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For internal use of Indian Audit & Accounts Department

Internal Controls Evaluation Manual

OFFICE OF THE COMPTROLLER & AUDITOR GENERAL OF INDIA
NEW DELHI

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Office of the Comptroller & Auditor General of India,
New Delhi

PREFACE

Internal controls are safeguards that are put in place by the management of an organisation to provide assurance that its operations are proceeding as planned.

The International Organisation of Supreme Audit Institutions (INTOSAI) has prepared Guidelines for Internal Controls in the Public Sector. This stipulates that internal control is an integral process that is effected by an entity's management and personnel and is designed to provide reasonable assurance that the following general objectives are being achieved:

- fulfilling accountability obligations;
- complying with applicable laws and regulations;
- executing orderly, ethical, economical, efficient and effective operations; and
- safeguarding resources against loss.

Internal controls consist of five interrelated components, viz.,

- control environment
- risk assessment
- control activities
- information and communication
- monitoring

The massive size and scale of government operations and expenditure call for effective internal controls over its operations. Internal controls help strengthen the public accountability of government and help balance the competing demands of delivering a responsive and quality service to the community whilst recognising fiduciary responsibilities and maintaining standards of probity, prudence and ethics. Internal controls are, therefore, closely aligned with good governance.

This Manual seeks to lay down a framework for evaluation of internal controls in Government Ministries and Departments. Internal control is a dynamic process that continuously adapts to the structural and other changes in an organization. Hence just as the checks indicated in the Manual would need to be supplemented by the field offices while carrying out assessment of the effectiveness of internal controls, this Manual would also need to be reviewed and updated periodically.

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Comptroller and Auditor General of India

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Part I

Chapter 1 INTRODUCTION

1. Nature of internal controls

Internal controls, in simple terms, are activities and safeguards that are put in place by the management of an organisation to ensure that its activities are proceeding as planned. Every organization has some form of internal controls. Effective internal controls are a prerequisite for any successful organisation. Internal controls are essential for good governance.

2. Need for internal controls in government

The size and scale of government operations call for effective internal controls over its operations. Internal controls help strengthen the public accountability of government and help balance the competing demands of delivering a responsive and quality service to the community whilst recognising fiduciary responsibilities and maintaining standards of probity, prudence and ethics.

3. Scope of the Manual

The present Manual seeks to lay down a framework for evaluation of internal controls in the ministries and departments of Government of India, State Governments, parastatal organizations, etc, which are audited by the IA&AD. The terms 'entity', 'organization' and 'management' wherever used in the Manual have to be understood in this context.

4. Definition

Internal control is an integral process that is effected by an entity's management and personnel and is designed to provide reasonable assurance that the following general objectives are being achieved:

- fulfilling accountability obligations;
- complying with applicable laws and regulations;
- executing orderly, ethical, economical, efficient and effective operations; and
- safeguarding resources against loss.

5. Internal control as an integral process

(1) Internal control is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions occur throughout an entity's operations on an ongoing basis. They are pervasive and inherent in the way the management runs the organisation.

> In the above context :
>
> "Internal Control System means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of Internal control with the objective of determining whether other internal controls are well designed and properly operated." (Refer AAS 6 issued by the ICAI)

(2) Internal control should be built in rather than built on. The internal control system is most effective when it is built into the organisation's infrastructure and operations and is an integral part of the essence of the organisation. By building in internal control, it becomes part of and integrated within the basic management processes of planning, executing and monitoring.

(3) Built in internal control also helps in cost control. Adding new procedures that are separate from existing ones adds costs. By focusing on existing operations and their contribution to effective internal control, and by integrating controls into basic operating activities, an organisation often can avoid unnecessary procedures and costs.

6. Effected by management and other personnel

(1) Internal control is accomplished by individuals within an organisation. Consequently, internal control is effected by people. They should know their roles and responsibilities, and limits of authority. An organisation's people include the management and other personnel. Although the management primarily provides oversight, they also set the entity's objectives and have overall responsibility for the internal control system. As internal control provides the mechanism needed to help understand risk in the context of the organisation's objectives, the management will put internal control activities in place and monitor and evaluate them. Therefore, internal control is a tool used by the management and is directly related to the entity's objectives. As such, management is an important element of internal control. However, all personnel in the organisation play important roles in making it happen.

(2) Similarly, internal control is affected by human nature. People do not always understand, communicate or perform consistently. Each individual brings to the workplace a unique background and technical ability, and has different needs and priorities. These realities affect, and are affected by, internal control.

7. Internal controls provide only reasonable assurance and not absolute assurance

(1) No matter how well designed and operated, internal control cannot provide management absolute assurance regarding the achievement of an entity's objectives. Reasonable assurance equates to a satisfactory level of confidence under given considerations of costs, benefits and risks.

(2) Determining how much assurance is reasonable requires judgment. In exercising that judgment, management should identify the risks inherent in their operations and the acceptable levels of risk under varying circumstances, and assess risk both quantitatively and qualitatively.

(3) Reasonable assurance reflects the notion that uncertainty and risk relate to the future, which no one can predict with certainty. Also factors outside the control or influence of the organisation can affect the ability to achieve the objectives. Limitations also result from the following realities:

- human judgment in decision making can be faulty;
- breakdowns can occur because of simple errors or mistakes;
- controls can be circumvented by collusion of two or more people;
- management can override the internal control system; and
- decisions on risk responses and establishing controls need to consider the relative costs and benefits.

These limitations preclude management from having absolute assurance that objectives will be achieved.

(4) Reasonable assurance recognises the fact that the cost of internal control should not exceed the benefit derived. Cost refers to the financial measure of resources consumed in accomplishing a specified purpose like Rupees spent and to the economic measure of lost opportunity, such as delay in operations, decline in service levels or productivity, or low employee morale. Benefit is measured by the degree to which the risk of failing to achieve stated objective is reduced. Examples include increasing the probability of detecting fraud, waste, abuse, or error; preventing an improper activity; or enhancing legal and regulatory compliance.

(5) Designing internal controls that are cost beneficial while reducing risk to an acceptable level requires that managers clearly understand the overall objectives to be achieved. Systems with excessive controls in one area of operations may adversely affect other operations. For example, employees may try to circumvent burdensome procedures, inefficient operations may cause delays, excessive procedures may stifle employee creativity and problem solving or impair the

timeliness, cost or quality of services provided to beneficiaries. Thus, benefits derived from excessive controls in one area may be outweighed by increased costs in other activities.

8. Achievement of objectives

(1) Internal control is geared to the achievement of a separate but interrelated series of general entity level objectives. These general objectives are:

(a) **Fulfilling accountability obligations**

Accountability is the process whereby public service bodies and the individuals within them are held to account for their decisions and actions, including their stewardship of public funds, fairness, and all aspects of performance. This will be realized by developing and maintaining reliable and relevant financial and non-financial information and by means of a fair disclosure of that information in timely reports to internal as well as external stakeholders.

Non-financial information may relate to the economy, efficiency and effectiveness of policies and operations (performance information), and to internal control and its effectiveness.

(b) **Complying with laws and regulations**

Government organisations are required to follow many laws and regulations. Examples include the Constitution, Finance Act, International treaties, laws and regulations on proper administration, accounting law, environmental protection and civil rights law, tax laws, anti-corruption law.

(c) **Executing orderly, ethical, economical, efficient and effective operations**

The entity's operations should be orderly, ethical, economical, efficient and effective.

'Orderly' means in a well-organised or methodical way.

'Economical' means not wasteful or extravagant. It means getting the right amount of resources of the right quality delivered at the right time and place at the lowest cost.

'Effective' refers to the accomplishment of objectives or to the extent to which the outcomes of an activity match the objectives or the intended effects of that activity.

'Efficient' refers to the resources used to achieve the objectives. It means the minimum resource inputs to achieve a given quantity and quality of output, or a maximum output with a given quantity and quality of resource inputs.

'Ethical' relates to moral principles. The importance of ethical behaviour and prevention and detection of fraud and corruption in the public sector has become more emphasized since the nineties. General expectations are that public servants should serve the public interest with fairness and manage public resources properly. Citizens should receive impartial treatment on the basis of legality and justice. Therefore, public ethics is a prerequisite to, and underpins public trust and is a keystone of good governance.

(d) Safeguarding of resources

(i) The significance of safeguarding the resources in the public sector needs to be stressed. This is due to the fact that budgetary accounting or accounting on a cash basis, which is still widespread in the public sector, does not provide sufficient assurance related to the maintenance of records of the resources. As a result, the organisations in the public sector do not always have a record of all their assets, which makes them more vulnerable. Therefore, controls should be embedded in each of the activities related to the management of resources of the entity, from the entry until the disposition.

(ii) Other resources such as information, source documents and accounting records are also in danger of being stolen, misused or accidentally destroyed. Safeguarding such resources and records has become increasingly important since the arrival of computer systems. Sensitive information stored on computer media can be destroyed or copied, distributed and abused if care is not taken to protect it.

9. Limitations on the effectiveness of internal controls

(1) An effective internal control system, no matter how well conceived and operated, can provide only reasonable and not absolute assurance to management about the achievement of an entity's objectives or its survival. It can give the management information about the entity's progress, or lack of it, towards the achievement of the objectives. But internal control cannot change an inherently poor manager into a good one.

(2) An effective system of internal control reduces the probability of not achieving the objectives. However, there will always be the risk that internal controls fail to operate as designed.

(3) Because internal control depends on the human factor, it is subject to flaws in design, errors of judgment or interpretation, misunderstanding, carelessness, fatigue, distraction, collusion, abuse or override.

(4) Shifts in government policy or programs, demographic or economic conditions are typically beyond management's control.

(5) The following are some of the reasons limiting the effectiveness of internal control systems.

(a) One major limiting factor is that the design of an internal control system faces resource constraints. The benefits of controls must consequently be considered in relation to their costs. Maintaining an internal control system that eliminates the risk of loss is not realistic and would probably cost more than is warranted by the benefit derived. In determining whether a particular control should be established, the likelihood of the risk occurring and the potential effect on the entity are considered along with the related costs of establishing a new control.

(b) Controls may not keep pace with changes in conditions.

(c) Generally, controls are aimed at routine or usual transactions. Hence, transactions of an unusual nature might escape the controls.

(d) The potential of human error remains in any system of internal control

Chapter 2

COMPONENTS OF INTERNAL CONTROL

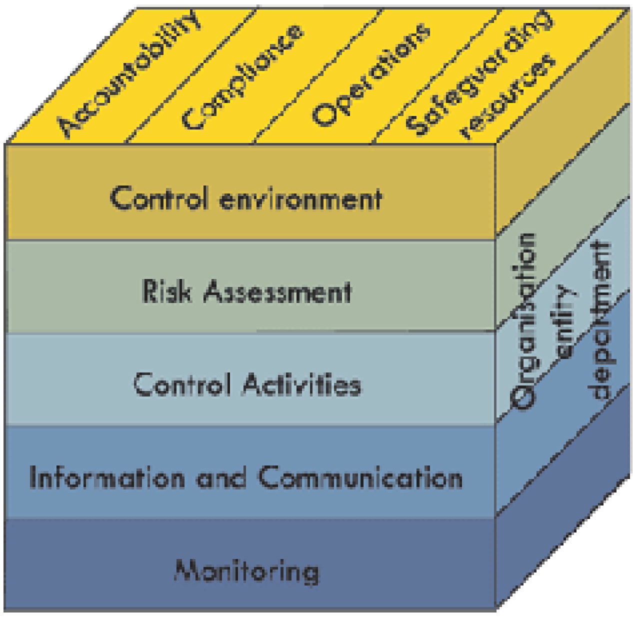
10. Internal control is designed to provide reasonable assurance that the entity's general objectives are being achieved. Therefore clear objectives are a prerequisite for an effective internal control process.

