors must be resourceful in using the institutional knowledge of their audit director, manager, supervisor and co-workers in the development and delivery of such interim reports. This is where judgment, tact and auditing knowledge play a key role.

The final report must present a current and objective picture of the situation, allowing management to take the action deemed necessary. Management uses the audit report as a basis of accurate, reliable and useful information from which an informed decision can be made. Management also realizes that its effectiveness is measured by external reviewers who may use the audit report as a gauge for investment or regulatory decisions, if the report is made public or required by law to be made public.

The report must be supported in what it says and linked, or cross referenced, back to the supporting working papers. This is where today's IT auditor can excel in the use of technology and support tools to link the actual report to the audit work performed. Thus, in closing dialogue with managers over audit findings, the actual examples or analysis can be brought in full view with references, pictures, documents, etc., that support the audit step. Today's technology is a powerful tool in supporting the audit process, development of the final report and communication of the results. It also can be an excellent support tool for follow-up as cited in the next section.

### **Follow-up to Findings and Recommendations**

The value of the audit must be assessed to assure that the findings and recommendations, reflecting cost-conscious, workable and timely solutions, have been achieved to some quantifiable degree and provide value to the organization. Unfortunately, this does not happen as often as it should in practice. More organizations would not outsource their audit function if they gained a thorough understanding of the savings and improvement to operations and processes the audit can bring.

The bottom line is how does audit enhance an organization's value? Follow-up is the answer, if an organization is to understand what value audit can have to improving operational integrity, efficiency and effectiveness. By looking at the prior audit recommendations of earlier work, auditors are able to assess if the agency, company or corporation has taken any action toward the report recommendations. If it has, a process is in place to try to assess what impact those recommendations had and to formally report the assessment and findings. Often, auditors will receive direct feedback from managers, supervisors or staff that their actions were the results of an earlier audit report. In some instances, they may even provide direct information and cost figures on how much is being saved as the result of new controls in place or improvements to the existing processes.

### **Conclusion**

The audit process is an old one. Assessment of an auditor's performance and the audit work and report undergoes a continuous process of self-improvement by the auditor and his/her organization. Yet, the importance of the audit report and follow-up is critical if the message is to be heard and acted upon by responsible managers. For the report and its recommendations to have effect, management must understand, support and value the role of audit in its organization and the value it can bring to enhancing control effectiveness and making the organization more effective, efficient and economic in competitive times. Audit follow-up easily can justify the value of audit to the organization. It also can tell outsiders how audit is recognized and valued by the organization and tell investors whether managers are acting responsibly and in the best interest of the organization and investors.

Finally, the audit report must be in the language of the business, so management can read, understand, assess, evaluate and take the action it deems appropriate based on the report, recommendations and supporting audit evidence.



## **Chapter 24**

### **Check lists**

Some specimen checklists which can be used as guidelines for internal audit purpose are given below-

#### **1) Internal Audit Checklist Guidelines**

##### **Financial Statements**

- a. Are monthly financial statements prepared on a timely basis and submitted to the appropriate authorities?
- b. Are account balances in the financial records reconciled with amounts presented in financial reports?

##### **Bank Statement Reconciliation**

- a. Are written bank reconciliations prepared on a timely basis? Test the reconciliation for the last month in the fiscal year. Trace transactions between the bank and the books for completeness and timeliness.
- b. Are the bank reconciliation reports signed and dated?
- c. Are there any cheques that have been outstanding for a longer period or cheques not presented for collection within normal time?

##### **Savings and Investment Accounts**

- a. Are all savings and investment accounts recorded in the financial records? Compare monthly statements to the books.
- b. Are earnings or losses from savings and investment accounts recorded in the books?

##### **Land, Buildings, and Equipment Records**

- a. Are there detailed records of land, buildings, and equipment including date acquired, description, and cost or fair market value at date of acquisition?
- b. Was an equipment physical inventory taken at year-end?
- c. Have the property records been reconciled to the insurance coverages?

##### **Accounts Payable**

- a. Is there a schedule of unpaid invoices including vendor name, invoice date, and due date?
- b. Are any of the accounts payable items significantly past-due?
- c. Are there any disputes with vendors over amounts owed?

##### **Insurance Policies**

- a. Is there a schedule of insurance coverage in force? Reflect effective and expiration dates, kind and classification of coverages, maximum amounts of each coverage, premiums, and terms of payment.
- b. What are the different policies taken by the Company and whether those are adequate for the business?



**1) Check List for Despatch of Goods (Finished Products)**

- a) Check that the plan for the despatch of finished products is received by the Despatch section clearly indicating the Quantity/ location and the description of the material.
- b) Examine the method and the procedure for the despatch of material to ensure that the despatches are affected smoothly.
- c) Check the despatch report prepared as at the end of the day to ensure that the despatches planned for the day are in fact affected in totality.
- d) Check the pending delivery / despatch status for a particular period (on a day to day basis). This information can be maintained in the form of a report.
- e) Ensure that there is a proper system to weigh the finished goods for despatch. The weighbridges and the related equipment should always be properly maintained (including calibration of weighing machines)
- f) If the sales invoices are prepared at the despatch section check a few invoices spread over a period to ensure that the invoices are prepared correctly as regards Rates / Excise duty / Sales Tax etc. Ensure that a proper control is kept over the stationery of blank invoices. The sales invoices should be authorized by a person duly authorized in writing in this behalf. Check that the Freight consignment Notes are properly prepared.
- g) Check that the consignment of finished goods once weighed and okayed at the despatch section are checked for the necessary papers - Gate pass / Sales Invoice / Road permit / Freight Consignment No, etc. at the exit gate by security or by a responsible person deputed in the sales despatch section.
- h) Verify the status of transporter wise trucks provided against the trucks ordered. Also, ensure that penalty for not providing the trucks is charged without exception.
- i) Check that all the trucks being despatched are not being loaded less than the minimum weight agreed for payment. If so, proper justification & approval should be reviewed.
- j) Status of marine insurance, if any to be checked.
- k) Check that all the transporters are approved transporters and their contract is approved by authorized person from Head Office.

