Compliance Auditing Guidelines

Comptroller and Auditor General of India

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Preface

Compliance audit is an assessment as to whether the provisions of the applicable laws, rules and regulations made there under and various orders and instructions issued by the competent authority are being complied with. This audit by its very nature promotes accountability, good governance and transparency as it is concerned with reporting deviations, identifying weaknesses and assessing propriety. Indian Audit & Accounts Department has been traditionally conducting transaction based audits, regularity audits, propriety audits, theme based and Chief Controlling Officer based audits which are essentially in the nature of assessing compliance. These constitute the bulk of the audit activity of the Department and it is imperative that they are planned and conducted in a structured manner.

CAG's Regulations on Audit and Accounts, 2007 recognised compliance audit as distinct stream of audit and these guidelines lay down the principles, approach and processes for regulating compliance audits within the Department. These guidelines reorient the planning process by instituting a top down, risk based and department centric approach and aims to instil the process rigour in audit implementation. These guidelines also provide clarity on reporting and follow up processes.

The discipline envisaged in these guidelines is expected to provide a holistic view of the compliance by entities under audit, improve quality of audits and optimize use of available resources. I am confident that the implementation of these guidelines would lead to improved audit practices and support the executive in strengthening internal controls.

I hope that these guidelines would be implemented in letter and spirit by the officers and staff of the Department and that they contribute to upgrading the standard of compliance audits in the years to come.

Shashi Kant Sharma
Comptroller and Auditor General of India
February 2016

1. Introduction

1.1 These guidelines contain the framework for the process of compliance auditing within the Indian Audit and Accounts Department headed by the Comptroller and Auditor General (CAG) of India hereinafter referred as IA &AD. The officers and the staff of IA &AD must follow these guidelines in planning, implementation, reporting, observing follow-up processes and obtaining quality assurance in compliance audits. They outline principles, objectives, approach, methodology, techniques and procedures for conducting compliance audits. These guidelines are based on the existing guidelines and instructions applicable within IA &AD and have adapted the ISSAIs (International Standards of Supreme Audit Institutions) for compliance auditing.

1.2 **Applicability**

These guidelines have been formulated to suit the requirements of IA &AD. These provide detailed instructions on preparation of audit plan for compliance risk profiling and reporting for compliance audits. However, the detailed audit checks to be performed while conducting compliance audits prescribed in the MSO (Audit) and the existing area specific checklists, instructions and guidance notes dealing with audit of contracts, fraud and corruption, quality and timelines etc. would continue to remain applicable.

Scope for individual initiative and professional judgement

1.3 While these guidelines are prescriptive in nature, they are not intended to supersede the professional judgement of the Accountant General[1], relevant to specific situations. The Accountant General is expected to make situation or subject specific adjustments to the provisions set out in these guidelines. However, Accountants General will be expected to document the rationale of all significant departures from the guidelines.

Audit Mandate

1.4 The audit mandate of IA&AD is derived from the Articles 149 & 151 of the Constitution of India. Article 149 of the Constitution of India envisages that CAG shall perform such duties and exercise such powers in relation to the accounts of the Union, of the States and of any authority or body as may be prescribed by or under any law made by Parliament. Article 151 of the Constitution of India provides that the reports of the CAG of India relating to the accounts of the Union or a State government shall be submitted to the President or the Governor of the State respectively, who shall cause them to be laid before each House of Parliament/ Legislature of the States. The statutory position is established under the CAG's (Duties, Powers and Conditions of Service), Act 1971. In addition to above, Audit

[1] The term Accountant General includes all heads of field audit offices of the rank of SAG and above within the IA&AD

mandate is governed by other provisions in the Constitution and other acts of Parliament which provide for audit of specific entities by the CAG. The audit mandate of CAG, therefore, extends to bodies or authorities such as statutory authorities, statutory corporations, government companies, autonomous bodies legally organised as societies, trusts or not-for-profit companies, urban and rural local bodies (the third tier of government below the Union and State Governments) and also to any other body or authority whose audit may be entrusted to the CAG under law. All these entities follow different systems, procedures and norms for their financial and operational management which may or may not conform to those applicable to government departments. The Accountants' General are therefore required to keep this broad consideration in mind while applying these guidelines for compliance audit of these auditable entities. CAG's Regulations on Audit and Accounts, 2007 provides appropriate guidance on the various audits undertaken by IA &AD and Chapter 6 of the CAG's Regulations on Audit and Accounts, 2007 contains specific guidance on compliance audit.

Compliance Auditing: Definition and Objective

1.5 The concept of compliance audit is embedded in the description of the purpose of public sector audit in the Lima Declaration of Guidelines on Auditing Precepts[2]:

> *'……**Audit is not an end in itself, but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent or at least render more difficult, such breaches'**.*

1.6 ISSAI 4100 defines compliance audit as follows:

> ***Compliance audit deals with the degree to which the audited entity follows rules, laws and regulations, policies, established codes, or agreed upon terms and conditions, etc. Compliance auditing may cover a wide range of subject matters.***

1.7 The CAG's Regulations on Audit and Accounts, 2007 define compliance audit as

> '***an assessment as to whether the provisions of the Constitution of India, applicable laws, rules and regulations made there under and various orders and instructions issued by the competent authority are being complied with'***.

1.8 The CAG's Regulations on Audit and Accounts, 2007 envisage that compliance audit includes an examination of the rules, regulations, orders and instructions for their

[2] adopted by acclamation of the delegates in October 1977 at the IX INCOSAI in Lima

legality, adequacy, transparency, propriety and prudence and effectiveness that is whether these are:

a) intra vires the provisions of the Constitution of India and the laws (legality);
b) sufficiently comprehensive and ensure effective control over government receipts, expenditure, assets and liabilities with sufficient safeguards against loss due to waste, misuse, mismanagement, errors, frauds and other irregularities (adequacy);
c) clear and free from ambiguity and promote observance of probity in decision making (transparency);
d) judicious and wise (propriety and prudence); and
e) effective and achieve the intended objectives and aims (effectiveness).

The CAG's Regulations on Audit and Accounts, 2007 further provide that the compliance audit also examines the rules, regulations, orders and instructions for their consistency with each other.

1.9 Seen from the perspective of public sector[3] audit, compliance with rules, regulations and applicable authorities[4] is the primary and most important requirement for ensuring accountability of the public executive, which primarily relate to safeguard and use of resources – financial, natural, human and other material resources. Compliance audit also performs the function of deterrence, especially in situations where internal controls are not as effective. The objective of public-sector compliance auditing, therefore, is to enable the CAG to assess whether the activities of public-sector entities are in accordance with the authorities governing those entities. Compliance audits are carried out by assessing whether activities, financial transactions and information comply, in all material respects, with the authorities, which govern the auditable entity. It is concerned with *regularity and propriety audit.*

- **Regularity**–that the subject matter of the audit adheres to formal criteria emanating from the relevant laws, regulations and agreements which are applicable to the auditable entity.

- **Propriety**– that general principles of sound public sector financial management and ethical conduct have been adhered to, legality and competence are ensured.

As such compliance audit not only includes examination of rules, regulations, orders, instructions but also every matter which, in the judgment of the auditor, appears to involve significant unnecessary, excessive, extravagant or wasteful expenditure of public money and resources despite compliance with the rules, regulations and orders.

[3] Public sector refers to the sector that is controlled by Central, State and Local Governments. Public sector entities include all Central and State Government Ministries, Departments, Directorates /Commissionerates, and all other entities/bodies owned/controlled by the Central and/or State Governments

[4] Authorities include the Constitution of India, laws, regulations etc. A detailed definition is provided in para 1.14

It also includes audit of sanctions to expenditure, which is guided by the principles of legality, propriety, competence of the sanctioning authority, adherence to the criteria for sanction, availability of funds, determination of physical targets, objects of expenditure and the accounting procedure. Thus, besides verifying compliance by the auditable entities to the applicable regulatory framework, compliance audit is also expected to examine the regulatory framework for consistency and raise questions on grounds of propriety also.

Elements of compliance audit

1.10 Compliance audit in Public Sector audits have certain basic elements (i) Three parties in the audit i.e. the auditor, the responsible party, intended user, (ii) Subject matter and (iii) Authorities and criteria to assess the subject matter.

The three parties

1.11 The three parties involved in compliance audit are briefly described below:

The auditor: represents the Indian Audit & Accounts Department and the persons delegated with the task of conducting audits. However, clear cut demarcation of roles and responsibilities of officers and staff for various audit functions is done through a hierarchical structure. Auditors in compliance audits typically work as a team with different and complementing skills. The auditor is responsible for planning and implementation of audit and issuing a compliance audit report.

The responsible party: represents the executive branch of government and/or its underlying hierarchy of public officials and entities responsible for the management of public funds and the exercise of authority under the control of the legislature. The responsible party in compliance auditing is responsible for the subject matter of the audit.

The intended users: represent the individuals, organizations or classes thereof for whom the auditor prepares the audit report. In compliance auditing the users generally comprise the executive which includes auditable entity and those charged with Governance, the legislature and the citizens who are the ultimate users of compliance audit reports.

Subject matter

1.12 Subject matter refers to the information, condition or activity that is measured or evaluated against certain criteria while conducting an audit. Compliance auditing may cover a wide range of subject matters depending upon the audit scope. Subject matter may be general or specific in nature. Some of these may be easily measureable (for example – compliance with a specific requirement like adherence to environment laws) while others may be more subjective in nature (for example- financial prudence or ethical behaviour).

Authorities and criteria

1.13 **Authorities** are the most fundamental element of compliance auditing, since the structure and content of authorities furnish the audit criteria and therefore form the basis of how the audit is to proceed under a specific constitutional arrangement. Authorities include the Constitution, Acts, Laws, rules and regulations, budgetary resolutions, policy, contracts, agreements, PPP contracts, established codes, sanctions, supply orders, agreed terms or the general principles governing sound public-sector financial management and the conduct of public officials. Most authorities originate in the basic premises and decisions of the legislature, but they may be issued at a lower level in the organisational structure of the public sector.

