6. THE AUDIT CYCLE

6.1 Introduction

Every audit assignment must be properly planned. The auditor has a professional duty to undertake each audit in a manner that ensures reliable and meaningful conclusions, which in turn lead to practical and useful audit recommendations. The auditor must therefore collect appropriate and sufficient evidence to arrive at such conclusions and recommendations. The efficient and effective collection of evidence depends on a clear audit plan. This audit plan should include a well-developed audit programme.

The audit plan should include:

- A clear statement of the audit objective(s);
- Statement of the magnitude of operations (expenditures, revenues, assets, personnel) and for an attest audit, the significant line items and accounts in the financial statements and significant financial statement assertions;
- Summary of significant issues and results of an initial risk assessment;
- Proposed audit scope, including:
  - Type(s) of audit activity (attest, compliance, effectiveness of internal controls, safeguarding of assets, fraud investigation, value-for-money, IT systems, or some combination thereof);
  - locations to be visited;
  - functions, activities, systems and procedures to be examined;
  - aspects of performance to be covered;
  - audit methods and tests; and
  - samples selected or methods of selecting samples;
- Budget and schedule;
- Audit steps; and
- Assigned audit responsibilities.

DAGP audit teams should plan to perform audits that encompass both financial attest and compliance components. These two audit components have much in common. Each requires the auditor to:

- Understand the audit entity;
- Conduct a risk assessment;
- Define audit objectives and scope;
- Develop an audit programme
- Test the controls;
- Determine sample size (for statistical or non-statistical);
- Conduct substantive tests;
- Report; and
- Follow up.

The audit cycle for an individual audit involves planning the audit, conducting the work, evaluating the results of the work, reporting the results of the work, and following up to see what the entity has done as a result of the work. (Sometimes the follow up is conducted as the first phase of the next audit of the entity, where the auditor determines what changes have occurred since the previous audit).

This Chapter describes the audit cycle for an individual audit performed in accordance with DAGP's auditing standards. This Chapter also summarises the work that is performed at each phase of the cycle. This material is expanded upon in subsequent Chapters of this Manual.

The audit cycle is shown in Figure 6.1. It contains six basic phases:

1. General audit planning;
2. Detailed activity and resource planning;
3. Fieldwork;
4. Evaluation;
5. Reporting; and
6. Follow-up.

These phases are discussed in more detail below.

Because many financial statement audits are performed every year, much of the general and detailed planning for these audit activities will be limited to updating the planning decisions made in the previous year to reflect changes to the entity or desired changes to the audit approach. There will rarely be a need to start from scratch.

Changes to the audit approach will normally have been identified at the end of the previous year's audit. The auditors will have identified significant issues that need to be revisited in the next audit, as well as areas requiring less audit effort, such as where the internal controls were found to be strong, allowing more reliance to be placed upon them. At that time, the auditors would have assessed the overall efficiency and effectiveness of their audit, and identified possible ways in which the efficiency and effectiveness could be improved. This process could include analysing the feedback obtained from entity officials, the PAC, and the media.