**2) Check List for Inward Material (Goods)**

- a) Check that entry for the incoming material is made at the entry gate register.
- b) Ensure that the weighment / Counting of the incoming material is made properly and correctly at the receiving section.
- c) Check that stamp / acknowledgement of the receipt of the incoming material is made on the back side of Freight consignment Note. The remark should indicate the quantity (weight / number of pieces etc.) of the material recorded at the receiving section along with condition (ok / damaged / wet etc) in which material has been received.

- d) The receiving section should maintain a record of all the incoming material received consignment wise, clearly giving the date / No. of vehicle / Description of the material / Quantity etc. This record can be maintained in the form of MIS report prepared on a daily basis.
- e) Check the Excise duty payment documents received along with material.

**3) Check List For Quality Assurance Function**

- a) Check the procedure for the clearance of RM, Finished goods and other related matters dealt by QA Department.
- b) Ensure that the procedure for quality testing of raw material / finished goods is well documented in the form of a quality manual.
- c) Ensure and check that the raw material / finished goods once rejected are not subsequently cleared under deviation. In special cases ensure that the approval under the deviation is duly approved.
- d) Check the specification / laid down standards for the testing and clearance of the raw material / finished goods and ensure that the actual test result conform to the laid down specification.
- e) Whenever there is a change in the laid down specification ensure that the change is approved and authorized in writing by an appropriate authority and that the change is incorporated in the manual of specification.
- f) Check the time taken at the quality assurance to clear the sample received for testing. The test sample of raw material and finished goods should be cleared within a short time.
- g) Check the management level to which the Head of Quality Assurance reports- As a matter of fact in order to ensure that the quality assurance function as an independent arm the quality assurance should report to the Head of the Organization / Unit.
- h) Ensure that the testing samples accepted / rejected are segregated and kept separately with proper and clear marking. Ensure that the sample do not get mixed up.

**4) Check list for Marketing Department**

A marketing audit should be done at the beginning of the marketing planning process. It takes a close look at the current business landscape internally and externally. The questions are designed to prompt examination of environments and practices to evaluate what your company is doing, why it is doing it and whether it is effective.

Everyone in the organization should be able to answer questions about the company from the receptionist at the front desk, to the clerk in facilities. If this is not true, then one of your objectives needs to include the internal socialization of the marketing plan.

| <b>External Audit focuses on:</b>                    | <b>Internal Audit focuses on:</b>                              |
|--|--|
| Business & economic environment<br>Economy<br>Fiscal | Sales<br>Total sales revenues<br>Geographic reach and location |

|  |   |
|--|---|
| Social<br>Technological  | Type of industry<br>by customer<br>by product                           |
| The market<br>size<br>characteristics<br>trends<br>channels<br>customers<br>industry behavior                        | Marketing<br>procedures<br>organizations<br>information<br>mix<br><br>- |
| The competition<br>major competitors<br>marketing methods<br>key strengths & weaknesses<br>extent of diversification |   |

#### Past Performance Indicators & Lessons Learned

1. Was a previous audit conducted, what were the conclusions and observations?
2. How successful were the implemented recommendations and suggestions from earlier audits?
3. How were those measured?
4. How often does your organization conduct audits?

#### Sales and its knowledge of the customer:

1. Do you know what the customer knows, feels and believes about your company?
2. What surveys are used to determine what customers know about your products & services?
3. How often are these conducted?
4. Have you ever asked what they know, feel, believe about your competition?
5. Is it different from what you want customer's to 'feel', about your company?
6. What do you want them to 'believe', 'know', about your company?
7. Is your plan market driven or engineering driven (build it and they will come)?
8. Do you know how your company develops new business opportunities?
9. Do you use any type of strategic account management practices? If so, what?
10. How would you define the company's Unique Selling Proposition (USP)

#### Customer Relationship Management (CRM)

1. Do you know how satisfied your customers are with your products/ services?

2. Do you use customer surveys or other forms of customer evaluations?
3. Do you consider CRM a sales, marketing or customer service responsibility?
4. Where does CRM reside within your company?
5. To what level is your company meeting or exceeding customer expectations?
6. Do you hold customer satisfaction reviews?
7. If you do, is there any internal resistance to customer satisfaction reviews?
8. Do you link any customer satisfaction feedback to your customer service planning, new product development, and/or marketing strategy development?
9. How do you detect problems customers may be experiencing with your company, brand or products? Who do you involve in the process and remediation?

#### **Marketing Questions**

1. How does your current marketing strategy align to business objectives and strategy?
2. Do you have the appropriate executive support and buy-in?
3. Are organizations properly budgeted to achieve their respective objectives?
4. Are company/organizational objectives clearly defined and articulated?
5. Do you feel you are getting value for money from your marketing budgets?
6. Is your corporate or brand image consistent with your product or service, in the eyes of your customers?
7. Do you actively manage your brand, product or corporate identity?
8. How effective do you feel your external communications are? In what way?
9. How effective do you feel your internal communications are? In what way?
10. When did you last launch a new product? Was it successful? Why/How?
11. How effective do you feel your current marketing is?

#### **Brand**

1. How would you define the company's brand? Is it actively managed? How?
2. How long has the brand/product been around?
3. What is the estimated brand equity?
4. What does the brand mean in the eyes of your customers?
5. Would your customers miss it if it did not exist?
6. Have you extended the brand or product line? If not, could you do it?
7. Are there any high-risk areas you should avoid?
8. Do your brand/product promotions reinforce the core values?

#### **Business Development:**

1. Are you developing new business from existing customers?
2. Are you developing new business from new customers?

3. Are you developing new business from new products?
4. Do you know what your customer retention rates are?
5. Do you have a definition for a 'good' sale or customer?
6. Do you set revenue targets?
7. Do you set profit targets?
8. How do you manage key accounts?
9. How do you target new, potential key accounts?
10. Do your customers know all the brands/products you offer? How much do you invest in business development activities?
11. What is the success rate of your business development efforts?
12. Do you have a customer relationship management (or marketing) system?

#### **Corporate, Brand or Product Identity**

1. Do you actively manage your corporate, brand or product identity? How do you do this?
2. Are your marketing and corporate communications materials consistent with this identity, and immediately recognizable as belonging to your business?
3. Do you feel that the identity works?
4. Does your identity portray the correct image?