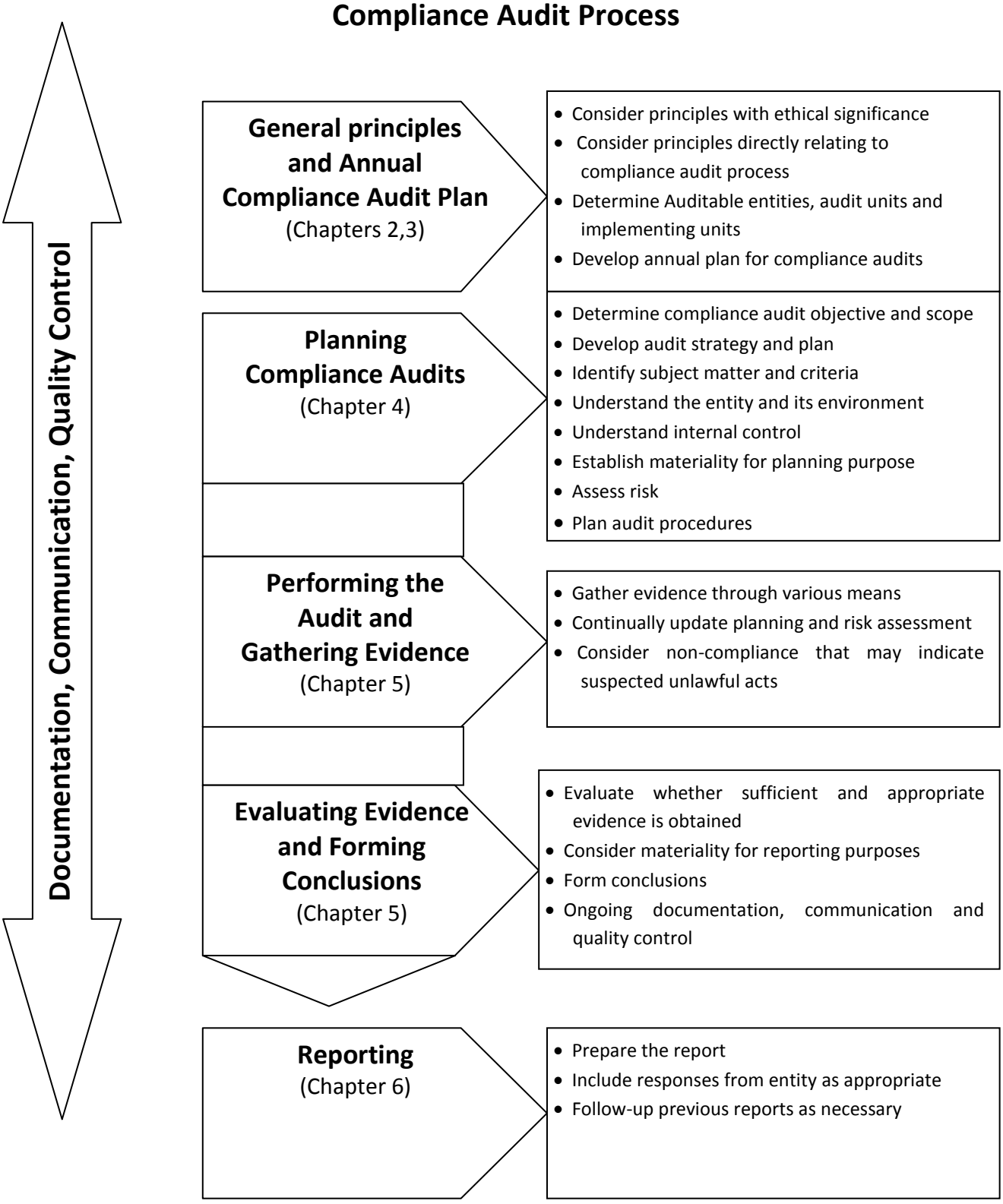
1.14 Because of the variety of possible authorities, they may have mutually conflicting provisions and be subject to differing interpretations. In addition, subordinate authorities may not be consistent with the requirements or limits of the enabling legislation and there may be legislative gaps. As a result, to assess compliance with authorities in the public sector it is necessary to have sufficient knowledge of the structure and content of the authorities themselves. Authorities are, typically the source of the criteria.

1.15 **Criteria** are the benchmarks used to evaluate or measure the subject matter consistently and reasonably. The auditor identifies criteria on the basis of the relevant authorities. To be suitable, compliance audit criteria must be relevant, reliable, complete, objective, understandable, comparable, acceptable and available. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Where formal criteria are absent audits may also examine compliance with the general principles governing sound financial management. Suitable criteria are needed both in audits focusing on regularity and in audits focusing on propriety.

General outlay of Compliance Auditing Guidelines

1.16 These guidelines are being presented sequentially to typically represent the process flow of compliance audit

Compliance Audit Process



2. General Principles for Compliance Audits

2.1 The General principles that apply during the conduct of compliance auditing and are relevant throughout the audit process are enumerated below.

Auditors should plan and conduct the audit with 'professional scepticism' and exercise 'professional judgement' throughout the audit process.

2.2 **Professional scepticism** refers to the attitude of the auditor, which must include a questioning mind. The auditor should plan and conduct the audit with an attitude of professional scepticism, recognising that certain circumstances may cause the subject matter to diverge from the criteria. An attitude of professional scepticism means that the auditor makes a critical assessment, with a questioning mind, of the sufficiency and appropriateness of evidence obtained throughout the audit. The concept of professional scepticism is fundamental to all audits.

Professional judgement refers to application of relevant training, knowledge, skills and experience, within the context provided by auditing standards, so that informed decisions can be taken about the courses of action that are appropriate given the circumstances of audit. The auditor must apply professional judgement at all stages of the audit process to assess the subject matter, suitable criteria, audit scope, risk, materiality, audit procedures to be used in response to the defined risks, in reporting and in determining the form, content and frequency of communication throughout the audit.

Auditors should possess the necessary skills

2.3 The audit team should collectively possess the knowledge, skills and expertise necessary to successfully complete the audit. This includes an understanding and practical experience of the type of audit being undertaken, familiarity with the applicable standards and authorities, an understanding of the auditable entity's operations and the ability and experience to exercise professional judgement. Auditors should be able to maintain their professional competence through ongoing professional development.

Audits may require specialised techniques, methods or skills from disciplines not available within IA&AD for which external experts may be deployed without involving them in actual conduct of audit. The confidentiality of the specific information/records made available by the auditable entity should be maintained in such interface with external experts. Auditors should evaluate and document whether experts have the necessary competence, capabilities and objectivity and determine whether their work is adequate for the purposes of the audit.

2.4 **Auditors should observe the code of ethics**

IA&AD has adopted a code of ethics which should be observed by auditors at all times. The auditor promotes trust, confidence and credibility by adopting and applying the ethical requirements of the concepts embodied in the key principles of

the code - Integrity, Independence and Objectivity, Confidentiality and Competence. The conduct of auditors should be beyond reproach at all times and in all circumstances.

2.5 **Auditors should take responsibility for the overall quality of audit**

The auditor is responsible for the conduct of audit and should implement quality control procedures throughout the audit process. Such procedures should be aimed at ensuring that the audit complies with the applicable standards and providing assurance that the audit report, conclusion or opinion is appropriate under the given circumstances.

2.6 **Auditors should consider audit risk throughout the audit process.**

Audits should be conducted in such a way as to manage, or reduce the audit risk to an acceptable level. Audit risk is the risk that the audit report – or more specifically the auditor's conclusion - will be inappropriate in the circumstances of the audit. The auditor should consider three different dimensions of audit risk – inherent risk, control risk and detection risk – in relation to the subject matter and the reporting format, i.e. whether the subject matter is quantitative or qualitative. The relative significance of these dimensions of audit risk depends on the nature of the subject matter and the nature of assurance to be provided.

2.7 **Auditors should consider materiality throughout the audit process.**

Determining materiality is a matter of professional judgement and depends on the auditor's interpretation of the users' needs. A matter can be judged material if knowledge of it would be likely to influence the decisions of the intended users. This judgement may relate to an individual item or to a group of items taken together. Materiality is often considered in terms of monetary value, but it also has other quantitative as well as qualitative aspects. The inherent characteristics of an item or group of items may render a matter material by its very nature. A matter may also be material because of the context in which it occurs. Materiality should be considered for the purposes of planning, evaluating the evidence obtained and reporting, though the materiality levels would differ for each of the processes. An essential part of determining materiality is to consider whether reported cases of compliance or non-compliance (potential or confirmed) could reasonably be expected to influence decisions by the intended users. Factors to be considered within this judgment are mandated requirements, public interest or expectations, specific areas of legislative focus, requests and significant funding and include other issues, which may have a low level of monetary value or incidence, such as fraud.

2.8 **Auditors should prepare sufficient audit documentation.**

Documentation should be sufficiently detailed to enable an experienced auditor, with no prior knowledge of the audit, to understand the following: the relationship between the subject matter, the criteria, the audit scope, the risk assessment, the audit strategy and audit plan and the nature, timing, extent and results of the

procedures performed; the evidence obtained in support of the auditor's conclusion or opinion; the reasoning behind all significant matters that required the exercise of professional judgement; and the related conclusions. Documentation should be prepared within a reasonable period before the issue of audit report and as far as possible audit processes may be documented simultaneously. The documentation should be retained for an appropriate period of time.

2.9 **Auditors should maintain effective communication throughout the audit process.**
Communication takes place at all audit stages - before the audit starts, during initial planning, during the audit process, and at the reporting phase. Any significant difficulties encountered during the audit, as well as instances of material non-compliance, should be communicated to the appropriate level of management or those charged with governance.