11. Internal control consists of five interrelated components:

- control environment
- risk assessment
- control activities
- information and communication
- monitoring

12. Relationship between objectives and components

(1) There is a direct relationship between the objectives, which represent what an entity strives to achieve, and the internal control components, which represent what is needed to achieve them. The relationship is depicted in a three-dimensional matrix, in the shape of a cube. The four objectives – accountability, compliance, operations and safeguarding resources – are represented by the vertical columns, the five components are represented by horizontal rows, and the organisation or entity and its departments are depicted by the third dimension of the matrix.



(2) Each component row "cuts across" and applies to all four objectives. For example, financial and non-financial data generated from internal and external sources, which belong to the information and communication component, are needed to manage operations, to report and fulfill accountability purposes, and to comply with applicable laws.

(3) Similarly, looking at the objectives, all five components are relevant to each objective. Taking one objective, e.g. effectiveness and efficiency of operations, it is clear that all five components are applicable and important to its achievement.

(4) Internal control is not only relevant to an entire organisation but also to an individual department. This relationship is depicted by the third dimension, which represents entire organisations, entities and departments. Thus, one can focus on any of the matrix's cells.

(5) The five components of internal control are briefly explained in the subsequent paragraphs.

13. Control environment

(1) Control environment means the overall attitude, awareness and actions of management regarding the internal control system and its importance in the entity.

(2) The control environment is the foundation for the entire internal control system. It provides the discipline and structure as well as the climate which influences the overall quality of internal control. It has overall influences on how objectives and strategy are established, and control activities are structured.

(3) The control environment sets the tone of an organisation, influencing the control consciousness of its staff. It is the foundation for all other components of internal control, providing discipline and structure.

(4) Elements of the control environment are:

- the personal and professional integrity and ethical values of the management and staff, including a supportive attitude toward internal control;
- competence;
- the "tone at the top";
- organisational structure; and
- human resource policies and practices.

14. Risk Assessment

(1) Risk assessment is the process of identifying and analysing relevant risks to the achievement of the entity's objectives and determining the appropriate response. As stressed in the definition, internal control can provide only reasonable assurance that the objectives of the organisation are being achieved. Risk assessment as a component of internal control, plays a key role in the selection of the appropriate control activities to undertake.

(2) Consequently, setting objectives is a precondition to risk assessment. Objectives must be defined before the management can identify the risks to their achievement and take the necessary actions to manage the risks. That means having in place an ongoing process for evaluating and addressing the impact of risks in a cost effective way and having staff with the appropriate skills to identify and assess the potential risks. Internal control activities are a response to risk in that they are designed to contain the uncertainty of outcome that has been identified.

Indicators of weak controls:

- Govt. policies set out in Acts, Rules, Statutes and Regulations, etc. (Weak control: policies poorly understood/improperly followed)
- Employees' codes of conduct (Weak control: violation of codes)
- Clear organizational chart (Weak control: a confused hierarchy)
- Internal pre-control systems like budget, treasury, etc. (Weak control: wrong budgetary assumptions, inadequate treasury control, etc.)
- Identification and control of internal and external risk factors (personnel policy, economic changes, calamities, etc.) (Weak control: potential or real risk factors not controlled)
- Cost-benefit analysis of major activities (Weak control: absence of CBA)
- Commitment to change (Weak control: a rigid system not responding to change)

15. Risk Identification

(1) A strategic approach to risk assessment depends on identifying risks against key organisational objectives. Risks relevant to those objectives are then considered and evaluated, resulting in a small number of key risks. Identifying key risks is not only important in order to identify the most important areas to which resources in risk assessment should be allocated, but also in order to allocate responsibility for management of these risks.

(2) An entity's performance can be at risk due to internal or external factors at both the entity and activity levels. It is, therefore, important that risk identification is comprehensive.

(3) Risk identification should be an ongoing, interactive process and is often integrated with the planning process.

Understanding Risk

A risk is anything that could jeopardise the achievement of objectives of an organisation. The following questions should be asked by the management while formulating an organisational policy/activity. The auditors, on the other hand, while evaluating internal control need to see if such issues have been considered while formulating policies and activities:

- What could go wrong?
- How could we fail?
- What must go right for us to succeed?
- Where are we vulnerable?
- What assets do we need to protect?
- Do we have liquid assets or assets with alternative uses?
- How could someone steal from the department?
- How could we know whether we are achieving our objectives?
- On what information do we most rely?
- On what do we spend the most money?
- How do we bill and collect our revenue?
- What decisions require the most judgment?
- What activities are most complex?
- What activities are regulated?
- What is our greatest legal exposure?

16. Risk evaluation

(1) In order to decide how to handle risk, it is essential not only to identify in principle that a certain type of risk exists, but to evaluate its significance and assess the likelihood of the risk event occurring. The methodology for analysing risks can vary, largely because many risks are difficult to quantify (e.g. risk to reputation and image) while others lend themselves to quantification (particularly financial risks). As such, risk evaluation especially for the former is a subjective exercise.

(2) One of the key purposes of risk evaluation is to inform management about areas of risk where action needs to be taken and their relative priority. Therefore, it will usually be necessary to develop some framework for categorising all risks. Generally, such categorization will be as high, medium, or low. It is better to minimize the categories, as over refinement may lead to spurious separation of levels which in reality cannot be separated clearly.

Understanding link between weak internal control and fraud.
Weak internal controls not only permit fraud, they actually encourage it.

Costs of fraud:

- Loss of public confidence in government
- Loss of reputation of the innocent
- Punishment of the perpetrator

Fraud prevention:

- Management's commitment to maintain good controls
- Elected officials' support for management's commitment to controls

How to control the fiduciary risk of fraud:

- Follow up on adverse indicators
- Check the control documents
- Careful examination of unusual transactions
- Analytical review of transactions through sources

Most common types of fraud:

- Missing assets/inventory
- Pilfering
- Inflated travel claims
- Double payments
- False claims
- Payroll fraud

In short, bypassing the regulatory framework is the most common anatomy of any fraud. The audit trail will be available through control documents like cash book, stock ledger, bin cards, etc.

17. Risk profile

The result of the actions outlined above will be a risk profile for the organisation.

18. Development of responses

(1) Having developed a risk profile, the organisation can then consider an appropriate response.

(2) The procedures that an organisation installs to treat risk are called internal control activities. Risk assessment should play a key role in the selection of appropriate control activities to undertake. It is not possible to eliminate all risks and internal controls can only provide reasonable assurance that the objectives of the organisation are being achieved. However, entities that actively assess and manage risks are more likely to be better prepared to respond quickly when things go wrong and to respond to change in general.

(3) In designing an internal control system, it is important that the control activity installed is proportionate to the risk. Apart from the most extreme undesirable outcome, it is normally sufficient to design a control to give a reasonable assurance of confining loss within the risk appetite of the organisation. Every control has an associated cost and the control activity must offer value for its cost in relation to the risk that it is addressing.

(4) Since governmental, economic, industrial, regulatory and operating conditions continually change, the risk environment of any organisation is constantly changing, and priorities of objectives and the consequent importance of risks will shift and change. Fundamental to risk assessment is an ongoing, iterative process to identify changed conditions and take actions as necessary. Risk models and related controls have to be regularly revisited and reconsidered in order to have assurance that the risk profile continues to be valid, that responses to risk remain appropriately targeted and proportionate, and mitigating controls remain effective as risks change over time.

19. Information and Communication

(1) Information and communication are essential to the realisation of all the internal control objectives. For example, one of the objectives of internal control in a government organisation is fulfilling public accountability obligations. This can be achieved by developing and maintaining reliable and relevant financial and non-financial information and communicating this information by means of a fair disclosure in timely reports. Information and communication relating to the organisation's performance will create the possibility to evaluate the orderliness, ethicality, economy, efficiency and effectiveness of operations. In many cases, certain information or communications have to be provided in order to comply with laws and regulations.

Information

(2) A precondition for reliable and relevant information is the prompt recording and proper classification of transactions and events. Pertinent information should be identified, captured and communicated in a form and timeframe that enables staff to carry out their internal control and responsibilities (timely communication to the right people). Therefore, the internal control system and all transactions and significant events should be fully documented.

(3) Information systems produce reports that contain operational, financial and non-financial, and compliance-related information and that make it possible to run and control the operations. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to enable decision-making and reporting.

(4) Management's ability to make appropriate decisions is affected by the quality of information which implies that the information is:

- appropriate (Is the needed information there?);
- timely (Is it there when required?);
- current (Is it the latest available?);
- accurate (Is it correct?);
- accessible (Can it be obtained easily by the relevant parties?).

Communication

(5) Effective communication should occur in all directions, flowing down, across and up the organisation, throughout all components and the entire structure.

(6) All personnel should receive a clear message from top management that control responsibilities should be taken seriously. They should understand their own role in the internal control system, as well as how their individual activities relate to the work of others.

(7) Information is a basis for communication, which must meet the expectations of groups and individuals, enabling them to carry out their responsibilities effectively.

(8) One of the most critical communications channels is that between the management and its staff. Management must be kept up to date on performance, developments, risks and the functioning of internal control, and other relevant events and issues. In the same way, the management should communicate to its staff what information it needs and provide feedback and direction.

(9) In addition to internal communications, management should ensure that there are adequate means of communicating with, and obtaining information from external parties, as external communications can provide input that may have a highly significant impact on the organisation achieving its goals.

20. Monitoring

(1) The system of internal control must be under continuing supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in conditions. Monitoring internal control ensures that controls are operating as intended and that they are modified appropriately for changes in conditions. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of both, in order to ensure that internal control continues to be applied at all levels and across the entity, and that internal control achieves the desired results.

> Indicators of weak controls:
>
> - Regular receipt of government orders, rules, regulations etc. by the field formations concerning their sphere of activity (Weak control: absence of a quick communication system)
> - Regular reporting system for management control (Weak control: absence of a reporting system through periodic returns)
> - A system of communication with internal audit (Weak control: internal audit not informed timely about system breaches)

(2) Ongoing monitoring occurs in the course of normal, recurring operations of an organisation. It is performed continually and on a real-time basis, it reacts dynamically to changing conditions and is ingrained in the entity's operations. As a result, it is more effective than separate evaluations. Since separate evaluations take place after the fact, problems will often be identified more quickly by ongoing monitoring routines.

(3) The scope and frequency of separate evaluations should depend primarily on the assessment of risks and the effectiveness of ongoing monitoring procedures. When making that determination, the organisation should consider the nature and degree of changes, from both internal and external events, and their associated risks; the competence and experience of the personnel implementing risk responses and related controls; and the results of the ongoing monitoring. Separate evaluations of control can also be useful by focusing directly on the effectiveness of the controls at a specific time. Separate evaluations may take the form of self-assessments as well as a review of control design and direct testing of internal control. Separate evaluations may also be performed by the external auditors.

(4) Usually, some combination of ongoing monitoring and separate evaluations will ensure that internal control maintains its effectiveness over time.

(5) All deficiencies found during ongoing monitoring or through separate evaluations should be communicated to the appropriate level of management to take necessary action. The term "deficiency" refers to a condition that affects an entity's ability to achieve its general objectives. A deficiency, therefore, may represent a perceived, potential or real shortcoming, or an opportunity to strengthen internal control to increase the likelihood that the entity's general objectives will be achieved.

(6) Monitoring internal control should include policies and procedures that ensure that the findings of audits and other reviews are adequately and promptly resolved. Managers are required to :

(i) promptly evaluate findings from audits and other reviews, including those showing deficiencies and recommendations reported by auditors and others who evaluate agencies' operations,

(ii) determine proper actions in response to findings and recommendations from audits and reviews, and

(iii) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to their attention.