#### **Planning**

1. How does your company approach the planning cycle?
2. Is marketing planning included in this process?
3. If yes, is the marketing planning process seen as a positive management tool?
4. Has the company set definitions and procedures for the business and marketing planning processes?
5. Are the budgeting, business and customer service planning processes part of, or linked to the marketing planning procedure?
6. How do you determine the marketing budget? Does this procedure work well?
7. Do your marketing plans get monitored and evaluated?
8. How successful has the marketing planning process been?
9. Do you feel that appropriate internal and external information is available during the planning and evaluation processes?

#### **Positioning**

1. Do you know where your brand / products are positioned?
2. Do you have a clearly developed marketing positioning strategy?
3. Do your customers clearly understand what your company stands for?
4. Does your company, brand or product make a real difference in the marketplace?

5. Do you feel that you have identified all the aspects of competitive advantage your brand or product offers?
6. Do you think you exploit this competitive advantage correctly?
7. Do you communicate these advantages actively, consistently and effectively?
8. Do you think the competitive advantages you communicate can motivate your customers to choose your product/brand over the competition?

### **Marketing Operations**

1. Do you know the capabilities and limitations of your marketers? If so, how?
2. Do you understand your market dynamics?
3. Do you have any proof of the market evolution?
4. Who are your competitors?
5. What are the differences between your products/services and branding and those of your competitors?
6. Do you have a clear set of business objectives and shorter term goals?
7. If yes, do your marketing objectives support this?
8. How is customer feedback incorporated into your marketing plans, service improvements and marketing communications activities?
9. Have you clearly defined the markets you want to develop or serve?
10. How systematically do you approach the market entry / support strategies?
11. Do you measure the return on investment provided by your marketing activities?

### **New Product Development**

1. How do you develop new products or services?
2. How long does development normally take?
3. How many successful new products/services did you introduce in the last year?
4. Are feasibility and investment criteria set for new product assessment?
5. Do you employ and evaluate launch plans for new products/services?
6. Is your product portfolio managed centrally or locally?
7. Do you link new product development to your business and marketing strategies? How do you do this?
8. How are new product/service ideas encouraged and captured?

### **5) HR Audit Check List**

- (a) Are HR goals in line with those of the organization?
- (b) What is recruitment policy of the Company? Does it relate of gender and regional representation?
- (c) Are workweeks identified and defined?
- (d) Are full time and part time hours defined?



- (e) Are shifts defined?
- (f) Is there open communication to and from the HR department?
- (g) Do job descriptions exist for all jobs?
- (h) Are job descriptions up to date?
- (i) Are employee information regarding his employment history, leave record, medical record are properly documented and properly maintained throughout the period of service of employee?
- (j) Are job openings offered to current employees?
- (k) Are applicant references checked?
- (l) Are selection processes used with reference to the Uniform Guidelines?
- (m) Are all applicants required to fill out and sign an application form?
- (n) Are applicant identities checked?
- (o) Are applicants asked to voluntarily identify their affirmative action information?
- (p) If the organization has a qualifying federal contract, is there an affirmative action plan?
- (q) Do employment applications refrain from requesting protected information?
- (r) Are independent contractors accurately identified?
- (s) Whether all the forms pertaining to new employees, left employees, current employees relating to various laws are filed in time?
- (t) Are workplace policies in place that focus on your workplace?
- (u) Are policies communicated?
- (v) Is this communication documented?
- (w) Are policies enforced?
- (x) Is there an employee handbook?
- (y) Is the employee handbook specific to your workplace?
- (z) Do employee orientations take place?
- (aa) Is there an orientation plan?
- (bb) Are employees trained on policies and work rules?
- (cc) Are employees trained on discrimination and harassment issues?
- (dd) Are compensation levels monitored and reviewed?
- (ee) Is there a formal pay structure that is reviewed regularly?
- (ff) Is working time documented?
- (gg) Are paid time off (vacation, holidays, etc) structures developed and equally enforced?
- (hh) Whether the employee benefits viz. PF, Gratuity, Insurance, Super annuation etc. properly paid in time?



- (ii) Whether the retired employee's forms are filled in time and forwarded to government authorities for further action?
- (jj) Is quality and quantity of work evaluated?
- (kk) Is performance tied to compensation?
- (ll) Is there a process for employees to lodge complaints?
- (mm) Are there a variety of individuals to whom employees may lodge complaints (supervisor, HR representative)?
- (nn) Is there a whistleblower policy in effect?

**6) Safety and security**

- a) Are safety hazards reported to the appropriate personnel?
- b) Are workplace accidents, injuries, and illnesses reported and investigated?
- c) Are measures in place to prevent intruders from entering the grounds or buildings?
- d) Is bright, effective lighting installed indoors and outdoors?
- e) Are measures in place (access badges, traffic control, etc.) to keep unauthorized persons from entering the facility through normal entrances?
- f) Are employees encouraged to promptly report incidents, and suggest ways to reduce or eliminate risks?
- g) Whether all the accidents are reported to the concerned government authorities in time?

**7) Check list for Wages & Payroll**

1. Is there a separate department to deal with wages?
2. Who is responsible for various Jobs relating to wages:
  - Time Cards
  - Payroll
  - Disbursements, etc.
3. What is the staff strength?
  - Workers
  - Other employees
    - Management
    - Others
4. How are the duties distributed? Explain how the work of one person is automatically checked by the other?
5. Who authorizes the following:
  - Engagement of Employees
  - Retirement & Dismissal
  - Rates of Pay





- Increment or any changes in pay
  - Deductions from Pay
  - Advance payment of salary
6. Are proper personnel records kept for all employees (e.g. engagement letter, rates of pay, specimen signatory, etc)?
  7. Are written orders passed for engagement, discharge, wage rate, etc. for all categories of workers?
  8. What are the arrangements for recording time? Are they adequate?
  9. Is there periodic rotation of duties?
  10. What is the basis of overtime?
  11. Who can authorize overtime? Are there any limits on such authority?
  12. Are job cards maintained? Is the attendance record reconciled with the job cards?
  13. How is the piecework recorded?
  14. Are there adequate checks on the quantity of piecework completed?
  15. Is the control over time and piece work excused by someone independent of the wages department?
  16. What are the rules regarding rates of pay, incentive schemes, holiday pay, bonus, and other payments? Are there rules available in writing?
  17. Is the wages sheet well designed? Does it show various elements of gross wages? Are the deductions shown clearly?
  18. Is the primary data (no. of hours or piece work) entered in the wages sheet? Is the regularly checked with the time cards and piece work record by an independent person?
  19. Are the rates of pay / wages periodically checked and updated with reference to the rate card by an independent person?
  20. Does the internal auditor or any other independent person periodically check the calculation for wages, overtime incentive, PF, ESI, and various deductions?
  21. Are the wages by persons responsible for their preparation, Checking and authorization?
  22. Are the wages payables as shown in the wages sheets approved by a senior manager before the cheque is drawn for the total amount payable?
  23. How are the wages packed? Do twice independent persons count the cash before putting them in the envelope?
  24. Are the wage packets prepared before wages for any section of employees are disbursed? Is the cash properly reconciled before putting them in the envelope?
  25. Are wages disbursed on fixed days & timings?