2.10 **Auditors should determine the audit scope.**
The audit scope is a clear statement of the focus, extent and limits of the audit in terms of the subject matter's compliance with the criteria. The scoping of an audit is influenced by materiality, risk and legal requirements, and it determines which authorities and parts thereof will be covered.

2.11 **Auditors should identify the subject matter, authorities and suitable criteria.**
Determination of the subject matter, authorities and criteria are one of the first steps in a compliance audit. As stated in Chapter 1 subject matter could be either general or specific. The subject matter should be identifiable, and it should be possible to assess it against suitable criteria. It should be of such a nature that it enables sufficient and appropriate audit evidence to be gathered in support of the audit conclusion. The auditor should identify authorities and suitable criteria to provide a basis for evaluating the audit evidence and developing audit findings and conclusions. The authorities and criteria should be made available to the intended users and others as appropriate.

2.12 **Auditors should understand the auditable entity**
Compliance auditing may cover all levels of the executive and can include various administrative levels, types of entities and combinations of entities. The auditor should therefore be familiar with the structure and operations of the auditable entity and its procedures for achieving compliance. The auditor will use this knowledge to determine materiality and assess the risk of non-compliance.

2.13 **Auditors should understand the control environment**
An understanding of the auditable entity and/or the subject matter relevant to the audit scope depends on the auditor's knowledge of the control environment and the system of internal controls. The control environment - encompassing the attitude and measures adopted by the management in the form of policies and procedures to instil a culture of honesty and ethical behaviour- forms the basis for the system of internal controls. In compliance auditing, a control environment that focuses on achieving compliance is of particular importance.

The particular type of controls which the auditor focuses on will depend on the nature of subject matter, nature and scope of the audit. In evaluating internal controls, the auditor should assess the risk that they may not prevent or detect material instances of non-compliance. The auditor should consider whether the internal controls are in harmony with the control environment so as to ensure compliance with the authorities and criteria in all material respects.

2.14 **Auditors should perform a risk assessment**

In the light of the audit criteria, audit scope and characteristics of the auditable entity, auditor should perform a risk assessment to determine the nature, timing and extent of the audit procedures to be performed. The identification of risks of non-compliance and their potential impact on the audit procedures should be considered throughout the audit process. As part of risk assessment, the auditor should evaluate any known instances of non-compliance in order to determine their materiality.

2.15 **Auditors should consider the risk of fraud**

Fraud in compliance auditing relates mainly to the abuse of public authority and to fraudulent reporting on compliance issues. Instances of non-compliance with authorities may constitute deliberate misuse of public authority for improper benefit. The execution of public authority includes decision making and avoidance of decision making, preparatory work, advice, information handling and other acts in the public service. Improper benefits are advantages of a non-economic or economic nature gained by an intentional act by one or more individuals among management, those charged with governance, employees or third parties.

While detecting fraud is not the main objective of compliance audit, auditors should include fraud risk factors in their risk assessments and remain alert to indications of fraud when carrying out their work. If the auditor comes across instances of non-compliance which may be indicative of fraud, the auditor should exercise due professional care and caution so as not to interfere with any future legal proceedings or investigations. When such suspected fraud has been identified, auditors should take action to ensure that they respond appropriately based on existing Headquarters instructions in this regard.

2.16 **Auditors should develop an audit strategy and an audit plan**

Audit planning should involve discussion among members of the audit team with a view to developing an overall audit strategy and an audit plan. The purpose of the audit strategy is to devise an effective response to the risk of non-compliance. It should include consideration of the planned audit responses to specific risks through the development of an audit plan. Both the audit strategy and the audit plan should be documented. Planning is not a distinct phase of the audit, but a continuous and iterative process.

2.17 **Auditors should gather sufficient and appropriate audit evidence**

The auditor should gather sufficient and appropriate audit evidence to provide the basis for the conclusion or opinion. **Sufficiency** is a measure of the quantity of

evidence, while **appropriateness** relates to the quality of evidence – its relevance, validity and reliability. The quantity of evidence required depends on the audit risk (the greater the risk, more the evidence that may be required) and on the quality of such evidence (the higher the quality, lesser the evidence that may be required). Therefore, sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence does not compensate for its poor quality. The reliability of evidence is influenced by its source and nature, and is dependent on the specific circumstances in which it was obtained. The auditor should consider both the relevance and the reliability of the information to be used as audit evidence and must respect the confidentiality of all audit evidence and information received.

The audit procedures should be appropriate in the circumstances of the audit and suited to the purpose of obtaining sufficient and appropriate audit evidence. The nature and sources of the necessary audit evidence are determined by the criteria, subject matter and scope of the audit. The auditor will often be needed to combine and compare evidence from different sources in order to meet the requirements for sufficiency and appropriateness of evidence. If audit evidence obtained from one source is inconsistent with that obtained from another, or if there are any doubts about the reliability of the information to be used as evidence, the auditor should determine what modifications or additions to the audit procedures would resolve the matter and consider the implications, if any, for other aspects of audit.

2.18 **Auditors should evaluate audit evidence and form relevant conclusions**

After completing the audit, the auditor will review the audit evidence, which includes consideration of the responses provided by the auditable entities, in order to reach a conclusion. The auditor should evaluate whether the evidence obtained is sufficient and appropriate so as to reduce the audit risk to an acceptably low level. It also includes considerations of materiality. After evaluating the evidence, the auditor should consider how best to conclude in the light of the evidence. The auditor should also determine whether the risk assessment and initial determination of materiality were appropriate in the light of the evidence collected, or whether they need to be revised.

2.19 **Auditors should prepare a report based on the principles of completeness, objectivity, timeliness and a contradictory process**

The principle of completeness requires the auditor to consider all relevant audit evidence before issuing a report. The principle of objectivity requires the auditor to apply professional judgement and scepticism in order to ensure that all reports are factually correct and that findings or conclusions are presented in a relevant and balanced manner. The principle of timeliness implies preparing the report in due time. The principle of a contradictory process implies checking the accuracy of facts with the auditable entity and incorporating responses from responsible officials as appropriate.

3. Compliance Audit Plan

3.1 Compliance with rules and regulations is the primary and the most important requirement for ensuring accountability of the public executive. Decision makers need to know whether relevant laws and regulations are being complied with, whether they have achieved the desired results, and whether the accepted standards of financial propriety are being adhered to; and if not, what corrective action is necessary. It is imperative that compliance audits are planned to achieve adequate coverage at an acceptably low level of audit risk, audit processes are carried out in an economic, efficient and effective manner and result in a high quality audit report. However, given the size of Government and its implementing arms and the limited audit resources it is impracticable to plan for audit coverage of all audit units in the audit universe-as defined at present. Proper planning and prioritisation of compliance audits based on an appropriate risk assessment, is therefore, paramount.

Audit Universe and Annual Compliance Audit Plans

3.2 Understanding the Audit Universe and prioritisation of compliance audits to be taken up is essential, which is in itself a complex task, given the various layers of Government and the Government implementing a significant number of programs /schemes with various implementing agencies, some of which could even be private sector entities. To implement the mandate entrusted to CAG by the Constitution of India, we are expected to cover, over a reasonable period of time, all the sectors/departments of the concerned State Governments/Central Government wherever public funds are spent or revenues are generated or nation's wealth or resources are utilised. While the various departments/sectors are accountable for policy formulation and implementation, the organisational hierarchies within each Department /sector are typically organised as Directorates/Commissionerates, zones, divisions, circles, ranges etc., and further down to the last mile implementing agencies. All these units together implement the Government policy and expend public money or collect public revenues and can be called as the audit universe. This Audit universe is required to be broken down into audit units for the purpose of planning and scheduling audits.

3.3 This requires *top down, risk based, Department centric mechanism* for macro level planning and conducting compliance audits and preparation of annual compliance audit plans by (a) defining the apex auditable entities and audit units and (b) risk profiling. This exercise can provide a holistic view of functioning of the auditable entities without the risk of dismissing audit findings as a random view and statistically insignificant.

Defining the Apex Auditable Entities and Audit Units

3.4 A top down and risk based approach to identification of audit units intends to place the Department/Sector as the centre piece of the audit focus and provide a scientific mechanism of defining audit units. The Department / Sector in the State Government or the Central Government being the top layer would be defined as the Apex Auditable Entity[5]. Since policy formulation and oversight flow from the Departments/Sectors (Apex Auditable Entities) and responsibility for implementation of schemes/programs vests with the lower formations of the Government (Directorates /Commissionerates/zones, divisions, circles, ranges etc.) a significant portion of the risk is embedded in these layers, while the lowest layer is typically the implementing arm and accountability for its performance invariably rests with the higher organisational hierarchies. The top down approach for identification of audit units mentioned in these guidelines therefore envisages that audit units are identified beginning with higher organisational hierarchies of the Apex Auditable Entity and fanning out to operational units at the field level.

3.5 The audit units may be defined based on the quantitative measures of devolution of administrative and financial powers, the qualitative measures of functional autonomy and operational significance attributable to the unit for achievement of objectives of the Department. The devolution of powers would have to be substantial and not limited to the routine delegation of powers for managing the establishment and contingent expenses. This would ensure that the administrative authority for allocation of funds and delegation of powers are at the centre of compliance audit.