(7) The resolution process begins when audit or other review results are reported to management, and is only completed after action has been taken that

(i) corrects the identified deficiencies,

(ii) produces improvements, or

(iii) demonstrates that the findings and recommendations do not warrant management action.

21. Control activities

(1) Control activities are the policies and procedures established and executed to address risks and to achieve the entity's objectives.

(2) To be effective, control activities need to:

- be appropriate (that is, the right control in the right place and commensurate to the risk involved);
- function consistently according to plan throughout the period (that is, be complied with carefully by all employees involved and not bypassed when key personnel are away or the workload is heavy);
- be cost effective (that is, the cost of implementing the control should not exceed the benefits derived);
- be comprehensive, reasonable and integrated into the overall organisational objectives.

(3) Control activities include a range of policies and procedures as indicated below.

(i) Authorization and approval **procedures**

Authorizing and executing transactions and events should be only done by persons acting within the scope of their authority. Authorization is the principal means of ensuring that only valid transactions and events are initiated as intended by management. Authorization procedures, which should be documented and clearly communicated to managers and employees, should include the specific conditions and terms under which authorizations are to be made. Conforming to the terms of an authorization means that employees act in accordance with directives and within the limitations established by management or legislation.

(ii) Segregation of duties (authorizing, processing, recording, reviewing)

To reduce the risk of error, waste, or wrongful acts and the risk of not detecting such problems, no single individual or section should control all key stages of a transaction or event. Rather, duties and responsibilities should be assigned systematically to a number of individuals to ensure that effective checks and balances exist. Key duties include authorizing and recording transactions, processing, and reviewing or auditing transactions. Collusion, however, can reduce or destroy the effectiveness of this internal control technique. A small organisation may have too few employees to fully implement this technique. In such cases, the management must be aware of the risks and compensate with other controls. Rotation of employees may help ensure that one person does not deal with all the key aspects of transactions or events for an undue length of time. Also, encouraging or requiring annual holidays may help reduce risk by bringing about a temporary rotation of duties.

(iii) Controls over access to resources and records

Access to resources and records is limited to authorized individuals who are accountable for the custody and/or use of the resources. Restricting access to resources reduces the risk of unauthorized use or loss to the government and helps to achieve management objectives. The degree of restriction depends on the vulnerability of the resource and the perceived risk of loss or improper use, and should be periodically assessed. When determining an asset's vulnerability, its cost, portability and exchangeability should be considered.

(iv) Verifications

Transactions and significant events are verified before and after processing, e.g. when goods are delivered, the number of goods supplied is verified with the number of goods ordered. Afterwards, the number of goods invoiced is verified with the number of goods received. The inventory is verified by performing physical stock verification.

(v) Reconciliations

Records are reconciled with the appropriate documents on a regular basis, e.g. the accounting records relating to bank accounts are reconciled with the corresponding bank statements.

(vi) Reviews of operating performance

Operating performances are reviewed against a set of standards on a regular basis, assessing effectiveness and efficiency.

(vii) Reviews of operations, processes and activities

Operations should be reviewed. This type of review of the actual operations of an organisation is different from the monitoring of internal control.

(viii) Supervision (assigning, reviewing and approving, guidance and training)

Competent supervision ensures that internal control objectives are achieved. Assignment, review, and approval of an employee's work encompass:

- clearly communicating the duties, responsibilities and accountabilities assigned to each staff member;
- systematically reviewing each member's work to the extent necessary;
- approving work at critical points to ensure that it flows as intended.

A supervisor's delegation of work should not diminish the supervisor's accountability for these responsibilities and duties. Supervisors also provide their employees with the necessary guidance and training to help ensure that errors, waste, and wrongful acts are minimized and that management directives are understood and achieved.

(4) The above mentioned list is not exhaustive but enumerates the most common preventive and detective control activities.

(5) Once a control activity is implemented, it is essential that assurance about its effectiveness is obtained. Moreover, it must be clear that control activities form only a component of internal control. They should be integrated with the other four components of internal control.

Indicators of weak controls

- Reviews of performance against objectives (Weak control: absence of reviews)
- Documentation of activities (Weak control: absence of proper documentation)
- Prescription of performance indicators (Weak control: lack of performance indicators)
- Key reconciliations like bank reconciliation, cash reconciliation, asset reconciliation, etc.) (Weak control: erratic or non-reconciliation)

22. Information Technology Control Activities

(1) As information technology has advanced, organisations have become increasingly dependent on computerized information systems to carry out their operations and to process, maintain, and report essential information. As a result, the reliability and security of computerized data and of the systems that process, maintain, and report these data are a major concern to the management and auditors of organisations.

(2) The use of automated systems to process information introduces several risks that need to be considered by the organisation. These risks arise, inter alia, from:

- uniform processing of transactions;
- information systems automatically initiating transactions;
- increased potential for undetected errors;
- existence, completeness, and volume of audit trails;
- the nature of the hardware and software used; and recording of unusual or non-routine transactions.

For example, an inherent risk from the uniform processing of transactions is that any error arising from computer programming problems will occur consistently in similar transactions. Effective information technology controls can provide management with reasonable assurance that information processed by its systems meets desired control objectives, such as ensuring the completeness, timeliness, and validity of data and preserving its integrity.

(3) Information systems imply specific types of control activities. Therefore information technology controls consist of two broad groupings:

- General controls; and
- Application controls

23. General Controls

(1) General controls are the structure, policies and procedures that apply to all or a large segment of an entity's information systems and help ensure their proper operation. They create the environment in which application systems and controls operate.

(2) The major categories of general controls are:

(i) entity-wide security program planning and management,
(ii) access controls,
(iii) controls on the development, maintenance and change of the application software,
(iv) system software controls,
(v) segregation of duties, and
(vi) service continuity.

24. Application Controls

(1) Application controls are the structure, policies, and procedures that apply to separate, individual application systems, and are directly related to individual computerized applications. These controls are generally designed to prevent, detect, and correct errors and irregularities as information flows through information systems.

(2) General and application controls are interrelated and both are needed to ensure complete and accurate information processing.

(3) Because information technology changes rapidly, the associated controls must evolve constantly to remain effective

Chapter 3

ROLE OF INTERNAL AUDIT IN INTERNAL CONTROLS

25. The role of Internal Audit

(1) Internal audit is a very important component of internal control. Internal auditors examine the effectiveness of internal control and recommend improvements, but they do not have primary responsibility for establishing or maintaining it.

(2) Traditionally, 'internal audit' developed as an audit service to management to ensure that each unit of the organization follows the policies, procedures and instructions laid down by the management and the records are maintained accurately and promptly. As such, the internal audit function was concerned more with routine checking and review of the various records maintained in an organization.

(3) According to the modern view, internal audit is no longer considered as a routine checking and review of the records. The following definition given by the Institute of Internal Auditors, USA (IIA) reflects the modern view.

"Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed."

According to this definition, an internal auditor has to go beyond the books of account and records and appraise the various functions of the organization.

(4) To achieve effective internal control, best practice requires a robust internal audit function complementary with other tools such as fraud controls, safety audit and program evaluation. Thus one of the principal functions of internal audit is the examination of internal control systems. Internal audit provides the senior management, with a valuable resource to evaluate internal control systems, and to provide assurance concerning the effectiveness of control systems. Internal audit is, in effect, part of the performance monitoring process.

26. Main Objectives of Internal Audit

(1) As per the modern practice, the internal audit should be vested with the responsibility to assess and review the internal control system, quality assurance procedures and risk management procedures in the office. It should help the office to identify and evaluate significant exposure to risk and improve the risk management and control systems.

(2) The internal audit activity should evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the

- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations.
- Safeguarding of assets.
- Compliance with laws, regulations, and contracts.

(3) The internal audit activity should assist an organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement. Based on the results of the risk assessment, the internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organisation governance, operations, and information systems. This should include:

- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations.
- Safeguarding of assets.
- Compliance with laws, regulations, and contracts.

27. Internal Audit in Government Departments

Internal audit units have been set up in the accounts organisations in the Ministries /Departments. However, their functioning is very limited and confined mainly to accounting work. The various reports of the Comptroller and Auditor General have brought to light several deficiencies in the functioning of the internal audit units and the need for effecting substantial improvements.

Chapter 4

ROLE OF EXTERNAL AUDIT IN INTERNAL CONTROL

28. Responsibility for internal control

(1) *It should be clearly borne in mind that the management of the administrative body/department is primarily responsible for internal control.* External auditors play an important role in the internal control process. However, they are not responsible for the establishment or operation of the organisation's internal control system.

(2) It is the policy of the Comptroller and Auditor General of India (C&AG), acting as independent external auditor, to encourage and support the establishment of effective internal control in the government. The assessment of internal control plays an important part in the C&AG's compliance, financial and performance audits. The various forms of audit reports *inter alia* communicate the audit findings and recommendations on internal controls to management and legislature.

29. Importance of assessment of internal control

(1) The assessment of internal control, before undertaking substantive audit tests, is important for the following reasons.

(i) In view of the large size and complexity of modern government ministries / departments, effective internal control systems are essential for their proper administration. In view of the huge volume of transactions, it will be impossible for the external auditor to carry out a detailed audit of a large number of transactions within the constraints of limited time and resources available.

(ii) Increasing use of computers and automation has considerably affected the flow of transactions and documents. The auditor may not be in a position to have the intermediate documents and links which are useful in a manual system. This calls for greater reliance on the internal controls in the computerised systems.

(iii) An audit can be made more efficient if the nature, timing and extent of substantive audit procedures are determined on the basis of an evaluation of the effectiveness of the internal control systems.

(2) The external auditor should get an understanding of the accounting system and related internal controls in the ministry / department under audit and should study and evaluate the operation of those controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the external auditor concludes that he can place reliance on certain internal controls, his substantive procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing. On the other hand, where the external auditor finds that internal controls in certain areas are not adequate, he may decide to apply more extensive substantive procedures, or change the timing of the tests to be applied, or extend his audit tests to carry out a more detailed examination of the unsatisfactory aspects of the system.

(3) The Auditing Standards of the Comptroller and Auditor General of India stipulate that the study and evaluation of internal control should be carried out according to the type of audit undertaken. In the case of regularity (financial) audit, mainly such controls are evaluated that assist in safeguarding assets and resources, and assure the accuracy and completeness of accounting records. In the case of regularity (compliance) audit, such assessment is mainly of controls that assist management in complying with laws and regulations. In the case of performance audit, such controls are evaluated that assist in conducting the business of the audited entity in an economic, efficient and effective manner, ensuring adherence to management policies, and producing timely and reliable financial and management information.

30. External auditors' assessing of internal control procedures

External auditors' assessing of internal control procedures implies:

- determining the significance and the sensitivity of the risk for which controls are being assessed;
- assessing the susceptibility to misuse of resources, failure to attain objectives regarding ethics, economy, efficiency and effectiveness, or failure to fulfill accountability obligations, and non-compliance with laws and regulations;
- identifying and understanding the relevant internal controls;
- determining what is already known about control effectiveness;
- assessing the adequacy of the control design;
- determining, through testing, if controls are effective;
- reporting on the internal control assessments and discussing the necessary corrective actions.

31. Interface between external auditor and internal audit

(1) The external auditors need to develop a good working relationship with the internal audit units so that experience and knowledge can be shared and work mutually can be supplemented and complemented so that the benefits to be gained can be maximised. Including internal audit observations and recognizing

their contributions in the external audit report, when appropriate, can also foster this relationship. The external auditors should develop procedures for assessing the internal audit unit's work to determine to which extent it can be relied upon. A strong internal audit unit could reduce the audit work of the external auditor and avoid needless duplication of work. The external auditors should study the internal audit reports, related working papers, and compliance to and settlement of internal audit findings.