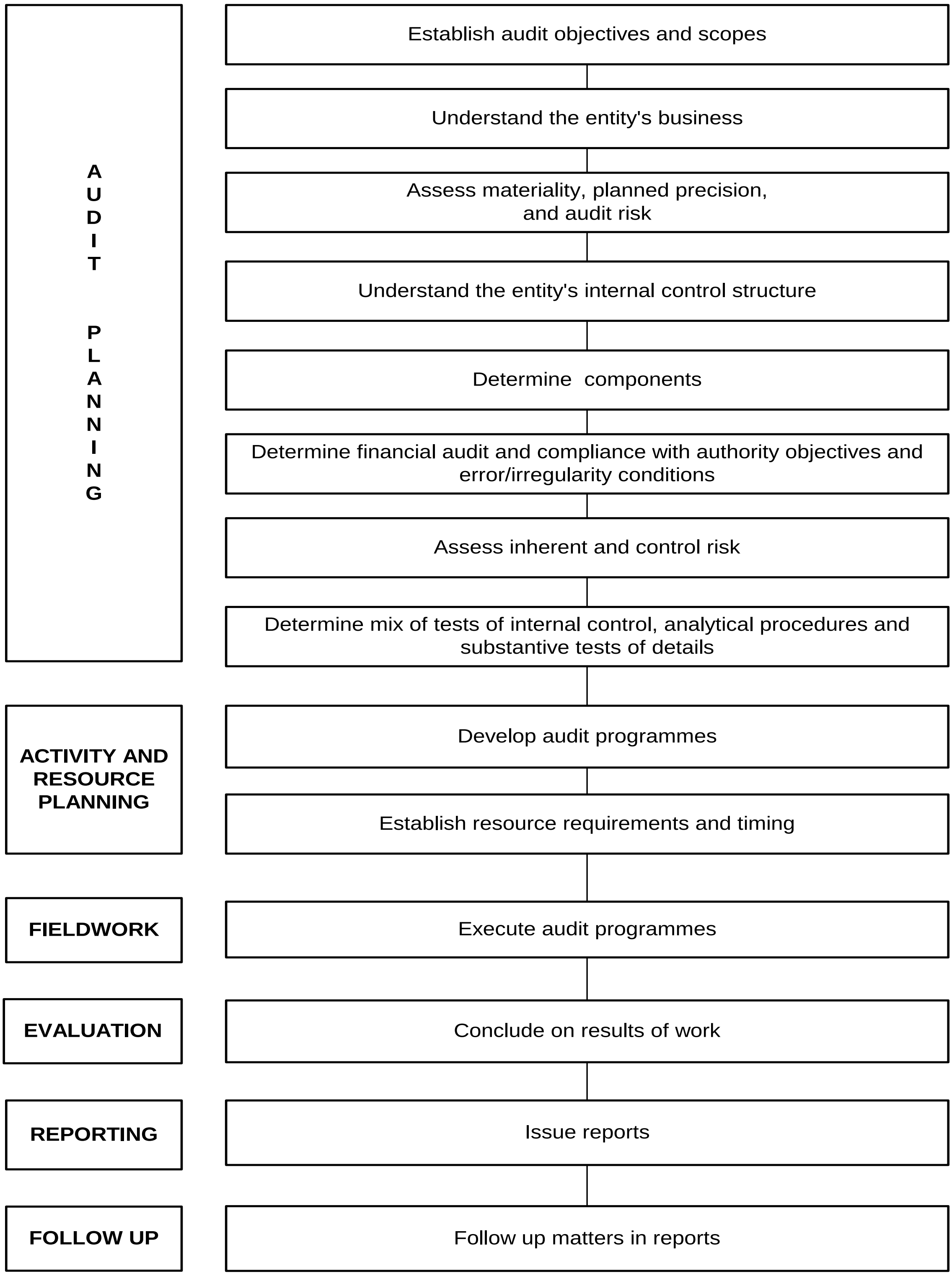
Audit management (providing advice, supervising, reviewing, approving, etc.) is not listed as a separate step in the audit cycle. This is because these activities need to occur throughout each phase of the process.

Creating good relations with entity officials is key to achieving an effective and efficient audit. The progress and outcomes of an audit will be enhanced if the audit team can obtain the cooperation of management and foster confidence by maintaining a fully professional approach during the course of the audit.

It is important for the auditor to avoid creating an adversarial relationship with entity officials. To facilitate good relations the auditor should:

- Be fully aware of all other audit activities being undertaken;
- Plan to minimise impact on the audit entity; and,
- Ensure that all discussions with entity officials take place at an appropriate and reasonable level, and at an appropriate and reasonable time.

Figure 6.1: Audit Cycle for Individual Audits



6.2 General audit planning

The general audit planning phase is where most key planning decisions are made. It involves:

Step 1 Establish audit objectives and scope;

Step 2 Understand the entity's business;

Step 3 Assess materiality, planned precision and audit risk;

Step 4 Understand the entity's internal control structure;

Step 5 Determine components;

Step 6 Determine financial audit and compliance with authority objectives, and error/irregularity conditions;

Step 7 Assess inherent risk and control risk; and

Step 8 Determine mix of tests of internal control, analytical procedures and substantive tests of details.

These steps are introduced below, and are discussed in more detail in the next Chapter.

Step 1 – Establish overall audit objectives and scope

The audit objective should be a clear statement of what the auditor intends to examine and what is to be achieved by the audit. There should be clear audit objectives for every assertion, for each financial statement component and for each audit area to be examined.