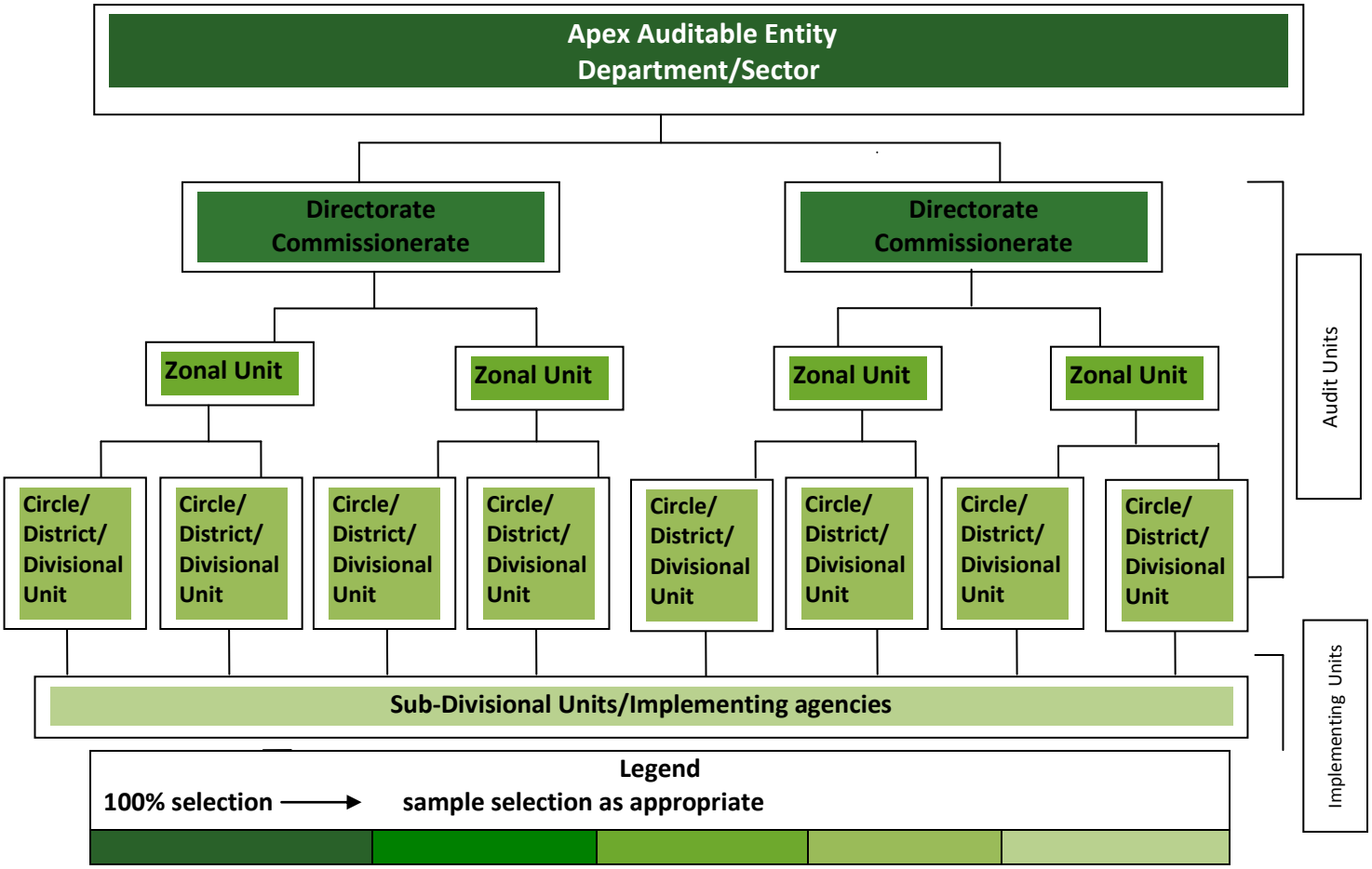
An Audit Unit is therefore defined as a unit, which has one or more of the following attributes:

- substantial devolution of administrative and financial powers;
- functional autonomy; and
- operational significance with reference to achievement of objectives of the apex auditable entity.

3.6 After determination of Audit Units based on the aforesaid parameters, the organisational hierarchies and implementing agencies below the Audit Units are to be categorised as Implementing Units. The Implementing Units are typically the last mile service providers and implementation arms of Government, with very limited delegation of financial and administrative powers - of contingent nature and for managing establishment. These Implementing Units would be audited, based on a sample selection, as a part of audit of their respective Audit Units. The process of

[5] The Regulation 2 of the CAG's Regulations of Audit and Accounts, 2007 defines Auditable entity as ''an office, authority, body, company, corporation or any other entity subject to audit by the CAG'. The highest authority or Head of Department under the audit jurisdiction of the Accountant General would be the Apex Auditable Entity.

sample selection is explained in the subsequent sections. The envisaged typical representation of Apex Auditable Entity, Audit Units and Implementing Units is shown below:



3.7 Preparation of audit universe by defining Apex Auditable Entity and Audit Units in terms of these guidelines would be carried out by the respective Accountants General in field offices. Each field office would be required to prepare an organisation chart of the Departments to identify the audit units based on the above parameters. The list of Audit Units and the Implementing Units would have to be maintained in the field offices, which would henceforth form the basis of planning compliance audits. While the above representation showcases organisational structure from the State Government's perspective, the central functions such as Central Revenue, Railways, Commercial, Posts and Telecommunications etc. and the Local Self Government – the Local Bodies shall also define their Apex Auditable Entities and Audit Units keeping in view the philosophy described in paras 3.4 to 3.6 above.

3.8 With the evolving governance structure, the nation's wealth/natural resources are being dealt with not only by the Union, State or its instrumentalities but also by the private parties, for delivery of public goods and services, it has become important that these implementing agencies or service providers are made accountable to the people and to the Parliament. These implementing agencies would also, therefore, be included in the aforementioned category of implementing units.

Records of these implementing agencies are required be accessed through the respective audit units. Detailed instructions of the procedure to be adopted for access and audit of records of such agencies are contained in the Guidance Note issued by Headquarters in this regard**.** However, the scope and extent of examination of records of such implementing agencies will depend upon the applicable regulatory framework including any contract/ agreement which the implementing agency may have entered into with the government, professional standard or practice used by the industry in which the entity operates and also judicial pronouncements.

Risk Profiling

3.9 The risk based approach to planning compliance audits is about focussing audit efforts on the perceived high risk areas/activities. Risk profiling of the Apex Auditable Entities and their Audit Units has to be done considering their structures, roles they are expected to perform and compliance requirements. As governments and other organisations transition into digital environment, they generate, process and store voluminous data. Also, useful and relevant data in disparate forms and continuously produced by various government and non-government agencies and entities. When collated, they provide the contextual framework and valuable insight into the functioning of an apex auditable entity. Capacity and infrastructure limitations have so far restricted the reach of auditors in the big data environment. The advent of big data marks a paradigm shift, which by design integrates data from various sources and in various formats to transform data into actionable information. This aims to enhance the efficiency and effectiveness of audits. IA&AD has adopted a Big Data Management Policy to harness such opportunities. This policy is expected to facilitate greater and deeper insights into the Apex Auditable Entity's environment to clearly identify risk areas and prioritise the audit units.

3.10 Apex Auditable Entities while being responsible for delivery of public goods and services and expending public funds or collecting revenues may also be responsible for administering and / or enforcing various laws, rules or regulations. At the same time, these are also governed by various rules, laws and regulations. Similarly, officials entrusted with management or stewardship of public funds and public entities are expected to act with propriety in all matters concerning the discharge of their responsibilities**.** Keeping all the above factors in mind, the field audit offices are encouraged to apply the risk assessment methodology by evaluating high risk areas/activities of these entities relating to:

- Administration and/ or enforcement of laws, rules and regulations etc.,
- Compliance with applicable laws, rules and other authorities;
- Responsibility for government receipts and expenditure;
- Safeguarding of assets and liabilities;
- Prevention of losses and wastage, frauds, leakage of revenue;
- Promoting transparency, prudence and probity; and
- Internal control environment

3.11 The risk assessment methodology should include a review of the following:

- Latest socio-economic survey of the Centre/ State
- Current Budget & Demands for Grant
- Outcome budgets
- Five year plans and Working Group reports/ Annual plans
- Finance Commission Report
- Annual/ Performance/ Activity Reports of Ministries / Departments/ Companies and other information on Government websites
- Major policy announcements/initiatives of Government
- VLC data & Report on State Finances
- Finance & Appropriation Accounts
- Geographical location
- Past audit coverage
- PAC/COPU suggestions
- Court orders
- Audit Advisory Board suggestions
- Reports of Legislative Committees
- Changes in legislation
- Replies to questions given to the Legislature
- Past Audit findings/ Inspection Reports
- Media reports and visibility of topics
- Trend of expenditure and /or receipts

Preparing Annual Compliance Audit Plans

3.12 The exercise, as described above, would help in creating risk profile of the apex auditable entities as well as audit units under these entities. Based on their risk profile, the audit units should be prioritised for planning and conduct of compliance audits. The risk profile of the audit units should be considered vis-à-vis the audit capacity of the field office- in terms of availability of resources, and an annual Audit plan of compliance audits to be taken up and completed during the year should be prepared by each field office.

The field offices under the IA&AD conduct financial audits, performance audits and compliance audits each year and the Annual Audit Plan of each office shall therefore be prepared by adopting a holistic approach of covering Apex Auditable

Entities/Audit Units for each type of audit and leveraging common processes. The Annual Audit Plan of each office would therefore indicate the Apex Auditable entities/Audit Units for which compliance audits would be conducted. The outcome of analysis of sanctions and vouchers by the Financial Audit Wing, detailed processes of which are provided in the Financial Attest Auditing Guidelines for audit of State Government Accounts and other existing manuals and instructions, can be leveraged for planning compliance audits.

3.13 It must be the endeavour of the field offices to ensure coverage of all Apex Auditable Entities in a reasonable period of time, between three to five years. The risk profile of the audit units would have to be reviewed and updated periodically to assess continued maintenance or to consider revision in the risk profile assigned to the apex auditable entities and audit units based on new intervening developments, changes and increase/decrease in irregularities noticed by various stakeholders, etc.