(2) Although internal and external auditors have different and clearly defined roles they do share the same broad purpose of serving Parliament and the public by helping to ensure the highest standards of regularity and propriety for the use of public funds and resources and in promoting efficient, effective and economic public administration. Good co-operation maximises the benefits which can be gained from working together in areas where there is an overlap in the work to be done.

Chapter 5

AUDIT METHODOGY

32. This chapter details the audit methodology to be used for evaluating the internal controls. This includes evaluating the adequacy of existing internal control arrangements and testing the actual operation of internal controls. The audit should be conducted through sample check of records in the selected departments and their subordinate/attached offices. The audit should also cover the systems and practices followed with reference to the provisions of the Central Secretariat Manual of Office Procedure (CSMOP), government rules, orders and instructions, etc. The sample for audit, *interalia*, should cover records relating to budget and expenditure, manpower policies, internal work study, internal audit and various control registers. One of the most important dimensions of internal controls is control over the state of affairs in the attached, field and subordinate offices functioning under the administrative control of the department and autonomous bodies receiving grant-in-aid from the department.

33. Evaluation of the adequacy of existing internal control arrangements

(1) In considering the adequacy of control, the auditor should start with higher level controls, for example, strategic planning, which affect the whole system, and work down to the lower level controls such as those over individual transactions. There is no absolute measure of what constitutes adequate control. Auditors must use their judgement in determining what level of control is appropriate in the light of their evaluation of the risk and materiality involved.

(2) In evaluating the adequacy of controls, the auditor needs to consider the likelihood of undesirable events occurring (risk) and their significance to the organisation (materiality).

(3) Risk may be viewed as the chance (or probability) of one or more of management's objectives not being met. It refers both to unwanted outcomes which might arise and to the potential failure to realise desired results.

(4) Materiality is a reflection of the significance to the organisation as a whole of a

failure to achieve management's objectives. In considering materiality, the auditor should take into account:

(i) the possible direct and indirect financial consequences;

(ii) the importance of particular management objectives in the context of the organisation's overall objectives; and

(iii) the potential for embarrassment to higher management (Ministers, Secretaries and other higher officers).

(5) If the auditor is not satisfied that the existing controls are adequate to ensure that objectives are achieved, or if no controls exist at all, a control weakness will have been identified. The auditor should use professional judgement in deciding whether controls are adequate.

(6) Controls should not be evaluated in isolation as they interrelate and often operate in a hierarchy. Where controls appear to be missing or inadequate, the auditor should search for other controls which compensate for the apparent weakness and enable the control objective to be met.

(7) Two most common tools used in internal control evaluation are flowcharting and internal control questionnaires.

34. Flowcharting

This is a diagrammatic method of recording and describing a system which can show the flow of documents, information or processes and the related controls within that system. It can show the internal control system at a glance and can be helpful to an auditor who analyses a system to find out how effectively it works and to detect any weaknesses in the system.

35. Internal control questionnaires (ICQs)

An ICQ lists a series of questions which the auditor may wish to ask to understand and evaluate an internal control system. The questions are pre-designed and it can be ensured that all aspects of an internal control system are covered. The questionnaire can also be kept as a record of the auditor's evaluation of the internal control system.

36. Testing of Internal Controls

(1) Auditors use testing to confirm their understanding of how a system works and to form or corroborate an opinion about the adequacy or otherwise of a internal control. This is done by measuring particular characteristics of selected transactions or processes and comparing the results with those expected.

(2 Testing may be undertaken at different stages in an audit, depending on the purpose of the tests.

37. Types of tests

'Walk through' tests

(1) "Walk through" tests are designed to confirm the auditor's understanding of how a system operates. This understanding can be derived from a combination of observation, interviews and examination of management's documentation of the system.

(2) In conducting "walk through" tests, the auditor looks primarily for evidence of the existence of controls. This may involve examining a number of different transactions at each stage of the process or following the same transaction from start to finish.

Compliance testing

(1) When the auditor considers that an internal control is adequate and will contribute to the achievement of a control objective, the next step is to determine whether the control is effectively and consistently applied. If the effectiveness of the control is likely to vary, for example, when different staff are responsible for operating the control, the auditor should ensure that the sample selected for testing takes account, as far as practicable, of such variations.

(2) The aim of compliance testing is to obtain assurance that controls established by management are operating as intended and are effective. It is not intended primarily as a means of identifying errors or failures to achieve objectives.

(3) Errors found in compliance testing may indicate control weaknesses. They do not demonstrate positively that the system is failing to achieve its objectives. The auditor should also consider the risks involved and the need for more stringent controls over application of the procedures. The auditor is more concerned with the reasons for errors or omissions and the effectiveness of controls rather than the mistakes themselves.

(4) Records of controls, e.g., signatures confirming that checks have been undertaken, are not necessarily proof that the controls have been properly applied. The auditor may need to reperform the process to discover any instances where the control has not been performed correctly.

38. Testing strategy and process

Planning the testing

(1) The auditor should decide:

- what to test
- what each test is for
- how to test.

(2) The level and direction of testing should take account of the analysis of risk and materiality undertaken as part of the evaluation of control.

(3) Where the auditor is satisfied that there are weaknesses, depending upon the audit objectives and time available, the auditor may carry on further testing to determine whether significant control weaknesses have been exploited.

Period of testing

(4) Tests should normally be reflecting the current transactions. If changes in operating conditions, for example the performance of particular staff or pressure at particular times, are likely to affect how controls operate, the auditor should take this into account in selecting the transactions to be examined so that the audit findings are representative.

Level of testing

(5) There can be no hard and fast rules about the amount of testing necessary except that the auditor should take into account the materiality of possible failures to meet objectives. The cost of testing large populations is usually prohibitive, unless computer interrogation is possible. The auditor can adopt sampling techniques. The auditor should take into account all relevant factors, including the testing objective, risk and materiality, results of evaluation of control by the auditor, the time available and the variability and volatility of the population to be tested.

39. Principal techniques for testing controls

(1) The following paragraphs describe the principal techniques for testing controls.

Observation

(2) Observation is particularly important where there is no permanent record of activities. For example, discreet observation by the auditor can reveal whether there is improper access to a restricted computer area despite stringent formal controls on paper.

Interviewing / Inquiry

(3) Interviewing is useful when evidence is absent or unclear. Care should be taken because the behaviour of the auditor could affect the attitude of the auditee and an insensitive approach could lead to an uncooperative and defensive reaction.

Analysis

(4) Where a transaction or process comprises a set of interrelated parts, the auditor may need to analyse and verify each part before he or she can form a judgement about the whole. For example, in audit of contracts, the soundness of the contract itself depends on the nature and inter-relationship of its individual terms and conditions.

Verification

(5) Verification involves the auditor confirming the truth, accuracy or validity of transactions. The role of audit is to evaluate and test the controls, not to confirm the validity of data as an end in itself. In using verification tests, therefore, the auditor should ensure that they are related to the operation of controls. Methods used are:

(i) comparison – with some ascertainable fact or standard, for example, that instruction manuals are up to date or staff have attended appropriate training courses at prescribed interval

(ii) confirmation - checking with third parties

(iii) vouching - checking a transaction against supporting documentation, for example, a payment to a supplier against the corresponding purchase order and stock entry, etc.

Re-performance

(6) Re-performance is particularly relevant where calculations or measurements have been supposedly checked as a control and the auditor wishes to check that the control actually operated. For example, there might be a control that a prescribed percentage of payments exceeding certain value should be checked by supervisory officers. The auditor may reperform the check on a sample of that percentage.

Test data

(7) Test data are commonly used for testing computer systems, but may also be used in manual systems, for example, to test controls over types of transactions which occur infrequently.

40. Documentation of test results

(1) Adequate documentation of the testing undertaken is important to support the conclusions reached by the auditor. For each test, this should include:

- test objectives
- detail of the nature and extent of tests including any methods used to determine the size and selection of samples
- test results and the auditor's evaluation
- conclusions.

(2) Testing should be documented to the level necessary to enable a reviewer to perform any of the tests.

41. Reporting

(1) The auditors should comply with the requirements of the Auditing Standards with regard to Reporting. The following are illustrative requirements:

In performance audits

(2) Auditors should report the scope of their work on internal controls and any significant weaknesses found during the audit.

(3) Reporting on internal controls will vary depending on the significance of any weaknesses found and the relationship of those weaknesses to the audit objectives.

In financial audits

(4) Auditors should report deficiencies in internal control that they consider to be reportable conditions. The following are examples of matters that may be reportable conditions:

- Absence of appropriate segregation of duties consistent with appropriate control objectives;
- Absence of appropriate reviews and approvals of transactions, accounting entries or systems output;
- Inadequate provisions for the safeguarding of assets;
- Evidence of failure to safeguard assets from loss, damage or misappropriation;
- Evidence that a system fails to provide complete and accurate output consistent with the auditee's control objectives because of the misapplication of control procedures;
- Evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system;
- Evidence of failure to perform tasks that are part of internal control, such as reconciliation not prepared or not timely prepared;
- Absence of a sufficient level of control consciousness within the organisation;
- Significant deficiencies in the design or operation of internal control that could result in violations of laws and regulations having a direct and material effect on the financial statements; and
- Failure to follow up and correct previously identified deficiencies in internal control.

(5 Auditors should report whether satisfactory action was taken or not, on the audit reports.

(6) In reporting reportable conditions, auditors should identify those that are individually or cumulatively material weaknesses. Auditors should ensure that standards for objectives, scope, methodology, audit results and report presentation, as appropriate are followed in their reports on audit of financial statements.

(7) When auditors detect deficiencies in internal control that are not of material nature, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated other deficiencies in internal control to top management, they should refer to such communication when they report on internal control. All communications to the auditee about deficiencies in internal control should be documented in the working papers.

(8) The report should be drafted in accordance with the requirements of the 'Style Guide' issued by the Comptroller and Auditor General.

(9) Additional guidance on understanding Audit Risk and extracts from Auditing and Assurance of the Institute of Chartered Accountants of India is given in Appendices I & II to this chapter.

Appendix I

UNDERSTANDING AUDIT RISK

- In very broad terms, audit risk is the risk of a material misstatement of a financial statement item that is or should be included in the audited financial statements of an entity. In this regard, a financial statement item includes any related notes to the financial statements.
- In theory, audit risk ranges anywhere from zero (0.0), where there is complete certainty of no material misstatement, to one (1.0), where there is complete certainty of a material misstatement. In practice, however, audit risk is always greater than zero. There is always some risk of material misstatement as it is not possible, (except for the audit of the simplest of financial statements), due to the limitations inherent in both accounting and auditing, to be absolutely certain that a material misstatement will not exist.

Components of audit risk

Audit risk [AR] may be initially decomposed into two components:

- the risk of a material misstatement of a financial statement item in the <u>unaudited</u> financial statements [RMM] and
- the risk that the misstatement will <u>not</u> be detected by the auditor (equal to one minus the probability of detection by the auditor, (1 - Pr(Da)).

Thus, if there was a 50% risk of a material misstatement in a financial statement item in the unaudited financial statements and a probability of 80% that the misstatement would be detected by the auditor, audit risk, or the risk of a material misstatement in the audited financial statements would be equal to 10%. i.e.

$$AR = RMM \times (1 - Pr(Da))$$

$$= 0.5 \times (1 - 0.8) = 0.10$$

The risk of material misstatement in the unaudited financial statement [RMM] may be decomposed as follows:

- the inherent risk of a material misstatement occurring (RMMi) and

- the risk that it will not be detected by the entity (equal to one minus the probability of the entity detecting the misstatement (1 - Pr(De)).