26. Is proper identification and receipts obtained before disbursement of wages? Are the wages disbursed in the presence of the foreman of the section concerned?
27. Can another person draw wages of his colleagues, if he is so authorized? What are the checks on the unauthorized collection of wages?
28. What is the procedure of wage disbursement to workers of contract sites? Do adequate checks exist on primary records, rates authorization & identification of such workers?
29. How are unclaimed wages recorded?
30. Who keeps the envelopes containing unclaimed wages? Are the content of such unclaimed envelope examined? How long are these packets kept?
31. Who authorizes the payment of unclaimed wages? Is there proper identification of the person claiming unclaimed wages? Are there wages paid through separate voucher?
32. Are the deductions on account of Provident Fund, ESI, and Income Tax deposited on time?

**8) Internal Audit in respect of Cash & Bank Balances**

1. Is the receipt and opening of mail responsibility of an independent person? Who is he? Is a list prepared showing receipts of money orders and cheques when the mail is opened?
2. Have clients been advised to send payments only by crossed cheques? Are cheques being stamped "Not Negotiable" as soon as they are received?
3. Is the custody and control of money received the responsibility of company cashier? His name? Are his duties defined?
4. Does the cashier handle and have access to the books of accounts, securities, negotiable instruments, sales invoices & credit notes etc.?
5. Are the receipts pre-numbered and carbonized?
6. Are the cash receipts independently rectified with the sales records?
7. What is the procedure for dealing with cash shortages or surpluses? Who authorizes the write off / write back thereof?
8. Are the cheques / drafts received banked the following day? The pay-in-slip (deposit slip) should be checked with the checklist prepared on receiving the mail. Is it being done?
9. Are all cash collections being banked intact?
10. Is there any fixed float for petty cash? What is the procedure for reimbursement of petty cash float?
11. Is access to cash restricted? Are there arrangements of safeguarding cash after business hours? Specify such arrangements?
12. Is there an insurance policy for cash in the safe and cash in transit? Policy details?
13. Are there independent surprise counts of cash balances done, periodically? By whom?



14. Are all bank accounts being reconciled on a monthly basis? Are long outstanding recording items? Is there being checked by the accountant? Who reviews the bank records?
15. What are procedures and controls in respect of funds in trust in respect of Provident Fund, Cooperative societies, Pension Funds, etc.?
16. What are controls with regard to issue of cheques? With whose authority / instructions they are issued?
17. Are pre-signed cheques left around? What are the procedures for safe custody of cheque books?
18. What are the documents on the basis of which cheques can be raised? How the Electronic Payments are processed?
19. Who are the signatories of the cheques? Are there joint signatories?
20. Are cheques issued by the company, normally account payable?
21. What are the procedures for issuing bearer cheques? Monetary limits special approvals?
22. Are payments made within the discount period?
23. Are signed cheques promptly dispatched?
24. Who authorizes cash payment? Any limits on signing powers?
25. Has the company clearly laid down what documents will support different kinds cash payments?
26. Are the discharged documents stamped "PAID" so that they cannot be presented for payment twice?
27. What are the rules and regulations of the company on :
  - (a) Cash / Staff advance to employees
  - (b) T.A.D.A. rules.
  - (c) Entertainment Expenses.
  - (d) Allowance to senior staff – e.g. telephone, conveyance, business, allowances, medical expenses, etc.

**9) Check List For Purchase & Creditors**

1. What is the procedure for issuing purchase requisitions?
2. Whether tenders are invited? If yes, then what is the procedure for opening and acceptance thereof?
3. Is the preparation and authorizing of purchase order, under a responsible manager?
4. Whether proper arrangements exist for inspection of goods, especially with regard to quantity & quality?
5. Do the documents evidencing the arrival and acceptance of goods, supplied to the accounts department?
6. Do the goods receipt records checked against authorized purchase orders?
7. Are separate persons in the accounts department responsible for checking supplier's invoice documents regarding purchase returns, purchase records, payment to suppliers, maintenance of ledger accounts and reconciliation of statements? If yes, then who is responsible for what?
8. Before payments to suppliers Are documents presented showing that goods have been received as specified in the purchase order?



9. What procedure is followed with regard to purchase returns, discounts on account of inferior quality of goods, and other similar adjustments?
10. Are there any purchases from the companies under the same group and from the employees? If yes, then whether special checks have been designed for the same?
11. Do the accounts of various suppliers confirmed periodically from statement received from them?
12. Is there any cut-off procedure to ensure that all liabilities for goods purchased during an accounting period are brought into accounts?

**10) Check list for Sales and Debtors**

1. What is the procedure for procurement of customer's orders? Is there any authority for negotiating the various terms like prices, discounts, delivery schedules, etc.?
2. How documents are linked between acceptance of the order and dispatch of goods?
3. Who is responsible for granting credit or special discounts to customers?
4. How the record of outward goods is reconciled with the Customer's orders, challans and invoices?
5. Does the sales ledger staff have access to cash, cashbook or stocks?
6. How are the duties segregated among different persons for recording sales, maintaining accounts of customers, procuring orders from customers and dispatching goods?
7. What control procedures are followed for inspecting the Quality of the goods before dispatch?
8. Is there any periodic review of overdue accounts? What action is taken against defaulting customers?
9. Has the company clearly laid down any authority for writing off any bad debts? Is a separate ledger maintained showing the bad debts?