3.14 The formulation of annual Compliance Audit Plan would therefore require:

a. Updating the Audit Universe such that it comprises all units that qualify as audit units. A separate inventory of implementing units under their respective Audit units may be maintained.
b. Applying risk assessment methodology to the Apex Auditable Entities for arriving at risk profile of the Apex Auditable Entities and Audit Units under these entities.
c. Preparing the annual Compliance Audit Plan by selecting audit units after considering available audit resources. This would include a risk based selection of Apex Auditable Entities and an appropriate sample of audit units at various hierarchies and implementing units within each Apex Auditable Entity. The selected sample of units shall be auditable both from the propriety and regularity perspective. Where evaluation of high risk areas/activities against regularity involves complexity and multifarious aspects, a specific subject matter may be selected within the high risk area/activity for evaluation of compliance against regularity.

3.15 **Components of Annual Compliance Audit Plan**

a. Selection of Apex Auditable Entities and Audit Units that would be taken up for compliance audits;
b. Selection of Implementing units under the audit units as necessary;
c. Determination of specific subject matter, where considered necessary; and
d. Allocation of audit resources for the audits to be undertaken.

3.16 With the introduction of risk based approach to planning compliance audits, tempered by the audit capacity of each field office, as envisaged in these guidelines, the question of audit arrears would generally not arise.

4. Planning Compliance Audits

4.1 A compliance audit has to be planned in a manner which ensures that a high quality audit is carried out in an economic, efficient and effective way and in a timely manner. Adequate planning will ensure that appropriate attention is accorded to crucial areas of audit and that potential problems are identified in a timely manner. It is essential that Auditors plan the audit with an attitude of professional scepticism and exercise professional judgement. Further, auditors should possess the knowledge, competence and skills to understand the compliance requirements that apply to the auditable entities.

4.2 After the preparation of the annual Compliance Audit Plan as discussed in Chapter 3, the process of planning for individual compliance audits commences. Individual compliance audit, hereafter means audit of the identified Apex Auditable Entity along with the selected Audit Units.

Planning for individual compliance audits

4.3 Planning for individual compliance audits includes preparing the audit strategy and an audit plan. Preparation of audit strategy for the identified audit entity would include:

- An understanding of the auditable entity and its internal control environment, including the statutory, regulatory and legal framework applicable to the auditable entity and the applicable rules, regulations, policies, codes, significant contracts or agreements etc;
- An understanding of relevant principles of sound public sector financial management and expectations regarding the conduct of public sector officials for propriety related issues;
- Identification of the intended users, including responsible party and those charged with governance;
- Consideration of materiality and risk assessment including suspected unlawful acts or fraud;
- Determining the scope of audit with reference to the selected specific subject matter, if selected, as well as proprietary concerns;
- Development of audit objectives for the specific subject matter, if selected;
- Identification of audit criteria for specific subject matter;
- Sampling considerations, specifically for implementing units below the selected audit units; and
- Considerations related to direction, supervision and review of the audit team(s).

4.4 Once the audit strategy is in place, the audit plan could be prepared. The plan for the identified apex auditable entity would include:

- Description of selected audit units;

- Sample selection of implementing units under the selected audit units;
- Extent of audit in each selected unit;
- Timing of audit;
- Formation of audit team/s (in case more than one audit team is needed for the auditable entity);
- Assignment plan detailing the duties of the audit team members;
- Planned audit procedures; and
- Potential audit evidence to be collected during the audit.

4.5 Both the overall audit strategy and the audit plan should be documented in the audit file. Planning for individual compliance audits is a continual and iterative process. The overall audit strategy and plan are therefore required to be updated as necessary throughout the audit.

Scope of Audit

4.6 The scope is the boundary of audit. It defines "what to audit", "who to audit", "where to audit" and "which period to audit".

- What to Audit - The propriety issues are to be seen in all units selected to be audited. However, the selected specific subject matter for regularity audit would define the scope for "what to audit" and would also determine the criteria.
- Who to Audit - The issue of "who to audit" is decided by the predetermined annual compliance audit plan as discussed in Chapter 3 that specifies the auditable entity and selected audit units below the auditable entity.
- Where to audit - brings us to selection of units for audit within the auditable entity, and also to the selection of transactions, areas etc. Sampling decisions would be crucial for this stage.
- Which period to Audit - the period of audit to be covered would have to be determined as per the risk assessment. In case of audit units, the period of audit should ordinarily cover period from the previous audit to the current period. However, specific circumstances may exist where current risk assessment reveal areas of concern that warrant coverage of period included in previous audit(s). In case of implementing units, the period of audit to be covered would correspond with the audit period of audit units.

Compliance Audit Objectives

4.7 The overall Compliance Audit Objectives can be summarized as below:

- To assess whether the subject matter adheres to the formal criteria arising out of the laws, regulations and agreements applicable to the auditable entity;
- To assess whether the general principles of sound public sector financial management and ethical conduct have been adhered to; and
- Report the findings and conclusions to the responsible party, those charged with governance, legislature and/or other parties as appropriate.

4.8 The particular objectives of a compliance audit for the identified apex auditable entity are to be derived from the scope of audit. Illustrative and not comprehensive, instances of scope and detailed audit objectives of compliance audits are given below:

Compliance audit scope	Detailed audit objectives
Contracting and procurement	• Verify whether procurement was carried out as per extant rules and in accordance with delegated financial powers. • Verify whether financial propriety was ensured during the stages of tendering, evaluation and award of contract.
Tax receipts	• Verify whether assessments were in accordance with the relevant tax laws and rules thereunder. • Verify whether the assessed demands were collected and properly accounted for.
Establishment audit	• Verify whether payments in respect of salaries and other entitlements were in accordance with the relevant rules and instructions.
Availability of infrastructure in Heath Department	• Verify whether health center has been set up in accordance with specified population norms. • Verify whether the necessary infrastructure facilities (medical equipment, operation theatre, UPS, water supply, stock of drugs, etc) have been provided as per Indian Public Health Standards (IPHS). • Verify whether the complement of doctors and other staff are as per IPHS.
Plant efficiency	• Verify whether the usage of power, fuel are as per approved norms. • Verify whether plant shutdowns are as per approved norms. • Verify whether the production is as per the prescribed scale. • Verify whether the installed capacity of the plant is designed as per regulatory approvals. • Verify whether the operation of plant complies with environmental norms.
Corporate social responsibility	• Verify whether corporate social responsibility framework is as per regulatory approvals. • Verify whether activities of corporate social responsibility are as per corporate policy. • Verify whether the corporate policy is in consonance with relevant regulations and DPE guidelines.
Audit of sanctions	• Verify whether the sanction is within the general or express powers delegated to the sanctioning authority. • Verify whether the criteria for sanction such as - availability of funds, determination of physical targets, objects of expenditure and accounting procedure- have been adhered to.

	• Verify whether the sanction is not split to avoid obtaining sanction of a higher authority. • Verify whether sanction is conflicting with general principles of public sector financial management or other orders /instructions.

Criteria

4.9 Criteria are the benchmarks used to evaluate or measure the subject matter consistently and reasonably. The criteria provide the basis for evaluating audit evidence, developing audit findings and conclusions. Criteria may be formal, such as a law or regulation, terms of a contract or agreement or less formal such as a code of conduct, principle of propriety or they may relate to expectations regarding behaviour. Generally, criteria for regularity audits would therefore emanate from specific authorities while criteria for propriety issues would emanate from the General Financial Rules of the Government of India and those codified in the corresponding State Financial Rules.

The criteria should have the following characteristics:

a) **Relevant**– relevant criteria provide meaningful contributions to the information and decision making needs of the intended users of the audit report.
b) **Reliable**– reliable criteria result in reasonably consistent conclusions when used by another auditor in the same circumstances.
c) **Complete**–complete criteria are those that are sufficient for the audit purpose and do not omit relevant factors. They are meaningful and make it possible to provide the intended users with a practical overview for their information and decision making needs.
d) **Objective** – objective criteria are neutral and free from any bias on the part of the auditor or on the part of the management of the auditable entity.
e) **Understandable** – understandable criteria are those that are clearly stated, contribute to clear conclusions and are comprehensible to the intended users.
f) **Comparable** – comparable criteria are consistent with those used in similar audits of other agencies or activities and with those used in previous audits of the entity.
g) **Acceptable** –acceptable criteria are those to which independent experts in the field, auditable entities, legislature, media and the general public are generally agreeable.
h) **Available** – criteria should be made available to intended users so that, they understand the nature of audit work performed and the basis for the audit report.

4.10 **Understanding internal controls**

Understanding internal controls is normally an integral part of understanding the entity and the relevant subject matter. The CAG's Regulations on Audit and Accounts, 2007 explain that the auditor should examine and evaluate the reliability of internal controls. In compliance audit, this includes understanding and evaluating controls that assist the executive in complying with laws and regulations applicable to the auditable entity. The type of controls that need to be evaluated depends on the subject matter, nature and scope of the particular compliance audit. In evaluating internal controls, auditors assess the risk that the control structure may not prevent or detect material non-compliance. The internal control system in an entity may also include controls designed to correct identified instances of non-compliance, presence and effectiveness of institutionalised mechanisms such as Internal Financial Adviser system, Internal Audit system etc.

Auditors should obtain an understanding of the internal controls relevant to the audit objectives and test controls on which they expect to rely. The assurance derived from the assessment of internal controls will assist the auditors to determine the confidence level and hence, the extent of audit procedures to perform. This would also determine the sample size of implementing units to be selected as well as the sample selection of transactions etc.