One or more audit objectives should be defined for each component of a financial audit and for each line of inquiry. The audit objective is a statement of what is to be achieved by the audit.

The audit scope is a statement of what areas will be looked at, what work must be done and what will not be done and the methodology to be used to achieve the audit objectives(s).

The auditor should update the audit plan to reflect the mix of financial certification and control and compliance objectives established for the current year.

The scope of the audit will reflect the audit entity. For audits that are required under Section 7 of the Auditor-General Ordinance, the entity to be audited will be defined by the applicable accounting policies of the government. For example, for an audit of the financial statements of the Federation, the entity to be audited would be all of the ministries, departments, agencies, etc. that the accounting policies require to be included in the financial statements of the Federation.

Step 2 – Understand entity's business

The auditor should assemble and review material that will enable the team to gain a sufficient knowledge of the business to assess materiality, determine components, identify error conditions, etc.

Step 3 – Assess materiality, planned precision, and audit risk

Materiality, planned precision and audit risk are key concepts when conducting an audit that will result in the Auditor-General expressing an opinion on the financial statements of an audit entity. The opinion paragraph of a standard unqualified auditor's report commences, "In my opinion, these financial statements properly present, in all material respects, the financial position of [the entity] …"

Materiality. When the Auditor-General states that the financial statements "properly present, in all material respects", he/she is stating that the financial statements are not materially misstated. An error (or the sum of the errors) is material if the error (or the sum of the errors) is big enough to influence the users of the financial statements. Therefore the auditor must determine what amount is considered material.

Planned precision. Planned precision is the auditor's planned allowance for further possible errors. To determine it, the auditor first estimates the most likely error that will exist in the financial statements as a whole. This estimate is referred to as the "expected aggregate error." The auditor then subtracts the expected aggregate error from the materiality amount to arrive at planned precision.

Audit risk. The opinion paragraph of the standard unqualified auditor's report begins "In my opinion …" This means that the auditor is not stating that he/she is absolutely certain that the financial statements "properly present in all material respects" (i.e., are not materially misstated). Rather, the auditor is stating that he/she has some degree of assurance that is less than 100% that the financial statements are not materially misstated. GAAS refers to this degree of assurance as "reasonable assurance".

The auditor should determine what level of confidence is required. If the auditor wants to be 95% confident that the financial statements are not materially misstated, this means that the auditor is prepared to take a 5% risk that he/she will fail to detect errors summing to more than the materiality amount. Audit risk in this case is therefore 5%.

Using a 5% audit risk and a Rs. 3,000,000 materiality amount, when the auditor states, "In my opinion, these financial statements present fairly, in all material respects …", the auditor is stating, "I have 95% assurance that the financial statements are not misstated by more than Rs. 3,000,000".

Step 4 – Understand entity's internal control structure

GAAS require the auditor to have an up-to-date understanding of the entity's internal control structure.

The required level of understanding depends on the extent to which the auditor intends to rely on the internal controls to reduce his/her substantive tests. Even when no reliance is intended, some knowledge is still required.

Step 5 – Determine components

Auditors normally do not plan audits for the financial statements as a whole. Rather, they divide the financial statements into parts and plan each part separately.

For an audit of financial statements, the most logical way of dividing up the financial statements is to consider each line item in the financial statements to be a separate component. Sometimes the financial statements include several different groupings of the same total amount. For example, expenditures may be grouped by:

- Organizational unit (the ministries, departments, agencies, etc. making up the reporting entity)
- Appropriation account;
- Economic function (general public services, defence affairs and services, etc.); and/or
- Object element (payroll expenditures, operating expenditures, civil works, etc.).

The auditor normally selects the grouping that makes it the easiest to plan, perform and evaluate the audit work.

If the financial statements group the expenditures by object element, the auditor might then plan the audit of each object element to obtain the desired assurance that errors in each object element do not sum to more than the materiality amount.

Step 6 – Determine financial audit and compliance with authority objectives, and error/irregularity conditions

Having divided the audit into components, the auditor needs to define attest and compliance objectives, as applicable, and define what is considered to be an error or irregularity.