**11) Internal Audit in respect of Stock**

1. Who looks after the overall receipt, storage and issue of stocks?
2. Are there any minimum and maximum levels for each type of stock?
3. Is there any independent check of actual stock done, periodically? By whom?
4. How the various kinds of stocks are stored keeping in view the minimum storage loss?
5. What are the arrangements regarding returnable containers?
6. What are the procedures and controls regarding issuance of material from the store?
7. What are the arrangements made for control over stocks of the enterprise held by others?
8. Has the company clearly laid down the policy regarding valuation of stocks? Is independent valuation of stock done, periodically?
9. What are the controls in respect of scrap or wastage?



**Annexure I**

**Form – CRA-1**

*[Pursuant to Rule 5(1) of the Companies (Cost Records and Audit) Rules, 2014]*

**Form in which Cost Records shall be maintained**

**Particulars relating to the Items of Costs to be included in the Books of Accounts:**

**1. Input Material(s)/Service(s):**

(1) Proper records shall be maintained showing separately all receipts, issues and balances both in quantities and cost of each item of raw material/input services (including all direct charges upto the works) required for the production of goods or rendering of services under reference. The basis, on which quantities, cost of issue and consumption are calculated, shall be indicated in the cost records and followed consistently. In the case of imported raw materials/input services, proper records shall be maintained showing quantity of imported material/service, Free On Board value, overseas freight, insurance, customs duty and inland freight charges along with license-wise quantities allowed, actual quantities imported, actual quantities consumed, quantities in stock and quantities yet to be imported out of total licensed quantities. If both indigenous and imported materials/services are consumed, the records showing details of percentage mix of the same have to be maintained for each item.

(2) Proper records shall be maintained separately showing the receipts, issues and balances both in quantities and cost of each item of intermediate material/service, process material, additives, bought out components, sub-assemblies, accessories, semi-finished goods, consumable stores, spares, other indirect materials/services etc. used in the production of the goods/rendering of services under reference. The cost shall include all direct charges upto works/services delivered. In case of additives, bought out components/bought out services, sub-assemblies, accessories, semi-finished goods, consumable stores, spares and other indirect materials/services, proper records shall be maintained for the value and quantity issued/rendered in a financial year suitably adjusted for consumption. If the life of any input material/service is more than one financial year, necessary adjustment should be made. If the life of any input material/service is not known, consumption may be assessed on technical basis.

(3) Where the company produces these raw materials/input services, intermediates or process materials, separate records showing the cost of production/cost of service of such items, shall be maintained. The basis on which quantities and cost of issues and consumption of such materials/services produced or processed by the company are calculated, shall be indicated in the cost records and followed consistently.

(4) The issues, consumption of all raw materials/input services, intermediates, process materials, additives, manufactured, bought out components/ bought out services, sub-assemblies, accessories, semi-finished goods, consumable stores, spares and other indirect materials/services shall be



identified with the process wise production of goods/rendering of services.

(5) Proper records shall be maintained indicating the quantity as well as value of recoveries at different stages/processes having significant value in relation to cost of material/service. In case the recoveries are not reused in the process and are sold/rendered or disposed of without further processing/rendering, the realisation from such sales shall be recorded and adjusted against the process concerned. In case further processing/augmentation is necessary to make the recoveries usable or saleable, as the case may be, proper records of the cost involved for such further processing/augmentation shall be maintained. If such processing/augmentation is done by any outside agency, proper records to show the quantity sent for processing/augmentation, quantity received back after processing/augmentation and cost incurred thereon shall be maintained. The net realization, if any, shall be adjusted against the major process relating to such recoveries. The cost of recoveries shall be determined on equitable and reasonable basis and applied consistently. The records indicating the actual sales realization of recoveries shall also be maintained.

(6) Proper records shall be maintained to show the receipts, issues and balances, both in quantities and cost of each item of consumable stores, other process materials/services not covered above, small tools and machinery spares, indirect materials/services etc. The cost shall include all direct charges upto works/services delivered.

(7) The cost of consumable stores, small tools and machinery spares shall be charged to the relevant cost center/service centre or department or production process of goods or rendering of services on the basis of actual issues. In the case of consumable stores and small tools, indirect services, the cost of which are insignificant (less than 5% of the cost of material consumed), the company may, if it so desires, maintain such records for the group of such consumable stores, tools and indirect services.

(8) Proper records shall be maintained showing the quantity and value of wastage, spoilage, rejections and losses of raw materials/input services, intermediates, process materials/services, consumable stores, small tools and machinery spares, whether in transit, storage, manufacture or at any other stage. The method followed for adjusting the above losses as well as the income derived from the disposal of rejected and waste materials/services including spoilage, if any, in determining the cost of good(s)/service(s), shall be indicated in the cost records. Any abnormal wastage or spoilage or rejection or losses shall be indicated distinctly and separately along with reasons thereof.

(9) Proper records shall also be maintained to indicate the value of raw materials/input services, intermediates and process materials/services, finished and semi-finished goods/services, consumable stores, small tools and machinery spares, additives, manufactured, bought out components/bought out services, sub-assemblies, accessories, semi-finished goods/services, consumable stores, spares and other indirect materials/services which have not moved/utilized for more than twelve months.

(10) Where any credit under Central Value Added Tax (CENVAT) under the Central Excise Act, 1944 (1 of



1944) or Finance Act in case of service tax, any other benefits of the nature of CENVAT/Service Tax credit, are available on any item of material/service, the cost of such material/service shall be shown after adjusting such credit or benefits.

(11) If any of the input materials/services is processed through an outside party, proper records shall be maintained for the quantity sent for processing, quantity received after processing, balance quantity of material/service, losses and wastage of material/service during processing, by-products recovered, if any, and the cost involved in processing/rendering of service.

## **2. Salaries and Wages:**

(1) Proper records shall be maintained to show the attendance and earnings of all employees assigned to the cost centres or departments and the work on which they are employed. The records shall also indicate the following separately for each cost centre or department:

- (a) piece rate wages (wherever applicable);
- (b) incentive wages, either individually or collectively as production bonus or under any other scheme based on output;
- (c) overtime wages;
- (d) earnings of casual or contractual labour;
- (e) bonus or gratuity, statutory as well as other;
- (f) contribution to superannuating scheme;
- (g) cost of employees stock option;
- (h) leave travel concession; paid holidays;
- (i) leave with pay;
- (j) Training, workshop, seminar expenses;
- (k) Medical/health, safety, education expenses;
- (l) any other statutory provision for labour welfare;
- (m) any other free or subsidized facility.