Materiality

4.11 Materiality consists of both quantitative and qualitative factors. Materiality is often considered in terms of monetary value but the inherent nature or characteristics of an item or group of items may also render a matter material. As mentioned in Chapter 2, determining materiality is a matter of professional judgement and depends on the auditor's interpretation of the users' needs. A matter can be judged material if knowledge of it is likely to influence the decisions of the intended users. The CAG's Regulations on Audit and Accounts, 2007 state that in formulating audit opinion or report, the auditor should inter-alia give due regard to the materiality of the matter keeping in view the amount, nature and context. In performing compliance audits, materiality is determined for

a) Planning purposes;
b) Purposes of evaluating the evidence obtained and the effects of identified instances of non-compliance; and
c) Purposes of reporting the results of the audit work

4.12 During the planning process, information is gathered about the entity in order to assess risk and establish materiality levels for designing audit procedures. Issues that may be considered material even if the monetary value is not significant would include the following:

a) Fraud;
b) Intentional unlawful acts or non-compliance;
c) Incorrect or incomplete information to executive, the auditor or to the legislature (concealment);
d) Intentional disregard to the executive, authoritative bodies or auditors; and
e) Events and transactions made despite knowledge of the lack of legal basis to carry out the particular event or transaction.

Risk assessment

4.13 Risk assessment is an essential part of performing a compliance audit. Due to the inherent limitations of an audit, a compliance audit does not provide a guarantee or absolute assurance that all instances of non-compliance will be detected. Inherent limitations in a compliance audit may include factors such as:

a) Judgement may be applied by the executive in interpreting laws and regulations;
b) Human errors;
c) Systems may be improperly designed or function ineffectively;
d) Controls may be circumvented; and
e) Evidence may be concealed or withheld

4.14 In performing compliance audits, auditors assess risks and perform audit procedures as necessary throughout the audit process. This is done in order to reduce audit risk to an acceptably low level in the particular circumstances, so as to obtain reasonable assurance to form the basis for the auditor's conclusions. The risks and the factors that may give rise to such risks will vary depending on the particular subject matter and circumstances of audit. Results of the risk assessment would again affect the sampling considerations.

Risk assessment considerations with regard to fraud

4.15 As a part of audit, auditors should identify and assess fraud risk and gather sufficient appropriate evidence related to the identified fraud risks by performing suitable audit procedures. As mentioned in Chapter 2, while detecting fraud is not the main objective of compliance audit, auditors should include fraud risk factors in their risk assessments and remain alert to indications of fraud when carrying out their work. If the auditor comes across instances of non-compliance which may be indicative of fraud, the auditor should exercise due professional care and caution so as not to interfere with any future legal proceedings or investigations.

4.16 **Planning audit procedures**

Planning audit procedures involves designing audit procedures to respond to the identified risks of non-compliance. The exact nature, timing and extent of audit procedures to be performed may vary widely from one audit to another. Nonetheless, compliance audit procedures in general involve establishing the

relevant criteria and then measuring the relevant subject matter information against such criteria.

4.17 After determination of the scope of audit, development of audit objectives, identification of relevant criteria for measuring the selected subject matters, when specifically selected for an apex auditable entity or across auditable entities, both for regularity and propriety issues, auditors should prepare a **Compliance Audit Design Matrix** for the identified apex Auditable entity in the following format.

Compliance Audit Design Matrix

Audit objective/Sub objective	**Audit questions on selected subject matters**	**Audit criteria**	**Data collection and analysis method**	**Audit evidence**

4.18 The Compliance Audit Plan would detail out the selected Apex Auditable Entity, the selected Audit Units and the Implementing Units. However, the selection of sample of transactions within the audit units may be necessary for detailed scrutiny. When compliance audit is planned and conducted based on a top down and department centric approach, sampling for selection of transactions may have to be conducted at multiple levels. This multi stage sampling typically involves the following:

- Selection of transactions from the selected Audit Units falling directly under the chain of command of the selected Apex Auditable Entity (either in whole or in part depending upon the selected specific subject matter) relevant to evaluation of the selected subject matters for regularity and propriety audits respectively; and
- Selection of transactions from the Implementing Units, as considered necessary, relevant to evaluation of the selected subject matters for regularity and propriety audits respectively.

4.19 Statistical sampling may be adopted for selection of transactions, which would enhance the level of verifiable audit assurance. Accountants General may exercise professional judgement with regard to adoption of a suitable sampling methodology depending upon the selected subject matters, audit objectives being pursued and the envisaged scope of audit, as per extant instructions.

Compliance auditing in digital environment

4.20 In case of departments/ sectors where e-governance has taken roots and transactions are being conducted in virtualised environments, digital auditing can also be adopted by the audit teams. Digital auditing facilitates looking at whole of

the population for outliers or unexpected variations. Such outliers can be taken up for detailed scrutiny. Data analytical tools can be of immense help here.

Team composition

4.21 Audit team(s) with an appropriate team composition should be constituted for each audit. As mentioned in Chapter 2, the audit team should collectively possess the knowledge, skills and expertise necessary to successfully complete the audit. This includes an understanding and practical experience of the type of audit being undertaken, familiarity with the applicable standards and authorities, an understanding of the auditable entity's operations and the ability and experience to exercise professional judgement. The work allocation for each member of the audit team should be clearly delineated and it must be ensured that each member understands his/her role in the audit team. Appropriate arrangements should be ensured for providing direction, supervision and review of audit teams. In some cases, it may be possible to conduct the audit of the apex auditable entity and its selected audit units by one dedicated team. However, in case of large entities, it may become necessary to constitute multiple teams for audit of the apex auditable entity and its selected audit units. In such a scenario, a lead team may be constituted from amongst the audit teams, which should be entrusted with the responsibility of providing a cohesive and synergised approach to compliance audit. The lead team in such cases may also be required to provide guidance, liaison support to other teams throughout the audit process and also consolidate audit findings of all other audit teams to enable achieving a holistic analysis and a reasoned conclusion.

Intimation to the auditable entity

4.22 After the overall strategy and audit plan as discussed above have been drawn up intimation should be provided to the identified auditable entity (executive) and all other audit units down the line regarding the audit being taken up. The intimation to the executive should include the scope of audit, audit objectives being pursued, subject matters that have been selected, criteria that would be used to evaluate the subject matters, designed sampling of audit units /implementing units. The intimation should indicate the composition of audit team(s), duration and schedule of audit and should solicit the requirements from and co-operation of the executive for the smooth conduct of audit.

5. Conducting compliance audits

5.1 Conduct of audits start after the finalisation of audit strategy and audit plan. Conduct of audits is about gathering evidence, evaluating evidence, forming conclusions, documenting the audit process and communicating with the auditable entities.

Audit evidence

5.2 Audit evidence is the information used by the auditor for arriving at the audit conclusions. Auditors design and apply appropriate audit procedures to obtain sufficient and appropriate audit evidence in order to form a conclusion or opinion as to whether a subject matter complies, in all material respects, with established criteria.

> ***The CAG's Regulations on Audit and Accounts, 2007 state that the auditor shall verify compliance with applicable laws, rules and regulations and highlight deviations, if any (Regulation 29(4)). Further, the auditor has to obtain competent, relevant and reasonable evidence to support his/her judgement as well as conclusions regarding the organisation, programme, activity or function under audit (Regulation 168).***

5.3 In the planning phase, as mentioned in Chapter 4 (para 4.10) auditors review the internal controls and institutional arrangements established by the auditable entity to prevent, detect, and rectify instances of noncompliance. Based on this review auditors identify control risks and other risks and keep these in consideration while they start gathering audit evidence. The audit procedures to be applied would depend on the particular subject matter and criteria and auditors' professional judgment. When the risks of noncompliance are significant and auditors plan to rely on the controls in place, such controls are required to be tested. When controls are not considered reliable, auditors plan and perform substantive procedures to respond to the identified risks. Auditors perform additional substantive procedures when there are significant risks of non-compliance.

5.4 The compliance auditor will often need to combine and compare evidence from different sources in order to meet the requirements for sufficiency and appropriateness of audit evidence. Professional judgment needs to be exercised in considering the quantity and quality of available evidence when performing the engagement, in particular when determining the nature, timing and extent of procedures.

Sufficiency and appropriateness of audit evidence:

5.5 The sufficiency and appropriateness of evidence are interrelated**.** Sufficiency is the measure of the quantity of evidence. The quantity of evidence needed is affected by the risks of the subject matter information being non-compliant or prone to compliance deviation (i.e. the higher the risks, the more evidence is likely to be required) and also by the quality of such evidence (i.e. the higher the quality, the less may be required). Obtaining more evidence, however, may not compensate for its poor quality. In assessing the sufficiency of evidence, the auditor needs to determine whether enough evidence has been obtained to persuade the intended users that the findings are reasonable. The need for further evidence is weighed against the cost and time needed to collect it.

5.6 Appropriateness is the measure of the quality of evidence; that is its relevance, its validity and its reliability in providing support for the auditor's conclusion.

- Relevance refers to the extent to which the evidence has a logical relationship with, and importance to, the issue being addressed;
- Validity refers to the extent to which the evidence is a meaningful or reasonable basis for measuring what is being evaluated. In other words, validity refers to the extent to which the evidence represents what it is purported to represent; and
- Reliability refers to the extent to which the evidence is consistent when measured or tested and includes the concepts of being verifiable or supported. The reliability of evidence is influenced by its source and by its nature. While recognising that exceptions may exist, the following generalisations about reliability of evidence are useful, when:
  - It is obtained from sources outside the responsible party;
  - It is obtained directly by the auditor e.g. by observation, inquiry and verification of the application of a control, by substantive checks;
  - It exists in documentary form whether paper, electronic or other media; and
  - It is obtained from different sources.

5.7 The auditor's professional judgment as to what constitutes sufficient and appropriate evidence is influenced by factors as the following:

- Significance of a potential non-compliance or compliance deviation and the likelihood of its having a material effect, individually or when aggregated with other potential non-compliance, on the subject matter information;
- Effectiveness of the responsible party's responses to address the known risk of noncompliance or compliance deviations;
- Experience gained during previous audit with respect to similar potential non-compliance or compliance deviation; and

- Results of procedures performed, including whether such procedures identified specific noncompliance or compliance deviation.