Specific financial audit objectives. For a financial statement audit, a component is considered to be in error if:

- It is not valid (the asset or liability does not exist or the revenue or expenditure has not occurred) – the **existence** objective; or
- The statement of the asset, liability, revenue or expenditure is not complete – the **completeness** objective; or
- The asset is not owned by the entity, or the liability is not owed by the entity – the **regularity** objective; or
- The asset or liability is not properly valued or is misclassified, or the revenue or expenditure is not properly measured or is misclassified - the **valuation or measurement** objective; or
- The financial statement presentation is not proper – the **presentation** objective.

Related compliance with authority objectives. Section 3.4 of DAGP's auditing standards states, *"In conducting regularity (financial) audits, a test should be made of compliance with applicable laws and regulations."*

To comply with this standard, the auditor should test for compliance with those laws and regulations that are related to the audit of the financial statements.

The following compliance with authority objectives are considered to be applicable:

(a) **Spend**:
The services were performed or the goods received;

The expenditure was consistent with the nature of the appropriation to which it was charged;
The expenditure is in accordance with applicable legislation and the rules and regulations issued by such legislation; and
The expenditure does not result in the total approved expenditure being exceeded.

(b) **Borrow**:
The amount and debt terms (period, interest rates, repayment schedule, etc.) are in accordance with applicable legislation, and related rules and regulations.

(c) **Raise revenue**:
The cash received was for an approved tax or other approved source;
The cash received is in accordance with applicable legislation and associated rules and regulations.

Error conditions. The last part to this step is to consider error conditions. The idea here is to consider possible ways in which an asset, liability, revenue or expenditure might not be valid, complete, compliant with applicable authorities etc. Put another way, the idea is to think of possible ways in which a monetary error can occur in the financial statements and the ways in which monetary amounts may not be in accordance with applicable authorities.

For example, to apply the validity and measurement objectives to the component "payroll expenditures", the auditor should consider how payroll expenditures might not be complete.

There are many possible reasons why payroll expenditures might not be valid or properly measured. However the chance of some of them occurring might be negligible. Similarly, the maximum possible error that could result from some of them might be insignificant. The idea is to identify the errors that have a real chance of occurring, and that could be relatively large in relation to the materiality amount.

For the validity and measurement objectives, the auditor may identify four error conditions, as follows:

(a) Services paid for are not performed;

(b) Employees are being paid more or less than they should be paid;

(c) Payroll expenditures are being charged to an incorrect account or appropriation; and

(d) The amounts in the payroll register are not included in the financial statements at the correct amount.

In addition, the auditor might also identify the following compliance with authority matters:

(a) the work being performed was not properly approved;

(b) the payments were not properly approved.

The auditor should then develop audit procedures to determine whether any of the possible errors or deviations have occurred.

Step 7 – Assess inherent risk and control risk

Inherent risk. Inherent risk is the chance of material error occurring in the first place assuming that there are no internal controls in place. "Material error" may be a single error or the sum of multiple smaller errors.

Inherent risk is assessed at this stage as it determines how much testing of internal controls and substantive testing (analytical procedures and substantive tests of details) the auditor needs to perform in total to achieve his/her desired level of reasonable assurance (95% in our illustration).

Control risk. Control risk is the chance that the entity's internal controls will not prevent or detect material error. Again, "material error" may be one error or the sum of multiple smaller errors.

Control risk is assessed at this stage as it determines the amount of assurance that the auditor can obtain from his/her tests of internal control.

Step 8 – Determine mix of tests of internal control, analytical procedures and substantive tests of details

The auditor needs to select a combination of tests of internal control, analytical procedures and substantive tests of details that, in total, will provide the desired level of assurance that payroll expenditures are not incomplete by an amount greater than the materiality amount.

The auditor can obtain this assurance in a number of ways, for example by:

- reviewing the internal controls that the entity has in place to ensure the completeness of, using our payroll example, payroll expenditures, and then performing tests of internal control to ensure that the controls are functioning properly;
- performing such analytical procedures as comparing the payroll expenditures by month to each other and to the equivalent amounts in the previous year; and/or
- selecting a sample of payroll transactions and performing various substantive tests of details on those transactions.

These methods can be used in different combinations. For example the auditor can:

- Place a lot of reliance on the internal controls. Under this option, the auditor would perform a lot of tests of internal control, supplemented by only limited analytical procedures, and select a very small sample of payroll transactions for substantive tests of details; or,
- Place very little reliance on the internal controls. Under this option, the auditor would do fewer tests of internal control than in the first option, but would perform more rigorous analytical procedures or select a larger sample of payroll transactions for substantive tests of details.

When deciding which combination to use, the auditor should consider the cost of each combination in terms of audit resources.

6.3 Activity and Resource Planning

This phase primarily involves taking the decisions made during the general planning phase and using them to build the audit programmes that will be used during the fieldwork phase. It also involves establishing budgets, staffing requirements, the timing of the audit work, and the information to be obtained from the entity.

These steps are introduced below, and are discussed in more detail later.

Develop audit programmes

The audit programmes provide the auditor with a list of all the procedures to perform.

The auditor can use the error conditions identified during the general planning phase, or a previous audit programme for the entity, as a starting point for the development of the audit programmes.

The auditor should also determine what information the entity management are required to make available for the audit work.

Establish resource requirements and timing considerations

For each audit determine:

- the number of auditors with required level of seniority and skill sets;
- related out-of-pocket expense budgets; and,
- timing of the work.

The resource requirements are based on the audit programmes. Resource allocations from previous audits of the entity may provide a helpful starting point.

6.3.1 Fieldwork

During the fieldwork phase, the auditors complete the procedures that are contained in the audit programmes. The required evidence is gathered, and the work performed is documented in the working paper files.

Chapter 8 contains detailed guidance on this phase of the audit cycle.

6.3.2 Evaluation

During the evaluation phase, the results of the audit are summarised and conclusions are reached.

The auditor first concludes on the results of each test. The auditor then reaches a conclusion on each component. Finally, the auditor reaches a conclusion on the financial statements as a whole, or identifies specific irregularities and general systemic weaknesses based on compliance with authority tests.

Chapter 9 contains detailed guidance on this phase of the audit cycle.

6.3.3 Reporting

The reporting phase involves performing some final clearance procedures and issuing an audit certificate (opinion) on the financial statements. In this certificate, the auditor expresses an opinion as to whether:

(a) the financial statements properly present in all material respects, the entity's financial position, the results of its operations, its cash flows and its expenditure and receipts by appropriation; and,

(b) the sums expended have been applied, in all material respects, for the purposes authorised by Parliament, and have, in all material respects, been booked to the relevant grants and appropriations.

Often, the reporting phase also involves issuing other reports dealing with internal controls, compliance with authorities, and performance matters that were identified as part of a financial audit, or in separate audits. These matters can be reported in a management report or in one of the Auditor-General's reports to Parliament and the Public Accounts Committee.

Chapter 10 contains detailed guidance on this phase of the audit cycle.

6.3.4 Follow up

The follow-up phase involves returning to the entity at a later date to determine if entity management has:

- Corrected errors identified during the audit; and
- Implemented recommendations made by the auditors or by the Public Accounts Committee.

Chapter 11 contains detailed guidance on this phase of the audit cycle.

6.4 Roles and responsibilities

6.4.1 General roles and responsibilities

The general planning phase is where most of the key planning decisions are made. Many of these decisions have a significant impact on the nature, extent and timing of the work that is performed during the fieldwork phase. Because of this, general planning decisions should be made by the more senior and experienced members of the audit directorate.

Similarly, conclusions reached during the evaluation phase may have a significant impact on the type of audit report that is issued. The more senior and experienced members of the audit directorate also need to be directly involved in the evaluation process, and in the finalisation of the report.

It is not possible to lay down specific roles and responsibilities for all audits. Each audit is different – some are quite complex and difficult to plan and perform; others are relatively small and straightforward. In addition, there may be differences in the knowledge of the entity and audit skills possessed by different staff members within each directorate.

To encourage consistency, Figure 6.2 contains a chart that shows the suggested roles and responsibilities of individuals at each level, for the general tasks to be performed during the audit.

6.4.2 Centrally led audits

These are audits where a central team is responsible for the overall planning, performance, evaluation, reporting and follow up. An example of such an audit is the annual audit of the financial statements of the Federation.