Thus, substituting the two components of RMM, audit risk can be mathematically defined as follows:

$$AR = RMMi \times (1 - Pr(De)) \times (1 - Pr(Da))$$

Thus, if there was:

- an 80% inherent risk of a material misstatement in a financial statement item,
- a 30% probability of such a misstatement being detected by the entity, and
- a probability of 40% that, if not detected by the entity, the misstatement would be detected by the auditor,

audit risk, or the risk of a material misstatement in the audited financial statements would be equal to 33.6%. i.e.

$$AR = RMMi \times (1 - Pr(De)) \times (1 - Pr(Da))$$

$$= 0.8 \times (1 - 0.3) \times (1 - 0.4) = 0.336$$

The three components of audit risk (RMMi, 1 - Pr(De), and 1 - Pr(Da)), are referred to respectively as inherent risk [IR], control risk [CR] and detection risk [DR]. This gives rise to the audit risk model of:

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

- **IR, inherent risk**, is the perceived level of risk that a material misstatement may occur in the client's unaudited financial statements, or underlying levels of aggregation, in the absence of internal control procedures. In the last example above, inherent risk was 80%.
- **CR, control risk**, is the perceived level of risk that a material misstatement in the client's unaudited financial statements, or underlying levels of aggregation, will <u>not</u> be detected and corrected by the management's internal control procedures. In the last example above, control risk was 70%.
- **DR, detection risk,** is the perceived level of risk that a material misstatement in the client's unaudited financial statements, or underlying levels of aggregation, will <u>not</u> be detected by the auditor. In the last example above, detection risk was 60%.

There are two distinct concepts of audit risk - the acceptable level of audit risk and the achievable level of audit risk. The acceptable level of audit risk [AR*] is the risk of a material misstatement in financial statements that is acceptable to the auditor. The achievable level of audit risk [AR] is the risk the audited financial statements will contain a material misstatement. (AR is an *ex ante* concept and thus it is referred to as the <u>achievable</u> level of risk rather than an ex *post* concept of an achieved level of risk).

- The acceptable level of audit risk [AR*] is estimated by reference to the expected reliance on the audited financial statements. The greater the expected reliance, the lower is the acceptable level of audit risk. The achievable level of audit risk [AR] is estimated by reference to the *ex ante* components of the audit risk model. That is, the estimated achievable values of inherent, control and detection risks. The aim of an auditor is to achieve an acceptable level of audit risk; to achieve a level of audit risk that is acceptable to the auditor.

- There are similarly two concepts of detection risk - the acceptable level of detection risk and the achievable level of detection risk. The acceptable level of detection risk [DR*] is the maximum level of detection risk an auditor can allow to occur. On the other hand, the achievable level of detection risk [DR] is, broadly, the risk that a material misstatement in the unaudited information will not be detected by the auditor, (Again, DR is an *ex ante* concept and thus it is referred to as the achievable level of risk rather than an *ex post* concept of an achieved level of risk).

Appendix II

AUDIT METHODOLOGY

Extracts from AAS 6

In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in controls. Before relying on procedures performed in prior audits, the auditor should obtain audit evidence which supports this reliance. The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The longer the time elapsed since the performance of such procedures the leser the assurance that may result.

The auditor should consider whether the internal controls were in use throughout the period. If substantially different controls were used at different times during the period, the auditor should consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period.

Accounting and Internal Control Systems

(I) Internal controls relating to the accounting system are concerned with achieving the following objectives:

  (a) Transactions are executed in accordance with management's general or specific authorisation.

  (b) All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting policies/practices and relevant statutory requirements, if any, and to maintain accountability for assets.

  (c) Assets and records are safeguarded from unauthorised access, use or disposition.

  (d) Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

(ii) The auditor should obtain an understanding of the accounting system sufficient to identify and understand:

- major classes of transactions in the entity's operations;
- how such transactions are initiated;
- significant accounting records, supporting documents and specific accounts in the financial statements; and
- accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.

Ordinarily, the auditor's understanding of the accounting and internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:

- inquiries of appropriate management, supervisory and other personnel at various organisational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions, systems descriptions and flow charts;
- inspection of documents and records produced by the accounting and internal control systems; and
- observation of the entity's activities and operations, including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing.

(iii) In the audit of financial statements, the auditor is concerned only with those policies and procedures within the accounting and internal control systems that are relevant to the assertions made in the financial statements. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

- assess the adequacy of the accounting system as a basis for preparing the financial statements;
- identify the types of potential material misstatements that could occur in the financial statements;
- consider factors that affect the risk of material misstatements; and
- develop an appropriate audit plan and determine the nature, timing and extent of his audit procedures

Chapter 6

DETAILED CHECKLISTS

42. This Chapter provides the illustrative checklists in the Annex that may be used for evaluating internal controls in government. The Annex contains a general checklist followed by checklists for some specific areas.

43. The checks mentioned in the checklists in the Annex and the areas to be covered are illustrative and not exhaustive. The auditors should take into account the nature of functions of the particular Ministry/Department, provisions laid down in relevant Codes, Manuals, Rules and Regulations as prescribed by the Government and Instructions issued from time to time by the Office of the Comptroller and Auditor General.

General Checklist for Evaluation of Internal Controls

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether there exists a formal mechanism in the shape of Acts & Policy statements in respect of standards and processes for internal control.				
2.	Whether the Organisational structure provides for clear reporting lines that establish links between accountability, responsibility and authorization of various activities				
3.	Whether the top management is conscious of the importance of internal control and gives it adequate importance. (Refer GFR 64)				
4.	Whether a well-defined delegation of powers exists, with important / exceptional matters being under the powers of higher levels of management				
5.	Whether the Objectives of the Organisation are well defined and whether there are any specific targets prescribed				
6.	Whether procedural manuals exist in respect of: a. Financial matters (cash, banking, accounting, income, expenditure, budgeting, etc) b. Staff recruitment, training, performance and discipline c. Purchase of goods and services, contracts d. Outsourcing of functions e. Code of personal conduct with guidance on gifts and hospitality f. Use of computer systems				
7.	Whether the various officials are given adequate training in their functional areas				
8.	Whether there are specific and attainable targets set for various officers / officials in the organisation				
9.	Whether an internal audit system is in place				
10.	Whether there is separation of duties in such a way that more than one individual is involved in a transaction				
11.	Whether there are physical access measures restricting access to buildings, information systems, valuables, etc.				

12.	Whether there is a system of supervision and review of the work of various functionaries				
13.	Whether there are systems for taking adequate remedial action in case of theft, fraud, defalcation, etc.				
14.	Whether there are adequate safeguards to protect cash, valuables and resources through security / police escort, safes, strong rooms, physical access restriction, etc.				
15.	Whether there are systems to ensure sequential numbering of documents, receipts, vouchers, etc.				
16.	Whether there are systems of Reconciliations, i.e., the act of balancing one system to another, for example, bank reconciliation, reconciliation of departmental figures with accounting figures				
17.	Whether there are systems to ensure timely rendition of accounts				
18.	Whether there are systems to obtain declaration of assets, intimation of certain high value transactions, etc.				
19.	Whether there is an adequate and reliable MIS which will ensure that important / exceptional matters or matters requiring attention are being reported to appropriate higher levels of management				
20.	Whether the department has prepared any manual or flow chart listing out steps in various activities and procedures which are specific to its working.				
21.	Whether the Staff Inspection Unit or Internal Work Study / O&M Unit or any other agency has performed (I) Organisation and Methods Studies and [ii] Work Measurement Study, etc. for prescribing appropriate work norms and standards of output in terms of quality and quantity as envisaged in CSMOP and, if so, whether their recommendations were complied with.				
22.	Whether time limits were fixed for disposal of cases and, if so, whether these time limits were adhered to.				
23.	Whether the references from Members of Parliament and VIPs were promptly attended to in the prescribed manner.				
24.	Whether any monthly programme of Inspection of sections / desks during a year was drawn by the Department / Ministry				
25.	Whether each section/desk in the department is inspected by an officer of or above the rank				

	of Under Secretary/Desk Officer, who does not handle any part of the work of the section/desk concerned, once in a year to ascertain the extent to which the provision of the CSMOP and instructions issued thereunder are being followed as per CSMOP.				
26.	Whether the Inspecting Officer, after carrying out the inspection as indicated above, has reported significant points, if any, emerging from the inspection, to the Secretary.				
27.	Whether the Inspecting Officer has, in addition, brought the important findings to the notice of the Department of Administrative Reforms and Public Grievances (AR & PG) by 30th April each year.				
28.	Whether the Department / Ministry has devised procedures and strategies for risk assessment / risk identification, grading of risk, analysis of impact and plan for risk management (including control activities for monitoring and mitigating the risks), commensurate with the quantum of funds handled, geographical spread, complexities, degree of decentralization, diversity in nature of the activities of the Department / Ministry.				
29.	**Organisational analysis including procedural manuals, delegation of power** Examine if internal controls have been structured to ensure a clear and logical plan of organisational functions which establishes clear lines of authority and responsibility for administrative, financial and technical activities keeping in view the entity's basic objective/activity. See if: a. Organisational set-up is designed to serve the main objectives/goals/activities of the organisation. b. The units are functionally segregated to ensure professional, functional and technical specialisation. c. Posts created and duties assigned have the approval of the competent authority. d. The financial functions are separate from administrative functions. e. The person responsible for the custody of the resources is separate from the one who				

	records transactions, maintain accounts and financial reports. f. The duties/responsibilities and financial powers of each authority are clearly defined g. No post has remained vacant for a long period and whether additional charge held by another official has diluted and impacted financial/functional propriety h. Procedural manuals have been prepared for various functions and activities and these manuals are reviewed and updated periodically.				
30.	**Administrative Control Registers:** Maintenance of various control registers is an important element of internal control structure. All registers including subsidiary records should be in prescribed form and pages should be numbered. Following is an illustrative list of some of the standard control registers being maintained: a) Expenditure control register b) Advance register c) Pay bill register d) TA and LTC bill register e) Medical claim expenditure registers f) Library accession/issue register g) Stationery register h) Stock register i) Stock issue register j) Dead stock register k) Investment register l) Register of contracts m) Register of refund of revenue n) Grants-in-aid register o) Sanction register p) Register of cheque books				
31.	**EDP controls** Examine: 1) Type of activity/function computerised 2) Whether various reports generated are being authenticated/utilised for the purpose for which these have been developed.				

	3) Whether provision exists for generating Management Information System (MIS) reports for control purposes. 4) Whether adequate security existed for accessing as well as recording/modification of data only by authorised personnel. 5) Whether there exist well defined policy or guidelines on access control, the system integrity and continuity plan in case of disaster.				
32.	Whether the administrative report contains:- • A certificate signed by the secretary of the ministry/department certifying that the prescribed internal control systems as per the Statement of Internal Controls (SIC) have been adhered to and the recommendations of internal audit have been acted upon. • A statement showing the recommendations of internal audit and action taken on each.				
33.	Monitoring & Evaluation of programmes and schemes • Whether the implementing agencies have submitted physical and financial targets in respect of the programmes/schemes implemented by the department/ministry. • Whether any physical inspection of works executed in the department was conducted by the Controlling Officer				
34.	Review the functioning of Parliament Unit to see how it ensures timely disposal of all papers and monitoring that the assurances given to the Lok Sabha and Rajya Sabha are fulfilled within a period of three months, whether a Register of Parliamentary Assurances was maintained.				
35.	As per Central Secretariat Manual of Office Procedure (CSMOP), every department should formulate an Annual Action Plan indicating time frame of action with month-wise break-up of targets to be achieved in respect of each of the activities to be performed during the ensuring financial year in the month of January, so that the programmes and projects undertaken by the department are implemented in a systematic manner within the prescribed time frame.				