(2) The records shall be maintained in such a manner as to enable the company to book these expenses cost centre wise or department wise with reference to goods/services under reference and to furnish necessary particulars. Where the employees work in such a manner that it is not possible to identify them with any specific cost centre/service centre or department, the employees cost shall be apportioned to the cost centre/service centres or departments on equitable and reasonable basis and applied consistently.



(3) The idle labour cost shall be separately recorded under classified headings indicating the reasons therefor. The method followed for accounting of idle time payments shall be disclosed in the cost records.

(4) Any wages and salaries allocable to capital works, such as, additions to plant and machinery, buildings or other fixed assets shall be accounted for under the relevant capital heads. The method followed for accounting of such payments in determining the cost of the goods/services under reference shall be on equitable and reasonable basis and applied consistently. The said method shall be disclosed in the cost records also.

(5) The cost of normal retirement benefits payable to employees shall be recorded separately and charged to cost. The method followed for accounting of such costs in determining the cost of the goods/services under reference shall be on equitable and reasonable basis and applied consistently and disclosed separately. Termination benefits which are payable in addition to the normal retirement benefits, such as benefits under voluntary retirement scheme, expenses treated as abnormal and not forming part of salaries and wages and cost of production of goods/rendering of services.

### **3. Utilities:**

(1) Proper records shall be maintained showing the quantity and cost of each major utility such as power, water, steam, effluent treatment, etc. produced and consumed by the different cost centres in such detail as to have particulars for each utility separately.

(2) If a utility is purchased, proper records showing the delivered cost including all direct charges shall be maintained for the quantity and value of each utility purchased.

(3) Where a utility is produced and supplied by any other unit of the company or any related party, proper records shall be maintained to assess cost and the quantity of the utility so procured.

(4) The cost of utility, if any, supplied to any other unit(s) of the company or any related party, shall be calculated on equitable and reasonable basis and applied consistently.

(5) The cost of utility allocated/apportioned to the cost centers and further to the individual goods/services shall be on equitable and reasonable basis and applied consistently.

(6) Where any utility is one of the major inputs to the raw material used in production or manufacture of any of the goods/services under reference, such direct utility shall be included in the cost of such raw material/input service and shown accordingly.

(7) Proper records indicating any subsidy, grant/incentive, credits, recoveries, abnormal costs, penalties or damages paid etc. in respect of utilities shall be maintained.

(8) The records shall also indicate the measures taken on conservation of energy and its corresponding impact on per unit cost of goods/services.





**4. Service Department Expenses:**

(1) Proper records shall be maintained to indicate expenses incurred in respect of each service cost centre like engineering, work shop, designing, laboratory, safety, transport, computer cell, welfare etc. These expenses shall be apportioned to other services and production departments on equitable and reasonable basis and applied consistently. Where these services are utilized for other goods/services of the company also, the basis of apportionment of such expenses to goods/services under reference and to the other goods/services shall be on equitable and reasonable basis and applied consistently. The said basis shall be disclosed in the cost records also. Proper records shall be maintained to indicate cost of purchase, production, distribution, marketing and price of services with reference to sales to outside parties. Proper records shall also be maintained regarding cost of services received from/rendered to related parties and cost of service cost centre incurred in foreign exchange besides proper maintenance of records in respect of any subsidy, grants, incentives, credits/recoveries, any abnormal cost, penalty and damages.

**5. Repairs and Maintenance:**

(1) Proper records showing the expenditure incurred by the workshop, tool room and on repairs and maintenance in the various cost centres or departments shall be maintained under different heads. The records shall also indicate the basis of charging such expenses to different cost centres or departments. Records in respect of repairs and maintenance cost of jobs done in-house and outsourced, cost of major overhauls, repair and maintenance paid/payable to the related party, incurred in foreign exchange and any subsidy, grant, incentive, credits/recoveries, penalty and damages and any abnormal portion of this item of cost shall be maintained. The manner of charging a share of the cost of workshop, tool room and repairs and maintenance expenses shall be on equitable and reasonable basis and applied consistently.

(2) In addition to the above, records shall indicate the amount and also the proportion of closing inventory of stores and spare parts representing items which have not moved for over twenty four months.

(3) The expenditure on major repair works from which benefit is likely to accrue for more than one financial year shall be shown separately and absorbed in the cost over the period for which such benefits are expected to accrue on equitable and reasonable basis and applied consistently. Method of accounting along with the basis of allocation of such costs shall also be clearly indicated in cost records.

**6. Fixed Assets, Depreciation and Lease Charges:**

(1) Proper and adequate records shall be maintained for assets used for production of goods/rendering of services under reference in respect of which depreciation has to be provided for. These records shall, inter-alia, indicate grouping of assets under each good/service, the cost of acquisition of each item of asset including installation charges, date of acquisition and rate of depreciation.

(2) Those records which enable to identify and/or allocate gross fixed assets, accumulated depreciation up

to the year and net fixed assets under the heads; land and building, plant and machinery, furniture and fixtures etc. employed for goods/services under reference shall be maintained. The basis of apportionment of common assets to the goods/services under reference shall be on equitable and reasonable basis and applied consistently. In case of revaluation of assets, the same shall be indicated separately and depreciation on revaluation shall also be indicated separately.

(3) The basis on which depreciation is calculated and allocated or apportioned to various cost centre/service centres or departments and absorbed on all goods/services shall be clearly indicated in the cost records. If depreciation charged or chargeable to the cost centres or departments is in excess or lower than the depreciation calculated by applying the rates of depreciation prescribed under the Companies Act, 2013 , such amount of excess or lower depreciation shall be indicated clearly in the cost records. The cost records shall also show the effect of such excess or lower depreciation, as the case may be, on per unit cost of each good/service. The cumulative depreciation charged in the cost records, against any individual item of asset shall not, however, exceed the original cost of the respective asset.

(4) Proper records shall be maintained giving details of assets taken or given on lease. The break- up of lease rental in terms of financial charges, depreciation etc. paid or received shall be maintained separately. The details shall be maintained separately for assets taken from or given to related party.

## **7. Overheads:**

(1) Proper records shall be maintained for various items of indirect expenses comprising overheads pertaining to goods/services under reference. These expenses shall be analyzed, classified and grouped according to functions, namely, works, administration, selling and distribution, Head Office expenses.

(2) Proper records shall be maintained in respect of overheads incurred in foreign exchange, any subsidy, grant, incentive, credits/recoveries, unabsorbed overheads and any abnormal portion and also relating to resources received from or supplied to any related party,

(3) Where the company is also manufacturing goods/rendering services other than the goods/services under reference, the records shall clearly indicate the basis followed for apportionment of the common overheads including head office expenses of the company to such other goods/services and the goods/services under reference, including capital works. Where certain expenses forming part of overheads can be identified with particular goods/services, such expenses shall be first segregated and charged to the relevant goods/services in the first instance and thereafter the residual expenses under the above categories of overheads shall be apportioned on equitable and reasonable basis and applied consistently. The overheads chargeable to capital works shall be indicated separately in the cost records. The basis of apportionment or absorption of overheads to the cost centres or departments and the goods/services shall be indicated in the cost records. The records shall be maintained in such a manner as to indicate the details of works, administration, selling and distribution overheads, H.O. expenses etc.



**8. Royalty and Technical Know-How Fee:**

Adequate records shall be maintained showing royalty and/or technical know-how fee including other recurring or non-recurring payments of similar nature, if any, made for the goods/services under reference to collaborators or technology suppliers in terms of agreements entered into with them. Such records shall be kept separately in respect of each such agreement or arrangement. The basis of charging such amount, including lump sum payment and its treatment shall be indicated in the cost records.

**9. Research and Development Expenses:**

(1) Proper records showing the details of expenses, if any, incurred by the company for research and development work on the goods/services covered under these rules, according to the nature of development of goods/services - existing and new, design and development of new facilities and market research for the existing and new goods/services, shall be maintained separately. The records shall also indicate the payments made to outside parties for the research and development work. The basis of charging such amount, including lump sum payment and its treatment shall be indicated in the cost records.

(2) The basis of charging these expenses to the cost of production of goods/services under reference and to other goods/services shall be indicated in the cost records. Where the utility of research and development work extends to over more than one financial year, such expenses shall be charged to the cost of goods/services under reference and to all other goods/services on equitable and reasonable basis and applied consistently indicating the criteria on the basis of which it has been decided to extend the utility period of these expenses to more than one financial year.

(3) Proper records shall be maintained in respect of such expenses incurred in foreign exchange and any subsidy, grant, incentive, credits/recoveries, penalty or damages paid and any abnormal portion and also for resources received from or supplied to any related party.

(4) The expenses incurred by the research and development department for providing technical know-how to outsiders shall be recorded separately and excluded from the cost of goods/services under reference. The amount recovered for providing technical know-how to outsiders shall also be indicated separately and excluded from the income arising from the sale of goods/services under reference.

**10. Quality Control:**

Adequate records shall be maintained to indicate the expenses incurred in respect of quality control department or cost centre/service centre for goods/services under reference. Where these services are also utilized for other goods/services of the company, the basis of apportionment to goods/services under reference and to other goods/services shall be on equitable and reasonable basis and applied consistently. Proper records shall be maintained in respect of such expenses relating to resources received from or supplied to the related party, incurred in foreign exchange and any subsidy, grant, incentive, credits/recoveries, unabsorbed overheads and any abnormal portion etc.

**11. Work-In-Progress and Finished Stock:**

The method followed for determining the cost of work-in-progress and finished stock of the goods and for

services under delivery or in-process shall be appropriate and shall be indicated in the cost records so as to reveal the cost element that have been taken into account in such computation. All conversion costs incurred in bringing the inventories to their present location and condition shall be taken into account while computing the cost of work-in-progress and finished stock. The method adopted for determining the cost of work-in- progress and finished goods shall be followed consistently.

**12. Captive Consumption:**

If the goods/services under reference are used for captive consumption, proper records shall be maintained showing the quantity and cost of each such goods/services transferred to other departments or cost centres or units of the company for self-consumption and sold to outside parties separately.

**13. By-Products:**

Proper Records shall be maintained for each item of by-product, if any, produced showing the receipt, issues and balances, both in quantity and value. The basis adopted for valuation of by-product for giving credit to the respective process shall be equitable and consistent and should be indicated in cost records. Records showing the expenses incurred on further processing, if any, as well as actual sales realization of by-product shall be maintained. The proper records shall be maintained in respect of credits/recoveries from the disposal of by-products.

**14. Joint Products/Services:**

Where more than one product/service which is of equal economic importance arises from a process, the cost up to the point of separation of products/services shall be apportioned to joint products/services on reasonable and equitable basis and shall be applied consistently. The basis on which such joint costs are apportioned to different products/services arising from the process shall be indicated in the cost records. Proper records shall be maintained in respect credits/recoveries from the disposal of joint products/services.

**15. Packing Expenses:**

Proper records shall be maintained separately for domestic and export packing showing the quantity and cost of various packing materials and other expenses incurred on primary and/or secondary packing indicating the basis of valuation. Where such expenses are incurred in common for other goods also, the basis of apportioning the expenses between the relevant goods shall be on equitable and reasonable basis and applied consistently. Proper records shall be maintained in respect of packing materials received from or supplied to the related party, costs incurred in foreign exchange and any subsidy, grant, incentive, credits/recoveries, unabsorbed overheads, penalty and damages, any abnormal portion etc.

**16. Interest and other Borrowing Costs:**

- (1) Proper records shall be maintained for money borrowed for each project and/or working capital and interest charged thereon. The amount of net interest and other borrowing costs shall be allocated or apportioned to the goods/services under reference and other goods/services on equitable and reasonable basis and applied consistently. The basis of further charging of the share of interest to the various types of such goods/services shall also be equitable and reasonable and applied consistently. The basis of such allocation or apportionment shall be spelt out clearly in

the cost records.

- (2) Net interest and other borrowing costs incurred for project under execution shall be capitalized for the period up to the date the project is commissioned.
- (3) Proper records shall be maintained in respect of such expenses paid/payable to the related party, incurred in foreign exchange and any subsidy, grant, incentive and any amount of similar nature received/receivable, payment of penal interest or fine/damages paid.
- (4) Proper records shall be maintained in respect of such expenses incurred relating to prior periods and taken to reconciliation directly.