With a centrally led audit, there will be a division of responsibilities between the central team and each directorate. For example, for the annual audit of the financial statements of the Federation, the central team is responsible for:

- Setting the basic planning parameters (materiality, planned precision, audit risk, components, etc.);
- Setting inherent risk, control risk, other substantive procedures risk and substantive test of details risk for each component and each specific financial audit objective and compliance with authority objective and error condition;
- Determining the optimum mix of tests of internal control, analytical procedures and substantive tests of details for each component and for each specific financial audit objective and related compliance with authority objective and error condition;
- Drafting the audit programmes, forms and checklists to be used by the audit teams performing the work;
- Performing the overall error evaluation; and
- Reporting the results of the audit.

The auditors from each of the directorates are, in turn, responsible for:

- Providing advice to assist the central team to plan the audit;
- Reviewing the material received from the central team to ensure audit programmes, forms and checklists reflect the optimum mix of tests for that particular directorate, and contain all the work required to obtain the required amount of overall assurance;
- Performing the audit work; and
- Reporting the results of the work, including individual errors and other matters of note, to the central team.

Regarding the above, the central team will likely not have the same detailed level of knowledge of a particular entity as the auditors from the applicable audit directorate. For example the central team may not be aware that the internal controls are weak and that the planned level of reliance on them is not possible. The auditors from the audit directorate must bring these matters to the attention of the central team and ensure necessary adjustments are made to the audit plan.

With a centrally led audit, some of the roles and responsibilities that, according to Figure 6.2, are to be performed by the Director General will be performed by the Director General responsible for the central team, while other roles and responsibilities will be performed by the Director General in charge of each directorate. The same applies to the other levels of staff shown in Figure 6.2.

To ensure that everyone is aware of their roles and responsibilities, the central team will provide a schedule similar to Figure 6.2 that clearly lays out the roles and responsibilities of individuals within the central team, and within each audit directorate.

Figure 6.2: Roles and Responsibilities

Step	**Auditor-General**	**DAG (Senior) or DAG**	**Director General**	**Director**	**Deputy Director or Asst. Director**	**Audit Officer**
General Planning						
Update overall audit objectives and audit scope		A(1)	R(1)	P		
Update understanding of entity's business		A(1)	R(1)	P		
Update assessment of materiality, planned precision, and audit risk		A(1)	R(1)	P		
Update understanding of the entity's internal control structure		A(1)	R(1)	P		
Update determination of components		A(1)	R(1)	P		

A = Approve R = Review S = Supervise
P = Responsible for performance of.

(1) The review and approval would be done through a review and approval of the permanent file, planning file, audit planning memorandum, audit programmes, etc. produced at the end of the planning process.

Step	**Auditor-General**	**DAG (Senior) or DAG**	**Director General**	**Director**	**Deputy Director or Asst. Director**	**Audit Officer**
Update determination of specific financial audit objectives, compliance with authority objectives and error conditions		A(1)	R(1)	P		
Update assessment of inherent risk and control risk		A(1)	R(1)	P		
Update optimum combination of procedures		A(1)	R(1)	P		
Detailed Planning						
Update audit programmes		A(1)	R(1)	S	P	
Update budgets, staffing requirements, timing considerations, etc.		A(1)	R(1)	S	P	
Fieldwork						
Complete audit programmes				R	S	P

A = Approve R = Review S = Supervise
P = Responsible for performance of.

(1) The review and approval would be done through a review and approval of the permanent file, planning file, audit planning memorandum, audit programmes, etc. produced at the end of the planning process.

Step	**Auditor-General**	**DAG (Senior) or DAG**	**Director General**	**Director**	**Deputy Director or Asst. Director**	**Audit Officer**
Evaluation						
Conclude on results of work			R	S	P	
Reporting						
• Audit Opinions	A(2)	A(2)	R	P		
• Audit Reports	A(2)	A(2)	R	P		
• Management reports			A	P		
Follow up						
Follow up matters in reports	(3)	(3)	(3)	(3)	(3)	(3)

A = Approve R = Review S = Supervise
P = Responsible for performance of.

(2) It is expected that the audit opinions and audit reports on the major entities would be approved by the Auditor-General; the other audit opinions and audit reports would be approved by the Deputy Auditor General (Senior) or a Deputy Auditor General.

(3) The roles and responsibilities would match those for the equivalent work performed during the audit itself.