	Monthly performance reports on the items of Action Plan indicating the details of targeted and actual performance with comments on variance, and quarterly reports should be prepared. Check whether the requirements were complied with.				

Comments / Compensating Controls:

Checklist for Evaluation of Internal Controls relating to Cash Management

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether cash book is maintained in prescribed form				
2.	Whether cash book pages are machine numbered				
3.	Whether cash book contains a certificate on the first page regarding the number of pages duly signed by competent authority				
4.	Whether entries of receipts and expenditure are made promptly every day in the Cash Book and attested by DDO everyday after verification of receipts and payments with challans and vouchers?				
5.	Whether pre-numbered receipts are issued in case of cash receipts				
6.	Whether the entries in the cash book are checked by an officer not connected with the writing of cash book				
7.	Whether certificate to the effect that the cash balance found during physical verification agreed with the balance is recorded in the cash book				
8.	Whether surprise check of cash balance is conducted periodically by authorities not responsible for maintenance of cash book and a certificate to the effect that the cash balance found during physical verification agreed with the book balance is recorded				
9.	Whether a report of surprise check is maintained.				
10.	Whether huge cash balance is maintained, in comparison with requirements for immediate disbursement. (As per Rule 100 (2) of Receipt & Payment Rules, 1983 money shall not be drawn from Government accounts unless it is required for immediate disbursement).				
11.	Whether payments are preferably made by cheque only and whether payment of large amounts (exceeding prescribed value) is made in cash and not by cheque (Payment of amount exceeding Rs. 10,000 should be made by cheques, as required by Receipt and Payment Rules, 1983).				
12.	Whether the book balances are periodically checked with physical balances and tallied				
13.	Whether receipts are correctly posted in chronological order from all receipt books				

14.	Whether bank reconciliation is prepared regularly and differences between balances as per bank pass book and cash book are being investigated and cleared.				
15.	Whether cash receipts are not diverted to meet day to day expenditure				
16.	Where subsidiary cash books are maintained, the transactions therein are accounted for in the main cash book promptly				
17.	Whether cashier has furnished fidelity bonds				
18.	Whether cash balances are kept within limits prescribed and not excessive				
19.	Whether all receipts (including cheques, drafts, etc.) were posted in accounts and deposited into Government account on the same day or next working day. (As per Receipt and Payment Rules, 1983)				
20.	Whether Bank accounts have been opened with proper approval.				
21.	Whether there is a need and justification of having more than one bank account.				
22.	Whether the payments are properly authorised and recorded immediately in the accounts.				
23.	Whether counterfoils of pay in slips or cash receipts are on record.				
24.	Whether cheque books are kept in safe custody and the prescribed procedure is duly observed.				
25.	Whether the paid cheques accompanying the Bank Scroll are examined to find out that there are no unauthorised alterations in the names of the payees and the amounts payable. In cases where such alterations are found even under attestation of the DDO, the cases are checked with reference to the related paid vouchers and sanction.				
26.	Whether adequate care is taken in issuing cheques in lieu of cancelled/time barred cheques with reference to relevant records				

Comments / compensating controls:

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether there are rules and instructions relating to the formulation of budget and revised estimates and responsibilities of different functionaries.				
2.	Whether there were wide variations under "Revenue Expenditure", "Capital Expenditure", "Loans", "Charged" and "Voted" categories.				
3.	• Whether the expenditure is contained within the approved revised estimates. • Was the expenditure under Plan and non-Plan within the revised estimate? Was there an excess or saving beyond 10%? • Were there persistent savings over last three years under any Major head, indicating poor pre-budget scrutiny of schemes?				
4.	Whether the Revised Estimates and Budget Estimates submitted to Finance Deptt. are supported by the estimate received from the estimating authorities for various zones/officers, etc. (DDOs)				
5.	Whether the savings were surrendered before the end of financial year/affecting implementation of programmes and activities.				
6.	Whether there are arrangements to prevent transfer of funds from the Consolidated Fund to deposit accounts for utilization in subsequent financial years				
7.	Whether the drawing and disbursing officers are adhering to the time schedules prescribed for submission of estimates.				
8.	Whether the Department is exercising adequate scrutiny over the estimates furnished by the drawing and disbursing officers and the justification furnished in support of original estimates and estimates of additional requirements.				
9.	Whether the administrative Secretary and Head of the Department are exercising adequate and effective role in formulating the departmental budget and exercising their designated responsibilities.				

10.	**Provision of funds** Examine whether: a. Control records are maintained to watch progress of revenue and expenditure against estimated receipts and allocated funds. b. Variation between actual expenditure and budget allocation are examined at appropriate levels and wherever necessary re-appropriation is approved by specified authorities				
11.	Whether there adequate systems and arrangements available for determination of allotment of funds to various drawing and disbursing officers and their timely release.				
12.	Whether the DDO is nominated by competent authority.				
13.	As per GFR 291, permanent advance or imprest for meeting day to day contingent and emergent expenditure should be granted to a government servant by the head of department in consultation with Internal Finance Wing, keeping the amount of advance to the minimum as required for smooth functioning. Check whether the provisions are complied with.				
14.	Whether the advances drawn on abstract contingent bills for making advance payment to supplier etc. are adjusted within fifteen days of the drawal of advance (as required by Rule 292(2) of GFRs 2005).				
15.	Check whether contingent advances, TA advances, LTC advances, etc. are adjusted within the prescribed period.				
16.	Whether the control registers prescribed under the GFRs, Receipt and Payment Rules, etc. for exercising check over expenditure are properly maintained in the prescribed manner. Some illustrative records are Cash Book, Bill Register, Dead Stock Register, Register of Undisbursed Pay and Allowances, Stock Register of Receipt Books, TA Bill Register and Log Books.				
17.	Whether the funds are released timely to various drawing and disbursing officers				
18.	Whether there are adequate arrangements for communication of allotments to the drawing and disbursing officers concerned				
19.	Whether there is adequate machinery for exercising expenditure control and monitoring expenditure incurred by field units				

20.	Whether the monthly expenditure statements are received timely from the drawing and disbursing officers, arrangements made for their documentation and analysis and are they utilized for the purpose of exercising effective control over expenditure.				
21.	Whether there is a mechanism to prevent irregular diversion of funds and exercising control over utilisation and prevention of diversions.				
22.	Whether there are adequate arrangements for monitoring expenditure on schemes and their adequacy.				
23.	**Rush of expenditure** Whether there is mechanism to ensure uniformity in expenditure in every quarter and prevent rush of expenditure towards the close of the financial year. (Rule 56(3) of GFRs provides that rush of expenditure, particularly in the closing months of the financial year, shall be regarded as a breach of financial propriety. MOF has emphasized that under an effective cash management system, not more than 33 percent of the budget should be utilized during the last quarter.)				
24.	Economy measures Whether the instructions issued from time to time by the Ministry of Finance, Department of Expenditure for observing fiscal prudence and austerity in expenditure management are complied with. (For example, according to instructions of 16.5.2001, reiterated on 24.9.2004 and 23.11.2005, 10 percent cut in the number of posts was to be made and posts lying vacant for more than one year were to be abolished. Have these Instructions been Implemented by the Ministry, and its attached and subordinate offices? Are restrictions on office expenses, telephones, petrol, hospitality, etc. imposed by MOF implemented?)				
25.	Whether the expenditure on secret services is being adequately monitored by the respective Head of the Office through reports submitted by the officer designated for incurring expenditure on secret services.				

26.	As per Rules 53 and 58 of GFRs, controlling officer should maintain a Liability Register in form GFR 6 in order to see that there is no case of excess expenditure over the sanctioned amount. Further, in order to maintain proper control over expenditure, the controlling officer should obtain from spending authorities, liability statements in form GFR - 6-A every month, starting from the month of October in each financial year. Check whether these provisions were complied with.				

Comments/Compensating Controls:

Checklist for Evaluation of Internal Controls relating to Accounting

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether there is regular reconciliation of figures of expenditure and receipts by the Drawing and Disbursing officers (DDOs) at periodical intervals with the figures booked by Pay and Accounts Offices (PAOs) in the accounts and with the accredited bank and by the PAO with the Bank and whether differences are investigated and corrections made? (Para 1.10 of the Civil Accounts Manual)				
2.	Whether the principal accounts officer (PAO) of each Ministry is sending in the prescribed proforma a monthly statement showing the expenditure vis-à-vis the budget provision under the various heads of account, to the head of Department responsible for overall control of expenditure against the grant of the Ministry as a whole. Whether the figures so communicated by the PAO are compared by the Heads of department with those consolidated in Form GFR 12 and differences if any, are taken up with the PAO. Whether the Head of Department is furnishing a quarterly certificate to the PAO certifying the correctness of the figures for the quarter. (Para 1.9 of the Civil Accounts Manual).				
3.	Whether the DDOs were sending the lists of miscellaneous receipts received in cash and valuables remitted into bank to the PAO.				
4.	Whether receipts are being used to meet expenditure, unless authorised by appropriate rules.				
5.	Whether a stock account of Receipt Books is maintained and closing balance in the stock account verified by the Head of Office periodically and a certificate to that effect recorded in the register (As per Rules 22 to 24 of Receipt and Payment Rules).				

6.	**Realisation of departmental revenue** Whether systems have been prescribed for ensuring that: a) Proper record of receipt books is kept and the books are issued only to persons authorised to issue receipts. b) Receipts are machine numbered and are issued in chronological order. c) Receipts are correctly posted in main cash book. d) Where subsidiary accounts are kept, totals are taken to main cashbook and the receipts are correctly posted. e) Revenue to be realised is correctly assessed, demand notice is issued and recovery watched through proper control records which are periodically reviewed. f) Revenue is correctly classified in account. g) In respect of realisation by way of money order, cheques and drafts, an effective system of collection and accounting has been prescribed and followed. h) The revenues realised are duly posted in Demand and Collection registers and cross checked to ensure that collections as posted in Demand and Collection registers have been duly taken to cash book. i) Loss of revenues is duly examined and written off under sanction of appropriate authority.				
7.	**Acquittance of payments** Whether the legal quittance in support of payment made is obtained in an Acquittance Roll in Form GAR 24 for pay and allowances and on the office copies of bills for other payments. Under Rule 92 of Central Government Account (Receipt and Payments) Rules.				
8.	Whether Acquittance Rolls and office copies of bills on which quittance is obtained are stamped as PAID.				