**17. Expenses or Incentives on Exports:**

- (1) Proper records showing the expenses incurred on the export sales, if any, of the goods/services under reference shall be separately maintained so that the cost of export sales can be determined correctly. Separate cost statements shall be prepared for goods/services exported giving details of export expenses incurred or incentive earned.
- (2) Proper records shall be maintained giving the details of export commitments license wise and the fulfillment of these commitments giving the reasons for non-compliance, if any. In case, duty free imports are made, the cost statements should reflect this fact. If the duty free imports have been made after actual production, the statement should reflect this fact also.

**18. Pollution Control:**

- (1) Expenditure incurred by the company on various measures to protect the environment like effluent treatment, control of pollution of air, water, etc., should be properly recorded. Records relating to basis of distribution of pollution control expenses, such costs of jobs done in-house and outsourced separately, pollution control costs paid/payable to related parties, incurred in foreign exchange and any subsidy, grant, incentive, credits/recoveries, any abnormal portion of such costs, penalty and damages paid and any amount received/receivable from pollution control agency.

**19. Production Records:**

- (1) Quantitative records of all finished goods (packed or unpacked)/services rendered showing production, issues for sales and balances of different type of the goods/services under reference, shall be maintained. The quantitative details of production of goods/services rendered shall be maintained separately for self-produced, third party on job work, loan license basis etc.

**20. Sales Records:**

Separate details of sales shall be maintained for domestic sales at control price, domestic sales at market price, export sales under advance license, export sales under other obligations, export sales at market price, and sales to related party/inter unit transfer. In case of services details of domestic delivery/sales at control price, domestic delivery/sales at market price, export delivery/sales under advance license, export delivery/sales under other obligations, export delivery/sales at market price, and delivery/sales to related party/inter unit



transfer. Such details shall be maintained separately for each plant/unit wise or service centre wise for total as well as per unit sales realization.

**21. Any other Item of Cost:**

Proper records shall be maintained for any other item of cost being indispensable and considered necessary for inclusion in cost records for calculating cost of production of goods/rendering of services, cost of sales, margin in total and per unit of the goods/services under reference.

**22. Adjustment of Cost Variances:**

Where the company maintains cost records on any basis other than actual such as standard costing, the records shall indicate the procedure followed by the company in working out the cost of the goods/services under such system. The cost variances shall be shown against separate heads and analyzed into material, labour, overheads and further segregated into quantity, price and efficiency variances. The method followed for adjusting the cost variances in determining the actual cost of the goods/services shall be indicated clearly in the cost records. The reasons for the variances shall be duly explained in the cost records and statements.

**23. Cost Statements:**

- (1) Cost statements (quarterly and annually) showing quantitative information in respect of each good/service under reference shall be prepared showing details of available capacity, actual production, production as per excise records, capacity utilization (in-house), stock purchased for trading, stock and other adjustments, quantity available for sale, wastage and actual sale etc. during current financial year and previous year.
- (2) Such statements shall also include details in respect of all major items of costs constituting cost of production of goods/services, cost of sales of goods/services and margin in total as well as per unit of the goods/services. The goods/services emerging from a process, which forms raw material or an input material/service for a subsequent process, shall be valued at the cost of production/cost of service up to the previous stage.
- (3) Cost Statements (quarterly and annually) in respect of reconciliation of indirect taxes showing details of total clearances of goods/services, assessable value, duties/taxes paid, CENVAT/VAT/Service Tax credit utilized, duties/taxes recovered and interest/penalty paid.
- (4) If the company is operating more than one plant, factory or service centre, separate cost statements as specified above shall be prepared in respect of each plant, factory or service centre.
- (5) Any other statement/information considered necessary for suitable presentation of Costs and Profitability of goods/services produced by the Company shall also be prepared.

**24. Reconciliation of Cost and Financial Accounts:**

- (1) The cost statements shall be reconciled with the financial statements for the financial year specifically indicating the expenses or incomes not considered in the cost records or statements so as to ensure accuracy and to adjust the profit of the goods/services under reference with the overall profit of the company. The variations, if any, shall be clearly indicated and explained.
- (2) A statement showing the total expenses incurred and income received by the company under



different heads of accounts and the share applicable to other goods/services and the goods/services under reference shall be prepared and reconciled with the financial statement.

**25. Statistical Records:**

- (1) The records regarding available machine hours or direct labour hours in different production departments and actually utilized shall be maintained for production of goods/rendering of services under reference and shortfall suitably analyzed. Suitable records for computation of idle time of machines and/or labour shall also be maintained and analyzed.
- (2) Proper records shall be maintained to enable the company to identify the capital employed, net fixed assets and working capital separately for the production of goods/rendering of services under reference and other goods/services to the extent such elements are separately identifiable. Non-identifiable items shall be allocated on a suitable and reasonable basis to different goods/services. Fresh investments on fixed assets for production of goods/rendering of services under reference that have not contributed to the production of goods/rendering of services during the relevant period/year shall be indicated in the cost records. The records shall, in addition, show assets added as replacement and those added for increasing existing capacity.

**26. Records of Physical Verification:**

Records of physical verification may be maintained in respect of all items held in the stock such as raw-materials, process materials, packing materials, consumables stores, machinery spares, chemicals, fuels, finished goods and fixed assets etc. Reasons for shortages/surplus arising out of such verifications and the method followed for adjusting the same in the cost of the goods/services shall be indicated in the records.

**27. Related Party Transactions:**

(1) In respect of related party transactions or supplies made or services rendered by a company to a company termed “related party relationship” and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of -

- (a) purchase and sale of raw materials, finished good(s), rendering of service(s), process materials and rejected goods including scraps, etc;
- (b) utilisation of plant facilities and technical know-how;
- (c) supply of utilities and any other services;
- (d) administrative, technical, managerial or any other consultancy services;
- (e) purchase and sale of capital goods including plant and machinery; and
- (f) any other payment related to the production of goods/rendering of services under reference.

(2) These records shall also indicate the basis followed for arriving at the rates charged or paid for such goods or services so as to enable determination of the reasonableness of such rates in so far as they are in any way related to goods/services under reference.