Gathering and Evaluating Evidence

5.8 The evidence gathering and evaluation is a simultaneous, systematic and an iterative process and involves:

a) Gathering evidence by performing appropriate audit procedures
b) Evaluating the evidence obtained as to its sufficiency (quantity) and appropriateness (quality)
c) Re-assessing risk and gathering further evidence as necessary

5.9 The evidence gathering and evaluation process should continue until the auditor is satisfied that sufficient and appropriate evidence exists to provide a basis for the auditors' conclusion.

Gathering Evidence

5.10 Audit evidence is gathered using a variety of techniques such as the following:

- **Document scrutiny -** This is the predominant mode of obtaining audit evidence and involves scrutiny of a wide variety of documents – Cabinet Notes, Expenditure Finance Committee minutes and recommendations, agenda and minutes of Board of Directors files, cash books and accounting records, reports etc.
- **Physical inspection/site visits-**This involves inspection of physical assets (eg a dam, road, bridge, stores and stock etc). Generally such inspection is conducted jointly with departmental personnel to ensure acceptability to the audit findings. Where the auditable entity does not co-operate with physical inspection, the fact of such non-cooperation may be appropriately documented and reported to the top management of the auditable entity, but the physical inspection may continue nevertheless by the audit team on its own. Photographs taken during physical inspection/site visits are an acceptable form of evidence, provided the location and date of photograph are amply clear.
- **Observation-**Observation involves looking at the process or procedure being performed. In performing compliance audit, this may include looking at how transactions are processed in real time by staff of the auditable entity, including processing of information and transactions in an IT system.
- **Questionnaires-** This involves seeking information from relevant persons within the auditable entity through issue of a formal questionnaire to elicit further information and gather relevant audit evidence.
- **Surveys-** This involves interaction with persons outside the auditable entity to get the information from the affected parties or the beneficiaries of programmes/ schemes, as the case may be. This would involve careful selection of the survey sample, formulation of an appropriate survey questionnaire, collation and analysis of the survey responses. Evidence gathered from surveys

would be corroborative in nature to support evidence gathered by conventional techniques.

- **Confirmation -** Confirmation is a type of inquiry and involves obtaining, independently of the auditable entity, a reply from a third party with regard to some particular information – for example confirmation of balances from the banks.
- **Re-performance -** Re performance involves independently carrying out the same procedures which have already been performed by the auditable entity. This can be carried out either manually or by computer assisted audit techniques. Where highly technical matters are involved experts may be involved for re-performance.
- **Analytical procedures -** Analytical procedures involve comparing data, or investigating fluctuations or relationships that appear inconsistent. Data analytics tools, statistical techniques or other mathematical models could also be used in comparing actual with expected results.

Evaluation of Evidence

5.11 Audit evidence, collected through above mentioned audit procedures, is to be evaluated against the relevant, already identified criteria. This involves consideration of evidence collected vis-à-vis the subject matter information as well as the written responses obtained from responsible officers of the auditable entity against the applicable criteria. The evaluation process enables auditors to assess whether the subject matter information is, in all material aspects, compliant with the identified criteria.

What constitutes material non-compliance is a matter of professional judgement and includes consideration of the circumstances, quantitative and qualitative aspects of the transactions or the issues concerned. Auditors consider a number of factors in applying professional judgement to determine whether or not the non-compliance is material. Such factors may include the following:

- Extent and importance of amounts involved, which include both monetary values and other quantitative measures;
- Nature of the non-compliance;
- Cause leading to the non-compliance;
- Possible effects and consequences of the non-compliance;
- Visibility and sensitivity of the program in question; and
- Needs and expectations of the legislature, public and other users of audit reports

5.12 After evaluating the evidence and considering its materiality, the auditor should decide how best to conclude in the light of the evidence collected, which would be the supporting key documents and arrive at audit conclusions. While evaluating evidence auditors can find that audit evidence is conflicting i.e. while some evidence supports the subject matter information other evidences seem to contradict it. In

such situations, auditors need to weigh the extent and credibility of conflicting evidence in order to reach a conclusion or collect more evidence to resolve the conflict.

5.13 Audit conclusion should clearly bring out the nature and extent of non-compliance, cause of such non-compliance, its materiality and also the effect of non-compliance, if possible. The audit conclusions in case of regularity issues should also indicate whether non-compliance is a solitary one-off case, or wide spread systemic issue in the auditable entity.

5.14 Auditors are encouraged to prepare an Audit Findings matrix in the following format. The Audit Findings matrix is an extension of audit design matrix as discussed in para 4.17. The Audit Findings matrix is intended to provide a link between the audit objectives, criteria, evidence gathered and evaluated and the audit findings that emerged on evaluation of the selected subject matters, if specifically selected, both for regularity and propriety issues. This should include all findings - both positive and negative findings. The Audit Findings Matrix has to be prepared for each audit unit.

Audit Findings Matrix				
Audit objective /Sub objective	**Audit questions on selected subject matters**	**Criteria**	**Audit Evidence**	**Conclusions**

Documentation

5.15 Documentation of audit evidence supports audit conclusions and confirms that the audit was carried out in accordance with relevant standards. CAGs Auditing Standards on Audit evidence state that

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

5.16 The **Standards** further add that **"**Adequate documentation is important for several reasons. It will

- confirm and support the auditor's opinion and report;
- increase the efficiency and effectiveness of audit;
- serve as a source of information for preparing reports or answering any; enquiries from the auditable entity or from any other party;
- serve as evidence of the auditor's compliance with Auditing Standards;
- facilitate planning ad supervision; and
- provide evidence of work done for future reference**"**

5.17 Documentation should take place throughout the entire audit process. The confidentiality of documentation should be maintained and they should be retained for a period sufficient to meet the professional, legislative and legal requirements as mentioned in para 2.8 of Chapter 2 of the guidelines.

5.18 Documentation in compliance audits should comprise

(a) Audit file and

(b) Working papers.

The Audit file for each compliance audit may include documentation relating to the audit strategy, scope and methodology, sample selection, nature and timing of planned audit procedures, audit design matrix, supervision and monitoring the progress and quality of audit, audit findings matrix, conclusions reached and the significant professional judgements made in reaching those conclusions. Audit file may also include discussions of significant matters with management, those charged with governance and others.

Audit file, maintained in one or more folders or other storage media in physical or electronic form, therefore contains documents that summarises the specific compliance audit engagement. Audit file should be properly indexed, referenced with and supplemented by the set of working papers.

Working papers for each compliance audit comprise of all documents collected during the field audit process. They include the documents relating to the nature timing and extent of audit procedures that were performed by individual members of the audit team, details of contracts/ agreements that were examined etc, evidences that were gathered, evaluation of evidences, consideration of written responses from responsible officials of the auditable entities, supporting key documents and the process of arriving at the results of audit procedures – audit findings and conclusions. The working papers could also be in one or more folders and should be similarly indexed and referenced. Working papers serve as a link between the field work and the audit report and should therefore be complete and appropriately detailed to provide a clear trail of audit.

5.19 Some of the broad characteristics of working papers are set out below:

- Completeness and accuracy: Provide support to audit conclusions.
- Clarity and conciseness: Facilitates understanding the entire audit process without need for any supplementary examination.
- Legibility and neatness : Applies particularly to photocopies.
- Relevance: Working papers should be restricted to matters, which are important, pertinent and useful for the intended purpose.
- Ease of reference: Working papers may be organised in volumes in a manner that facilitates easy reference. An omnibus, easy to follow, index may be created for all the volumes with a proper narration to broadly explain their contents. Each of the volumes may further be internally indexed.

- Ease of review: Working papers should contain cross references to audit memoranda, discussion papers, audit observations, field audit report and the compliance audit report as the case may be to enable Accountants General and supervisory officers to link the working papers to audit findings and conclusions.
- Complete audit trail of analysis: Working papers should provide a complete trail of the audit procedures performed, evidence that were gathered and evaluated, audit findings and conclusions that were drawn. This should contain evidence for positive findings as well.
- Documentation of significant audit findings.

Communication with the auditable entity

5.20 Good communication with the auditable entity throughout the audit process will help make the process more effective and constructive. Communication takes place at various levels and at various stages – during initial planning, conduct of audit and reporting as mentioned in para 2.9 of Chapter 2 of this guidelines, which should be retained for future reference. During planning phase –the audit strategy, suitable audit criteria and other elements of planning should be discussed with the appropriate level of management and those charged with governance. Regular interaction needs to be maintained throughout the audit conduct phase – to make enquiries of relevant persons, communicate any significant difficulties being encountered in audit and significant instances of non-compliance to the appropriate level of management or to those charged with governance.

5.21 Audit teams should also hold entry meeting(s) with the heads of audit units before the commencement of audit. During these meetings, the audit team should explain the purpose, objectives of audit, timelines and cooperation expected from the head of the audit unit. Similarly at the close of audit, the audit team leader or the Group officer in charge should also hold an exit meeting with the officer in charge of the audit unit to discuss the audit findings and request responses. The minutes of the exit meeting should be prepared and shared with the audit unit and acknowledgement requested.

5.22 If auditors come across instances of non-compliance, which may be indicative of unlawful acts or fraud, due professional care and caution needs to be exercised so as not to interfere with the potential future legal proceedings or investigations and respond appropriately as mentioned in para 2.15 of Chapter 2 of the guidelines. Auditors may communicate their findings to the appropriate level of Management or to those charged with governance and then follow up to ascertain whether appropriate action has been taken.

6. Reporting compliance audits

CAG's Regulations on Audit and Accounts, 2007 (Regulation 205) state that the form, content and time of submission of audit reports shall be decided by the CAG.

6.1 Reporting is an essential part of any audit as through this process the results of audit are presented to the intended users on the responsible party's compliance with the stated criteria. Compliance audits involve reporting the deviations from the applicable criteria and violations of the applicable rules, regulations etc., so that corrective actions may be taken, and those responsible for such deviations or violations could be held accountable for their actions.

6.2 Auditors should consider materiality for reporting purposes and adhere to the principles of completeness, objectivity, timeliness and contradictory process while reporting.

- The principle of completeness requires the auditor to consider all relevant audit evidence before issuing a report;
- The principle of objectivity requires the auditor to apply professional judgement and scepticism in order to ensure that all reports are factually correct and that findings or conclusions are presented in a relevant and balanced manner;
- The principle of timeliness implies preparing the report in due time; and
- The principle of a contradictory process implies checking the accuracy of facts with the apex auditable entity and incorporating responses from responsible officials as appropriate.

Forms and Content of Reports

6.3 The top down, risk based approach to conducting compliance audit, as described in earlier chapters, is envisaged to provide a department centric view of the extent of compliance. As the compliance audit involves evaluation of both regularity and propriety aspects, as discussed in earlier chapters, Auditors are required to report results of audit on both these aspects. The audit findings on the selected specific subject matter are to be relied upon for providing the audit conclusion on the extent of compliance. Other audit findings noticed during the conduct of audit are to be reported separately.

As the compliance audit is conducted at various levels of the organisational hierarchy and needs to be reported to the responsible party, those charged with governance, and the legislature, the form of reports to present compliance audit findings and conclusion would have to address these perspectives. Therefore, Auditors shall present the results of compliance audit in the following reports.

- **Inspection Report**

- **Departmental Appreciation Note**[6]
- **Compliance Audit Report**

Inspection Reports[7]

6.4 On completion of audit, an Inspection Report presenting all the findings – both positive and negative – shall be issued within 30 days of completion of audit to each of the selected Audit Units with a copy to the corresponding next higher level in the organisational hierarchy and to the lead team if constituted. The findings pertaining to implementing units shall be included in the Inspection Report of the respective Audit Units. A period of four weeks may be allowed to the Audit Units to provide responses to the audit findings contained in the Inspection Report.

6.5 The Inspection Report of an audit unit should provide a perspective of the unit level compliance and may comprise the following parts:

- **Part I** – **Introduction**- This part may commence with an overview of the audit unit and may provide its functional/geographical jurisdiction, budget, financial performance and a perspective of the relative significance of the unit in the overall hierarchy of the department in pursuit of organisational goals. This may be followed by a brief explanation of the scope of audit, the sampling procedure followed and the audit sample – including the implementing units, the subject matter(s) selected and the sources of criteria that have been adopted to evaluate the selected subject matter(s). It may indicate that the audit has been conducted in accordance with the applicable Auditing Standards of CAG.

  Part II – Audit findings–This part shall contain all findings – both positive and negative findings that pertain to the audit unit and may be arranged in two distinct parts - Part IIA and IIB - the first part comprising significant audit findings relating to evaluation of the regularity related subject matter(s)/ specific subject matter(s) and propriety related subject matters and the second part – IIB comprising other incidental findings relating to both regularity and propriety aspects. The audit findings should be organised in decreasing order of materiality and significance, if possible.

  Presentation of audit findings shall conform to the Auditing Standards and other reporting principles enunciated in this chapter and clearly bring out the applied criteria, the results of evaluation of the subject matter against the criteria highlighting the cause and effect relationship. Audit findings may also appropriately indicate the extent of non-compliance and whether they involve systemic issues or represent isolated cases of non-compliance.

[6] Where considered necessary

[7] Even though compliance audits conducted in accordance with these guidelines are not in the nature of an inspection, the existing terminology of Inspection Report is continued because of its historical import.

- **Part III – Follow up on findings outstanding from previous reports**–This part may indicate the progress of settlement of audit findings outstanding from previous Inspection Reports and list out the findings that continue to be outstanding.
- **Part IV– Best practices –** Any good practices or innovations, if noticed, during the course of audit may be mentioned.
- **Part V – Acknowledgement**– This part may contain the acknowledgement of the extent of audit units' cooperation in all matters including production of records called for in Audit. It may also contain details of persons holding the leadership positions in the audit units.

6.6 The responsibility of drafting the Inspection Reports shall vest with the respective audit team and that of review and approval with the respective Group Officer in field offices.

Departmental Appreciation Note

6.7 A Departmental Appreciation Note may be issued to the Apex Auditable Entity (Department/ Sector) where a specific subject matter has been selected to assess the extent of compliance from a departmental perspective or the Accountant General intends to draw attention of the executive towards system weaknesses etc. A consolidation of audit findings presented through the Departmental Appreciation Note would enable appreciation of both the audit findings that form the basis for Auditor's conclusion on compliance by departments as well as the audit findings that would feature as standalone findings. The Departmental Appreciation Note shall be issued to the Head of the Department typically the Principal Secretary, for initiating remedial measures with a copy provided for information to the Secretary Finance, Chief Secretary - the next higher level charged with governance and to Headquarters Office.

6.8 The Departmental Appreciation Note may comprise the following features:

Title: Departmental Appreciation Note on compliance audit of (name of the Apex Auditable entity)

Introduction: This part may commence with a broad overview of the Department, the organisational goals, governance structure, jurisdiction, and challenges of the Department, financial and operational performance, which may be followed by a broad description of the high risk areas and the related internal controls to enable the responsible party/intended users to appreciate the factors that were considered by auditors while selecting the area for compliance audit during the year.

Objectives and scope: A brief explanation of the objectives and scope of audit should be provided.

Audit findings: This part shall contain all significant audit findings – both positive and negative findings aggregated from all audit units and may be arranged in two distinct sections – the first section comprising audit findings relating to evaluation of the

selected subject matter(s), and the second section comprising audit findings on other subject matters and other incidental findings

These findings may be organised in decreasing order of materiality and significance. The audit findings included in the Departmental Appreciation Note, which could potentially feature in the next level of reporting through the Compliance Audit Report (discussed in para 6.10 to 6.12 below) should be clearly indicated to the responsible party.

Conclusion: Depending upon the extent and pervasiveness of compliance of the selected subject matter observed during audit, auditors may provide conclusion of compliance of the selected subject matter with the applied criteria. Further based on the veracity and pervasiveness of findings relating to adherence of sound financial management principles and ethical conduct and other findings, Auditors may conclude, as appropriate, on the efficiency and effectiveness of internal controls in the areas audited.

Acknowledgement: This part may contain acknowledgement of the extent of Department's cooperation in all matters including production of records.

6.9 The responsibility of drafting the Departmental Appreciation Note may vest with the Audit team and that of approval with the Accountant General in field offices. In cases where multiple teams were deployed for audit of an Apex Auditable Entity and a lead team has been identified for conduct of compliance audit, lead team may draft and finalise the Departmental Appreciation Note, for approval by the respective Accountant General.

Compliance Audit Report

6.10 The Compliance Audit Report represents the last phase of reporting the results of compliance audits and shall feature significant audit findings which require the attention of the legislature and other intended users including the public at large. Presently, the significant audit findings that could potentially feature in the Compliance Audit Report are communicated to the Apex Auditable Entity by issuing Draft Paragraphs and/or Statement of Facts. The significant audit findings would therefore emerge from the Inspection Reports, Draft paragraphs, Statement of Facts and from the Departmental Appreciation Notes containing conclusion if any on a specific subject matter, which shall be carried forward for reporting in the form of a Compliance Audit Report of the CAG of India.

To ensure objectivity of the audit findings and conclusions of the Compliance Audit Report, confirmation of facts and figures by the Apex Auditable Entity and incorporation of responses of the responsible party is very crucial. Auditors shall therefore ensure that facts and figures are accepted by the Apex Auditable entity and shall pursue responses from the Apex Auditable Entity.

6.11 The responsibility of preparing and ensuring the quality of the Compliance Audit Report before it is submitted to CAG for approval would be with the head of the field audit office.

6.12 The Compliance Audit Report could be brought out as a separate Audit Report or alternatively could be included as distinct Chapter(s) in a consolidated Report with findings of other types of audit. The decision with regard to the manner of featuring the compliance audit report shall vest with the respective DAI/ADAI.

Follow up

6.13 A follow up process facilitates the effective implementation of corrective actions and provides useful feedback to the Apex Auditable Entity/ audit units and at the same time facilitates the auditors to plan future audits. The need for follow up will vary with the nature of non-compliance and the particular circumstances. While some findings pointing out deviations from authorities and violations of principles of sound financial management may have to be followed up at the audit unit level the audit findings warranting systemic changes may have to be followed at higher levels of the organisational hierarchy. Further some findings may be fully/partially accepted by the apex auditable entity/ audit units while there may be findings that have not been accepted by the apex auditable entity/ audit units.

6.14 The following process shall be adopted by field offices for follow up of audit findings and conclusions included in the Inspection Report and the Compliance Audit Report:

Inspection Report

The outstanding paragraphs of previous Inspection Reports shall be reviewed during the conduct of audit and their status included in the current Inspection Report as envisaged in para 6.5 above. The responses to paragraphs included in the Inspection Report shall be pursued by regular reminders to the respective audit units. There shall be a regular interaction with the Departmental Audit Committees[8] to review and settle old paragraphs as per extant orders.

Compliance Audit Report

The receipt of explanatory notes/ Action Taken Notes (ATNs) to the paragraphs that have appeared in the Compliance Audit Reports shall be monitored in all field offices and Heads of Department shall be impressed upon to send explanatory notes/ATNs within the prescribed time frame as per extant orders.

Accountants General may encourage the Heads of Department to send suo moto replies to all observations which have appeared in the Compliance Audit Reports but have not been discussed by the Public Accounts Committee/Committee on Public Undertakings.

[8] Departmental Audit Committees are constituted in all Departments of the Government headed by the Secretaries of the respective Departments