9.	Whether moneys were drawn on AC Bills and kept in "Deposit" to avoid lapse of grant.				
10.	Whether moneys drawn on fully vouched contingent bills were supported by proper certificates, for example, certificate regarding receipt of stores, sub vouchers.				
11.	Whether advances are adjusted to appropriate head (for example, medical advances), what is the control exercised by Head of office/Department in this regard?				
12.	Whether bills submitted at the fag end are cleared by PAO/ Treasury/how many returned?				
13.	Whether the returns in form GFRs-12 were submitted by the controlling officers to the Admn. Department?				
14.	Whether the prescribed forms to show expenditure against the heads of accounts, to watch receipt of the prescribed returns, etc. are maintained in the Directorates or in the offices of the selected DDOs.				
15.	Whether Dead Stock register is maintained and entries made as soon as an item is procured and issues are made?				
16.	Whether the physical balance of dead stock items is tallied with the book balance of each item periodically?				
17.	**Register of undisbursed pay and allowances** • Whether an account of undisbursed pay and allowances is kept in a register in Form GAR 25 (As per Note 2 below Rule 92(3) of Receipt and Payment Rules) • Whether entries of the total and particular amount undisbursed are made against each bill serially and subsequent payments thereof entered in the appropriate columns of the register and the cash book and each such entry attested by a gazetted officer. • Whether balances of each month are properly carried forward to the next? • Whether action is taken to disburse the amount to the payees promptly?				
18.	Whether the Bill Register is maintained in Form GAR-9 by each head of office who is authorized to draw money on bills signed by him, reviewed monthly by a gazetted officer and the result of				

	the review recorded therein to prevent presentation of fraudulent bills.				
19.	**TA Bill register** • Whether there is a control to ensure that TA advances are adjusted within 15 days of completion of the tour? • Whether it is ensured that, even when no advance is drawn for the tour, TA bill is submitted within one year, as prescribed in GFRs?				
20.	**Log Books** • Are logbooks in respect of staff cars and other vehicles maintained in the correct form and entries made promptly? • Is the log book being scrutinized by a senior officer once a month? • Is there a control to check misuse of the staff car? • Is history sheet of vehicle maintained?				
21.	**Office Contingencies** Examine whether: a. Proper record of expenditure under each category i.e. stationery/postage, maintenance of vehicles, freight, carriage etc. is being maintained. b. Expenditure on various items of contingencies is regulated according to prescribed scales and provision of funds				
22.	**Vouchers** Examine whether the following controls are in place: a. Vouchers are entered in a chronological order and are given distinct serial numbers. b. Claims are clearly stated and are due and admissible. c. Arithmetical calculations are checked.				

	d. Receipts of the claimants are available. e. Materials purchased with reference to the claims admitted for payment are duly recorded in the relevant stores/stock registers. f. Claim admitted is considered reasonable for the purchase and sanction for purchase/payment issued by prescribed authority is available on record. g. Vouchers are duly stamped "paid" and cancelled to eliminate possibility of double payment. h. Payments are, as far as possible, made by crossed cheques i.Vouchers are correctly classified and entered into accounts.				
23.	Whether registers for watching disposal of audit objections are maintained?				

Comments / compensating controls:

General Checklist for Evaluation of Internal Controls relating to Personnel Administration

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether there exists a transfer / placement policy of officers at various levels? If so, whether the policy provides for rotation of officers posted at a particular place / post after completing a defined tenure (especially sensitive places/posts)? Whether the policy was implemented? Whether approval of the competent authority was obtained, for any deviations from the laid down policy? Whether there exists a centralized database of officers' places of posting, duration, posts held, etc. for enabling implementation of the transfer/placement policy?				
2.	Whether there is a policy of rotating the duties of staff, to prevent development of vested interests and enlarge the range of the skills of employees by exposing them to different kinds of work (for example, say, in a key seat for not more than 2-3 years and in a section for not more than 5 years).				
3.	Whether there are systems to obtain declaration of assets, intimation of certain high value transactions, etc.				
4.	Whether the department has prepared any Manual or flow chart listing out steps in various activities and procedures which are specific to its working.				
5.	Whether there is an effective system in place for monitoring of: (a) Fresh appointments, (b) Promotion and transfer				
6.	Whether, in terms of Department of Expenditure, Ministry of Finance OM Nos.. 7(3) E.Coord/99 dated 05-08-99 and DOPT OM no.2/8/2001-PIC dated 16.5.01, reiterated by the Ministry of Finance o.m. nos. 7(5) E.Coord/2004, dated 24.09.04 and 7(2)E. Coord/2005, dated 23.11.05, 10 *per cent* cut in number of posts was made and abolition of posts lying vacant for more than one year was ensured.				

7.	Whether, in case of upgradation of posts, the conditions of upgradation were complied with (like surrender of a lower post)				
8.	Whether, as required by G.O.I., M.F., O.M. No. 3 (3)-E IV (A)/ 76 dated 25th November 1976 below Rule 199 of Supplementary Rules (SR), the head of the office is inspecting annually at least ten *per cent* of the service books and leave accounts.				
9.	Whether the service books of officials completing twenty five years of service/before five years of retirement were verified by the Pay and Accounts office				
10.	Whether any induction/seniority list is maintained?				
11.	Whether government has installed internal control for monitoring fresh appointments and transfer and postings in the department.				
12.	Whether information regarding sanctioned posts vs. persons in position was available in a data base.				
13.	Whether persons were transferred from/to Autonomous Bodies only with proper government orders.				
14.	**Manpower analysis** whether internal controls are in place for ensuring that: a. Staff patterns conform to norms and standards prescribed for the purpose. b. Clear demarcation of functional responsibilities exist among the personnel c. Job analysis, description and specifications have been clearly spelt out. d. Allocation and actual deployment of manpower is as per sanctioned strength and controls are available for monitoring efficient and effective utilisation of manpower. e. Proper systems have been instituted for reviewing at periodical intervals the work load and adequacy or otherwise of manpower resources.				

15.	**Advances to employees** Audit will examine whether control records have been devised and are being maintained for ensuring that: a. Proper record of advance is kept and recovery is watched b. Amount remaining unutilised is promptly refunded c. Recoveries are made in all cases as per rules				
16.	**HBA** Whether there is a system to ensure insurance of house/flat purchased using House Building Advance (HBA). As per Rule 7(b) of the House Building Advance Rules an official has to insure the house/flat immediately at his own cost on completion of construction or purchase of house/flat for not less than the amount of advance and shall keep it so insured till the advance together with interest thereon is fully repaid to the government.				
17.	**Provident Fund Accounts** Examine whether : • Whether there are adequate controls over sanction of advance/withdrawal from GPF to prevent fraudulent drawals. • The contributions to the fund are in accordance with the prescribed rates and are credited to proper accounts. • The increase or decrease is regulated in accordance with rules and contributions recovered. • The advance or withdrawal, both refundable and non-refundable are duly authorised for the specified purposes according to prescribed rules/scales and refund of advance/withdrawal is watched. • Interest is correctly assessed at prescribed rates and credited at the end of the financial year to the individual accounts. • Balance in each account is worked out at the end of the year and communicated to				

	the individual employee for acceptance/ verification.				
18.	**Expenditure on salary/wages** Examine whether: a. The employment of individual is approved by the competent authority. b. There are written authorities in accounts department for general increase in pay, individual increase in pay, advances of salary/wages/TA, etc., leave availed, medical reimbursement, bonus, etc. c. Proper control record of employment on specified jobs is available. d. An assessment of work vis-à-vis the expenditure incurred is made. e. There are adequate controls against the chances of inclusion of fictitious names, over-stating of rates of wages or the days of work put in, etc. f. All existing posts have been created under orders of competent authority and are in prescribed pay scales. g. Pay fixation has been regulated correctly according to the rules applicable and that deductions for provident fund, income tax and advances taken have been correctly made and control registers have been maintained. h. Tours are duly sanctioned by the competent authority and claims regulated according to rules				
19.	**Service records** Examine whether: a. Procedures have been laid for ensuring that service records of all employees are being maintained and checked. b. All events are being recorded in service records and are being checked. c. Nominations in respect of DCRG and provident fund have been made and are available in the service records. d. All personal entitlements are being correctly worked out, checked, paid and properly recorded.				

Comments / Compensating Controls:

Checklist for Evaluation of Internal Audit

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether there is an arrangement for Internal audit				
2.	Whether there are arrangements to ensure Independence of the internal audit officials and prevent conflict of interest				
3.	Whether the internal audit work encompasses all the important functional areas and desks or merely confined to accounts				
4.	Whether the internal audit wing also covers the various public sector units and autonomous bodies under the Ministry / Department				
5.	Whether the duties relating to internal audit are separate from those relating to financial advice, receipt, disbursement and accounting functions				
6.	Whether the head of internal audit (Chief Controller of Accounts) reports directly to the Secretary.				
7.	Whether the internal audit wing is adequately staffed by qualified and trained personnel				
8.	Whether the internal audit officials are given adequate training in internal audit work and periodical in-service training programmes for upgrading their knowledge and skills.				
9.	Whether the internal audit officials are possessing adequate experience in the functional areas which they are required to audit				
10.	Whether the internal audit officials are being retained in the internal audit wing as specialists, or being transferred out to other wings?				
11.	Whether large number of internal audit objections are outstanding for long				
12.	Whether the frequency of internal audit is adequate				
13.	Whether the planning of internal audit work and allocation of time and periodicity of audit are based on risk assessment How/whether it is ensured in audit planning that: • All key risks are identified and categorized; and • Examined with reference to their likelihood and impact				

14.	Whether all the units or offices planned for internal audit were covered, or whether there is a shortfall				
15.	Whether adequate follow-up action is taken in respect of the findings and recommendations of internal audit				
16.	Whether the internal audit reports include substantive findings, and not merely minor procedural lapses				
17.	Whether the internal audit report contains genuine issues of internal controls, compliance, fraud awareness and prevention and performance issues.				
18.	Whether the internal audit reports contain recommendations for correcting the deficiencies noticed.				
19.	Whether the internal audit reports on each assignment are sent to the concerned Secretary in the form of a management letter? (copy endorsed to the head of the unit audited).				
20.	Whether there is a Best Practice Guide or Manual for the internal audit wing and whether they are updated				
21.	Whether the internal audit wing is associated with any risk assessment activity for the Department / Ministry				
22.	Whether Audit Committees are constituted in the Ministry/Department for reviewing the compliance of the recommendations given by the internal audit				
23.	Coordination between internal and statutory audits- • whether Annual Audit Plans and programmes are shared to avoid duplication and assist in their respective audit planning; • whether institutional mechanisms are created to ensure common understanding and sharing of audit techniques and methods; • whether there is any sharing of training				
24.	Whether the Internal auditor assists the Secretary of the Ministry/department in monitoring the action taken on the findings and recommendations contained in the local Audit Inspection Reports and Audit Reports of the CBAG?				
25.	Whether periodic meetings are held between the statutory auditor and Internal audit to review the progress?				
26.	Whether a Register of Settlement of Audit Objections (Statutory Audit) was maintained.				

Comments / Compensating Controls:

Checklist for Evaluation of Internal Controls relating to Stores

Purchase of Stores

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1	Check whether there are well-devised departmental regulations / instructions governing purchase, receipt, inspection, custody, issue, condemnation, sale / disposal and stock verification of stores				
2	Check whether there are checks to ensure that the quantity to be purchased was determined taking into account the present and future work requirements of the concerned auditee entity (including requirements received from units and field formations) and the requirements have been assessed on a realistic basis and not merely based on availability of funds.				
3	Check whether availability of funds (budget provisions) is checked and not exceeded, before considering procurement.				
4	Check whether stores of the required specifications covered under rate contracts entered into by the Directorate General of Supplies and Disposals or any other approved rate contract were purchased only under such rate contracts.				
5	Check whether there is a system to ensure that open competitive tender (as prescribed under the relevant Financial Rules) was adopted for purchases from contractors or suppliers.				
6	Check whether the system ensures that purchases are made only from the lowest tenderer unless there are recorded reasons for not doing so and duly approved by the competent authority (Rules 137 to 161 of GFRs)				
7	Check whether there is a system to ensure that stores procured (ordered) are of approved quality and specifications.				
8	Check whether there is a well defined delegation of powers to sanction purchases.				
9	Check whether the purchase orders are split up so as to avoid the necessity for obtaining the requisite sanction of higher authorities (Rule 148 of GFRs).				

10	Check whether there is a mechanism to ensure that the purchase order terms and conditions conform to the applicable codal provisions and instructions / orders issued from time to time by the Government.				
11	Check whether necessary precautions are taken to safeguard government interests in cases involving advance payments for supply of stores in terms of the contract provisions or Government orders.				
12	In cases where advance was paid to suppliers, check whether the a. Advances paid are as per terms of agreement b. Advance has been limited to the admissible amount and is not paid ahead of prescribe time c. A proper record of such advance is kept and recovery/adjustment is watched d. Stores were received within the stipulated period and the advance payments adjusted.				
13	In case an the officer draws money on abstract contingent bills for making advance payment to supplier etc. whether it is ensured that the advance is adjusted within fifteen days of the drawal of advance. (Rule 292 (2) of the GFRs 2005).				

Comments / compensating controls:

Custody and Issue of Stores

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Check whether officers entrusted with custody of stores or holding charge of stores have furnished the security prescribed in terms of the instructions issued from time to time by the competent authority and whether such security is currently in force				
2.	Check whether a particular official has been responsible for the custody of stores for prolonged periods and, if so, what safeguards were taken to prevent misuse of his position				
3.	Check whether adequate storage facilities are available and precautionary measures have been taken to protect stores from damage, undue deterioration, theft, pilferage, etc.				

4.	Check whether discrepancies, if any, between the book balances and the ground balances were reconciled promptly.				
5.	Check whether appropriate and effective follow-up action has been taken on reports of physical verification of stores for making good any losses.				
6.	Check whether adequate precautionary measures have been taken to prevent misuse of materials issued to contractors for use in works.				
7.	Check whether there is a mechanism to ensure that adequate efforts are made to transfer surplus stores to other works, divisions, departments or offices where these could be utilized.				
8.	Check whether a report on surplus stores that could not be so transferred to other works, divisions, departments or offices and on obsolete and unserviceable stores, specifying the reasons for so declaring them, has been promptly sent to the competent authority for facilitating their disposal.				
9.	Check whether there is a mechanism to ensure that all issues of stores are supported by proper indents and have been approved by the competent authority and acknowledged by the intended recipients				
10.	Check whether there is a mechanism to ensure that only such materials as are provided in the agreement were issued to contractors in a phased manner based on its use within a reasonable period.				
11.	Check whether there is a mechanism to ensure that the scale, if any, prescribed by the Government or any other authority for issue of stores of any particular kind, was not exceeded while issuing the stores.				

Comments / compensating controls:

Write-off/disposal of stores

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether there is a mechanism to ensure that adequate measures are taken to survey and segregate surplus, unserviceable and obsolete stores and to consider their disposal in accordance with the procedures prescribed by Government in this regard.				
2.	Check whether the sale of surplus stores is made on receipt of payments in advance against proforma invoices				
3.	Check whether sales on credit are authorised by the competent authority				
4.	Check whether the sale proceeds are promptly realised, in case of sales on credit. Analyse and comment upon any instances of proceeds against credit sales remaining unrealised for considerable periods.				

Comments / compensating controls:

Stores management

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1	Check whether appropriate stock limits for different categories of stores were fixed by the auditee entity / Government.				
2	Check whether the balances in stock exceed the prescribed limits.				
3	Check whether there has been rush of expenditure on procurement at the close of the financial year or fictitious booking merely with a view to utilising the budget grants.				

Comments / compensating controls:

Stores records

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Check whether all stores were examined, on receipt and while accepting delivery, to determine their condition and to ensure that they were of the approved quality, make and specifications and the quantities conformed to those agreed upon.				
2.	Check whether the stores have been taken on stock and entered in the Goods Received Sheets/Bin Cards.				
3.	Check whether the previous stock balances have been correctly worked out, carried forward and authenticated by a responsible officer.				
4.	Check whether the individual bin cards have been maintained chronologically based on receipts and issues.				
5.	Check whether the Priced Stores Ledgers containing the value account of stores have been maintained, wherever required to be maintained.				

Where priced accounts are maintained

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1	Check whether the stores are priced in the prescribed manner with reasonable accuracy and the rates initially fixed are reviewed periodically, correlated with market prices and revised where necessary.				
2	Check whether the value accounts tally with the accounts of works and departments connected with stores transactions.				
3	Check whether there is a system of reconciliation of the balances with quantity accounts				
4	Check whether steps have been taken for the adjustment of profit or loss due to revaluation, stock verification or other causes not indicative of any serious disregard of rules.				

Comments / compensating controls:

Physical verification of stores

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Check whether there is a system of regular physical verification of all stores. (Rules192 and 194 of GFRs provides for physical verification of all stores at least once every year under rules prescribed by the head of the Department.)				
2.	Check whether a certificate of verification of stores is recorded periodically by the responsible authority.				
3.	Check whether the system adopted by the executive for verification is adequate and proper.				
4.	Check whether the discrepancies found on stock verification are properly investigated and reconciled.				
5.	Check whether the staff responsible for stock verification are, wherever possible, independent of those responsible for the physical custody of stores or for maintaining the accounts.				
6.	Check whether the stock verifiers work, wherever practicable, directly under the control of the Government and not under the heads of the individual departments concerned.				

Comments / compensating controls:

Checklist for Evaluation of Internal Controls relating to Grants-in-aid and Loans

S. No.	Check	Yes	No	-NA-	Work Paper Reference
1.	Whether there is an adequate system to furnish to C&AG / Audit Office of the IA&AD every year detailed information about the financial assistance given to various institutions, the purpose(s) for which the assistance was sanctioned and the total expenditure of the institutions in order to identify the bodies and authorities that attract audit under Sections 14 and 15 of the C&AG's (DPC) Act.				
2.	Whether there is a well defined delegation of powers to sanction grants in aid?				
3.	Whether there is a system to watch receipt of utilisation certificates from the recipients of grants?				
4.	Whether there is a system of assessment by the sanctioning authority regarding the suitability of the institution seeking the grant and satisfying about clearance of any allegations against the institution				
5.	Whether there is a mechanism to ensure that no grants are sanctioned where there is reasonable doubt or suggestion of corrupt practices unless the institution concerned has been cleared of the allegations;				
6.	Whether there is a system of indicating, in every order sanctioning a grant, • whether it is recurring or non-recurring in nature • the object for which it is given • the general and special conditions, if any, attached to the grant • a provision to the effect that the accounts of the grantee institutions shall be open to inspection by the sanctioning authority/Audit whenever considered necessary by them				
7.	Where the power of sanctioning grants is delegated to subordinate authorities subject to the prior fulfillment of certain conditions by the grantees, whether the sanctioning authority is having adequate methods to satisfy itself of such fulfillment.				

8.	Whether there is a system to ensure that, before a grant is paid, the sanctioning authorities under its control should, as far as possible, obtain audited statements of the accounts of the grantee institutions in order to establish that the grant is justified by their financial position and also to ensure that any previous grant was spent for the purpose for which it was intended, in case such requirement is stipulated by the Government.				
9.	In case of recurring grants-in-aid made to an institution, whether the sanctioning authority has a system to satisfy itself that the institution continues to function as intended and that the circumstances in recognition of which the grant was sanctioned still continue to exist.				
10.	Whether there is a system to provide to Audit, a formal certificate confirming the proper utilization of the grant from the administrative, technical and financial points of view. Audit should watch the compliance of this requirement. *Explanation:* Normally, the certificates should be based on audited statements of accounts and reports regarding the performance or achievements of the grantee in relation to the objects and conditions of the grants.				
11.	**Release of grant-in-aid (GIA)** Whether the Ministry of Finance (MoF) expenditure management guidelines of 23.11.2005 or other relevant instructions have been followed while releasing GIA to autonomous bodies. **Explanation** Ministry of Finance through its expenditure management guidelines dated 23.11.05, had directed that in order to reduce the dependence of autonomous bodies on budgetary support and set them on a course of greater self-reliance, the general purpose deficit grant-in-aid in 2005-06 would be reduced to 95 *per cent* of actual amount of such grants given in previous three years.				
12.	**Control to watch utilization of loans and grants** Under Rule 226(2) of GFRs, the utilization				

	certificate (UC) in respect of loan should be furnished within a reasonable time after the loan is paid to an institution. The target date should as far as possible be not later than eighteen months from the date of sanction of the loan. The due date for submission of the utilization certificate should be specified in the letter of sanction of the loan. The target date as specified should be rigidly enforced and extension should be allowed only in very exceptional circumstances in consultation with the MOF under intimation to the Audit Officer. No further loans should be sanctioned unless the sanctioning authorities are satisfied about the proper utilization of earlier loan sanctioned to an institution. What is the amount of loans for which utilization certificates have not been received even after the due date? Was there a control system to watch timely receipt of UCs and to ensure that further release of loan is not made unless the UC for previous loans was submitted?				
13.	Under Rule 212(1) of GFRs, whenever a non-recurring grant is sanctioned to an institution, a certificate of actual utilization of the grant for the purpose for which it was given should be insisted upon. The UC should be submitted within 12 months of the closure of the financial year. Further, according to instruction of MOF of May 2003, no fresh grant is to be released unless utilization certificates for the previous grants were furnished. Check whether there was release of further grants even though the UCs in respect of the earlier grant was not received.				
14.	Under Rules 208 and 209 of GFRs, if financial assistance was proposed to be granted to a profit-making society or organization, the feasibility of giving such assistance as loan instead of grant-in-aid should be specifically considered by the sanctioning authority in consultation with the MoF. Was this considered before releasing grants to profit-making societies/organizations?				

15.	• Have general principles for award of grant-in-aid for centrally sponsored schemes been followed? • Whether time bound targets for monitoring, mid term evaluation and detailed impact studies were prescribed? • Whether there were any changes in the time schedule, financial position and objectives of the original schemes? If so, were the changes reported to the Ministry? • Whether an evaluation mechanism was built into the project for concurrent review and mid-term action where necessary? • Whether a mechanism exists to ensure that the funds released have been utilized effectively? • Whether a mechanism exists to ensure that the data and facts relating to physical and financial performance are correct? • Whether plan schemes that are in operation with similar objectives targeting the same population were converged and the schemes not yielding results were weeded out? • Whether post completion review of centrally sponsored schemes was done and reviewed by the Ministry?				
16.	**Outstanding loans and advances** When the department gives loans to institutions/organizations including public sector enterprises, the terms and conditions are specified. The number of instalments in which the loan is to be repaid, and the rate of interest are specified. PAO will submit to the ministry annually a statement in Form GFR 20 showing details of outstanding loans. Under Rule 233 of GFRs, the Ministry should watch receipt of the annual statement from the PAO, and conduct a review of the cases of defaults in repayment of the instalments of principal and interest due, and take suitable measures to enforce repayment of the same. Under Rule 220(3) of GFRs, Government should lay down a procedure for periodical review of the old loans so that prompt action can be taken, if necessary, for enforcing regular payments.				

	Ascertain the amount of repayments of outstanding and interest. Analyse the outstanding year wise. Was any action taken by the Department / Ministry to enforce repayment?				
17.	**Outstanding guarantee fees** As per rule 248 (1) and (2) of GFRs, 2005 all Government guarantees in respect of internal borrowings by Public Sector Undertakings would be subject to a guarantee fee of one *per cent* per annum on the outstanding amount at the beginning of the year and is payable in advance. Such guarantee fee should be levied before the guarantee is given and thereafter on the first of April every year. In case of non-payment of guarantee fee on the due date, the guarantee fee should be charged at double the normal rates for the period of default. Check whether there are adequate controls to ensure compliance with this requirement.				
18.	Check whether appropriation or re-appropriation from Plan heads to non-Plan heads are made only with the prior approval of Ministry of Finance. (Rule 10(6)(d) of Delegation of Financial Powers Rules).				

Comments / compensating controls: