9. CONDUCTING THE AUDIT

9.1 Introduction

By the end of the planning phase and after completing the detailed activity and resource planning work, the auditors will have updated the:

- Permanent file;
- Planning file;
- Audit planning memorandum;
- Audit programmes;
- Staffing requirements, and the staff to be assigned to each component of the audit;
- Budget requirements;
- Timing considerations; and
- List of information to be obtained from entity officials.

The auditors will use this information during the fieldwork stage to perform the audit work. In particular, the set of updated audit programmes selected for the audit will guide the detailed activities of the auditor. The following sections of this Chapter introduce the conceptual basis for the auditors' work of testing and sampling transactions, collecting and evaluating evidence, and maintaining working paper files.

9.2 Compliance Testing

In conducting the audit, the first step is to evaluate the effectiveness of internal controls. This is done through compliance testing. During the planning phase, the auditor will have assessed the appropriateness of internal controls and made an initial judgment as to the extent to which the auditor can rely on the internal controls when deciding on the sample sizes to take for detailed testing of transactions.

To determine how well internal controls are being applied, the auditor should test the controls with a sample of transactions. The sample taken for compliance testing will usually be part of the sample required for substantive testing (see later).

Generally, for compliance testing, basing the assumptions on a zero deviation (or error) rate and a tolerable rate of 5%, the auditor would take a sample size of between 30 and 60. Thus, with a sample size of, say, 45 items, if the auditor finds no errors, then the controls can be assessed as having a low control risk. If in this sample, one error is found, then the auditor can determine control risk is moderate. If, however, more than one error is found in the sample, the auditor cannot place much reliance on the controls (and therefore would increase the amount of substantive testing).

Compliance tests are designed to determine whether the controls are effective. Any significant misstatements or instances of non-compliance should lead the auditor to identify weaknesses in controls, report the specific weaknesses in the controls, consider the implications on the financial statements and reconsider the extent of reliance on the controls (and therefore the size of sample needed for direct testing of transactions).

A similar approach is taken to sampling and testing compliance with authorities, authorities being one specific type of internal control over the entity's operations.

9.3 Substantive Testing

For financial audit purposes, substantive testing is required to determine how much assurance can be placed on financial assertions. Some testing is by analysis and other procedures but most assurance is provided through detailed testing of sampled transactions.

9.3.1 Substantive Analysis

Substantive analysis is a means of deciding whether financial data appear reasonable and acceptable and therefore may allow the auditor to conduct less detailed testing of transactions. The extent of reliance on substantive analysis procedures depends on the following factors:

- Materiality of items involved in relation to the financial information taken as a whole (if the amount is high, the auditor does not rely on analytical procedures alone in forming an opinion);
- Other audit procedures relating to the same audit objectives;
- The likely level of precision and reliability that can be obtained from the analysis (for example, if the construction of a road is through uniform terrain, a unit cost per kilometre can be applied to provide a reasonable estimate of expected cost; however, such an analysis would not likely provide a reliable figure if the road is constructed through variable terrain of mountains and plains);
- Results of the evaluation of internal controls. If the internal controls are assessed as weak, more reliance should be placed on tests of detailed transactions than on analytical procedures.

9.3.2 Tests of Details

Tests of details are the application of one or more of the following audit techniques to individual transactions that make up an account balance:

- Recomputation;
- Confirmation;
- Inspection; and
- Cut-off tests.

Recomputation provides strong evidence of the arithmetical accuracy of the tested operations. It cannot, however, by itself provide evidence as to the existence, completeness, accuracy or authorisation of components of the computation and should therefore be supplemented by other procedures directed to those assertions.

Confirmation generally provides strong and documented evidence from an external source. Confirmation procedures are used for example to confirm cash at banks or amounts owing by creditors. DAGP should maintain control over the confirmation letters, mailing procedures and any exceptions throughout the process in order to minimise any interference by the entity's management.

Inspection procedures are applied both to assets (to obtain evidence about existence) and to documentation (vouching as to the accuracy of a recorded transaction, such as the date, party, quantity, unit price, description, total amount and signature of authorisation). Inspection of assets provides evidence of physical existence but does not normally provide evidence as to ownership, completeness or valuation of the inspected assets. The collection of further evidence relating to these can often be designed to be tied into the physical inspection procedures.

Cut-off procedures are tests of transactions occurring close to the cut-off date to ensure that the transactions are recorded in the correct accounting period.

Selecting items for tests of details. Normally only a proportion of the items within an account is tested even though the auditor wants to conclude about the account as a whole.

This is done by:

- Selecting key and high value items; or
- Taking a representative sample; or
- A combination of both.

Key items are normally selected when:

- There is reliance on internal controls and there is substantive audit evidence from analytical procedures (and therefore require relatively little substantive audit evidence from tests of details); or,
- A small number of high value items form a large proportion of the account (therefore testing these items will include a high proportion of the total value of the account); or
- The population consists largely of non-routine transactions and therefore the account is unlikely to consist of similar items that could be sampled.

As well as having a high value, key items can be other unusual or suspicious items, such as:

- multiple transactions with very similar values/dates/suppliers;
- apparently duplicate transactions;
- items which are unmatched; or,
- items with other specific characteristics that catch the auditors' attention.

Representative sampling is likely to be most effective when:

- There is little or no evidence from analytical procedures so the auditor has to rely on substantive audit evidence from tests of details;
- The population contains a large number of individually insignificant items; and/or
- The population contains routine transactions and therefore the account is likely to consist mostly of similar items (i.e. a homogeneous population).

9.3.3 Substantive Sampling

It is important to ensure that whatever sampling is chosen, an estimate of the total level of errors in the population can be deduced from the sample on a scientific basis. Without having a scientifically selected sample that is sufficient and representative, no assurance on the financial statements can be concluded and no projection of other quantitative concerns can be concluded.

In implementing a substantive sampling plan, the following need to be considered:

- Decide what is to be tested;
- Define the sample and select the sample;
- Audit the sample items; and
- Evaluate and interpret the results.

Decide what is to be tested. First, the auditor needs to define the objective of the test. This includes defining what assertions are being tested, what constitutes an error, the acceptable risk of material error, the population from which a sample is to be selected, the sampling technique and the definition of a sampling unit (the physical unit to be selected). The population is the collection of items from which a sample is drawn and about which the sample is to provide information.

Note that the completeness of the population cannot be tested using a sample because omitted items have no chance of selection. Therefore, completeness should be tested separately to ensure that substantially all items are included in the recorded population and will have a chance of selection.

Define the sample and select the sample. To obtain reliable conclusions about the population as a whole, a representative sample should be taken. For the sample to be representative, each item in the population should have an equal chance of being selected (i.e. the sample is random) or, if the sample is stratified (for example, large transactions are treated differently from the rest of the population), the sample from each stratified component is representative of that component and thus conclusions can be determined for each stratified selection. For a guide to sample selection, see Appendix B.

The sample size is determined by what is considered an acceptable level of materiality (compared to the value of the population as a whole), the level of confidence that the auditor wishes to have about the conclusions (for example a 95% level of confidence – that is the conclusion arrived at is correct 19 times out of 20) and the assumed level of error in the population (which is not normally known until the sample has been taken and analysed). The method of determining the sample size is provided in Appendix B.

The preferred method of selecting a sample is the monetary unit sampling (MUS) method. Standard CAATs software can provide the auditor with the sample size and the sample items. The auditor can sometimes reduce the sample size by using a stratified sample (for example, testing 100% of the large transaction values and then taking a sample from the remainder of the population – where the sample of the remainder of the population represents a relatively small part of the total population value).

Audit the sample items. To enable the auditor to draw conclusions on the whole population, all items in the sample need to be examined. The audit effort can be reduced where a pattern

can be identified. For example, the errors in the sampled items may be grouped together where of the observed errors have a common cause.

The first use of the sampled items is to determine whether the level of errors, when projected to the population as a whole suggests that the acceptable level of materiality has been exceeded in which case, the auditor may not be prepared to accept the reliability of the financial statements.

As well as determining the extent of inaccuracies discovered in the sample, the auditor needs to determine the causes of the errors. There are two reasons to follow up on identified errors:

1) To assess the internal controls (and where necessary, adjust the level of reliance on the controls as a result of the substantive testing) which will assist the auditor in concluding whether reliance can be placed on the financial statements; and

2) To conduct a compliance audit on any errors that suggest that the transactions were not carried out in compliance with relevant and applicable laws, regulations and internal controls. Also, following up on errors should help the auditor identify the underlying cause of the errors and thus be able to provide practical recommendations on corrective action.

Where the compliance with authority work is being performed as part of a financial certification audit, the auditor should only be concerned with compliance where the impact of non-compliance is significant. Minor cases of non-compliance should be picked up by the internal audit function. Where the potential impact of lack of compliance, or mismanagement, or misallocation of funds is serious, it is very important that the audit work is completed. Where appropriate, the sample should be expanded to follow up on other suspected situations of serious mismanagement of funds.

For other compliance with authority work, the audit objectives will determine what is significant.

Evaluate and interpret the results. Especially for reporting purposes, the auditor must be able to conclude on the population as a whole, based on the findings from the sample items. If the sample size is 1,000 and the population size is 100,000 (and provided the sample is representative of the population) the most likely errors in the population as a whole would be estimated at one hundred times as great as the errors discovered in the sample. Say for example, errors in the sample amounted to 50,000 Rupees, the errors in the population as a whole would be a hundred times as large, which would be approximately 5 million Rupees. Whereas the errors in the sample may not be large enough to include in the Auditor-General's Annual Report, the estimated errors in the population as a whole become a much more serious concern.

The audit work should be sufficient to conclude on the nature of the errors detected and the underlying causes of the errors. An understanding of the causes of the errors allows the auditor to form judgments on the seriousness of the observations. For example, the errors may have occurred only in a particular month when an inexperienced clerk was handling the transactions. If so, and there is sufficient evidence to be assured that for the rest of the year the problem did not occur, then the errors can be assumed to have occurred only during a small part of the year's transactions. Thus, conclusions on the population as a whole are not necessarily a simple projection based on the sample. The explanation of the errors found is critical for forming reliable inferences on the evidence obtained.

9.3.4 Management of Sample

The Director of Audit should personally ensure the proper selection of the required sample and follow up to check that this sample was the one used in the field.

Reliable audit results depend on having an unbiased and representative sample. Any changes to that sample can possibly invalidate the conclusions to be derived from the sample.

In practice, the auditor may not be able to utilize all items in the selected sample. This can be due to a wrong identification of the item (an item from a different office or location was inadvertently included in the sample); the transaction was later reversed; or due to a whole host of possible reasons. A frequent problem is that the supporting documentation for the transaction cannot be found. Although the auditor must be careful to determine why the documentation is missing since this could well indicate irregular activities, in certain circumstances, other items might have to be substituted. Also, the auditor should be encouraged to use initiative and include other items, especially when conducting the regularity component of the audit. ***Although substitution of other items during the field audit can be appropriate, the auditor MUST inform the Director of Audit of the intended substitution or addition of items in the sample and ONLY include these items (and/or drop other items) after obtaining the approval of the Director of Audit.*** It is the responsibility of the Director of Audit to be assured that any substitutions are fully justified and after the field work has been completed, to review the file to be assured that the items audited were consistent with the original sample and/or with the approved changes.

It is the role of quality assurance to pay particular attention to the proper selection of audit sample and ensure that that sample was indeed the one followed up during the field work.

9.3.5 Sampling for Regulatory Audit Purposes (Compliance with Authorities)

Regulatory Audit Combined with Certification Audit. In general, the sample taken for certification purposes is also appropriate for regulatory audit purposes. Although it has often been the custom of auditors to take large samples for regulatory audit purposes, in most cases this is not necessary. In fact the converse is usually the case. The sample for certification audit purposes has to be sufficiently large to conclude whether the financial information (e.g. line-item) is sufficiently accurate to be relied upon. The regulatory audit on the other hand only has to determine whether there are control problems and does NOT have to estimate the error rates in the irregularity occurring. The audit evidence only has to be sufficiently convincing to point out to management that there needs to be improved controls and better administrative performance.

The exception to this is where the irregularity occurs only infrequently (say at one particular location, or only on the last day of the month) and the sample cannot be designed to focus in on this problem, then a larger sample is required to make sure of including some of these irregularities. Yet, since it is infrequent, it is not material. It is an audit judgement whether to exert considerable audit effort to try to catch these infrequent irregularities. Wherever possible, the use of other methods, than using a large sample, such as analytical techniques and examining internal controls would be a more cost-effective means of detecting and zeroing-in on the problem area.

Regulatory Audit Not Part of Certification Audit. In some cases, the regulatory audit is carried out without performing certification audit, such as conducting regulatory audit work where the organization has an auditor from the private sector performing the certification audit work. Wherever possible, the use of a CAAT for analysing the patterns of transactions and/or for obtaining a random selection of transactions is preferable to a manual selection of the sample.

The sample size, in this case, is not defined by the needs of the certification audit, so some other means has to be used. Regulatory audit is not normally concerned with estimating the financial value of the transactions that have been carried out in an irregular manner. Nevertheless, the auditor would prefer to ensure that the majority of transactions examined were significant transactions not very small transactions. Thus for regulatory purposes as well as for certification purposes, the auditor would like to be assured that the larger transactions were given greater emphasis in the sample than small ones. Thus, a 100% sample, or high proportion sample, of the largest transactions combined with a random sample from the rest is one approach. Alternatively, there is no reason why a MUS cannot be used to select a sample solely for regulatory audit purposes.

Appropriate Sample Size For Regulatory Audit. Whether the sample used for regulatory audit is taken from the sample selected for certification audit purposes (the full sample or a sub-set of the sample) or is generated separately, the same question arises: how to determine an appropriate sample size.

It is better to do a thorough examination of all aspects of a transaction (including digging down to discover what caused the irregularity) than examine a large number of transactions at a superficial level (e.g. checking for a signature).

As with most sampling situations, the decision on the size of sample is first based on the assumption of a homogenious population (i.e. any item in the sample is just as likely as another to have the particular characteristics of the typical member of the population). Secondly, the appropriate sample size is dependent on the characteristics of the population (which usually is not known until the sample is taken). So the sample size calculation needs to make an assumption about the error rate (in the case of attribution sampling[1]). There are formulae that the auditor can use to calculate the desired sample size, based on certain assumptions. Alternatively it is practical in most cases to take a sample size of between 50 and 100 for regulatory purposes. Or, as discussed above a much larger sample if attempting to find an irregularity that occurs infrequently in the population as a whole.

The best way to illustrate this is to discuss what conclusions can be derived from the sample. After taking a particular sample, the error rate for the population as a whole can be estimated based on the results obtained from the sample.

For example, if the auditor has taken a sample size of 60 and finds no errors, then it can be said with 95% level of confidence[2] that the population as a whole contains less than 5%

[1] Attribute Sampling. A type of statistical sampling used for compliance testing whereby sample items are evaluated for compliance or attributes. Items either are or are not (yes or no) in compliance. This type of sampling reaches a conclusion on the frequency of occurrence of a particular attribute in a universe.

[2] That is to say that the statement will be a correct statement 19 times out of 20.

level of errors. If the auditor found 10% of the transactions had errors, then it can be said with 95% confidence that the errors in the population as a whole were somewhere between 5% and 20% level of error (approximately). This is true for a population of more than 500 transactions from which the 60 was a representative sample[3].

If the auditor wants to be sure that there was less than 1% level of error in the population (with 95% level of confidence), a sample size of 300 would be needed and no errors found. This statement would be correct if the population size was over 1,000.

Interpretation of Regulatory Errors. It is not the job of the regulatory auditor to find every error. What the auditor needs to know is:

- Is there a problem with irregularities and if so how serious is the problem; and
- What is the cause (or set of causes) that has led to the problem.

In addition, the auditor would like to be able to recommend a way of correcting the problem(s) observed.

A rule in quality control is that usually only one or two, or perhaps a few more, causes can explain almost all of the observed errors. Thus as soon as the auditor discovers the underlying causes of the errors found, and as long as it can be concluded that there is a serious problem, the auditors have done their job. No additional auditing is really that useful. From a regulatory perspective, it is not all that important to determine the precise level of error rate.

Finally, the auditor must be able to communicate the findings relating to regulatory concerns in a manner that management can understand and accept as important. The auditor is referred to the Chapter on Reporting in this Manual.

[3] This formula is affected by the size of the population as a whole. If the population (i.e. all transactions from which the sample has been taken) is small compared to the size of the sample, then the results are slightly different.

9.4 Evidence

The auditor requires evidence to support all information presented in the audit report. Even the background description of the entity and generalised statements about the organisation must be supported by appropriate evidence. The final audit report must be able to withstand all challenges and the auditor must be able to demonstrate his/her professionalism in the way the audit is carried out and in the presentation and contents of the final report.

9.4.1 Attributes of Evidence

To support the auditors' findings, conclusions and recommendations the evidence must be:

- Sufficient;
- Relevant;
- Reliable; and
- Objective.

Sufficient. Evidence should be sufficient to lead a reasonable person to the same conclusions as the auditor. The sufficiency of evidence will be influenced by a wide variety of matters including:

- The auditor's knowledge of the entity and its environment;
- The materiality/significance of the matter in hand;
- Whether the report is addressing only a limited area of coverage or whether it encompasses all activities and transactions within a large area of management responsibilities;
- Whether the audit is providing assurance or just identifying particular weaknesses in need of correction;
- The degree of risk that insufficient evidence will lead to a misleading statement or conclusion or produce an inappropriate recommendation;
- The quality and persuasiveness of the evidence; and
- The degree of acceptance of the evidence by management.

The auditor should take care that the evidence is strong enough to support statements in the report.

If the audit report simply lists a series of negative findings, the evidence required applies only to those particular projects/activities/transactions examined. If however, the auditor wishes to generalise about ***all*** projects/activities/transactions, the audit evidence has to be sufficient to demonstrate, usually on the basis of a statistically valid sample, that the majority of such projects/activities/transactions have the same characteristics of satisfactory performance (assurance) or suffer from the same negative findings.

Relevant. The relevance of audit evidence refers to the relationship of the evidence to its use and applicability. The auditor should have a clear audit programme with distinct audit objectives. The auditor is expected to collect relevant evidence to conclude against those audit objectives to complete the audit satisfactorily.

In practice, the auditor is likely to encounter situations not anticipated in the audit plan. The auditor should not be blind to evidence outside of the audit objective(s). If the auditor obtains evidence of a significant issue outside of the defined scope and objectives of the audit, the auditor should discuss the situation with his/her superior or other appropriate person in DAGP. If the auditor pursues an area of investigation substantially outside of the audit objectives, it would be appropriate to brief the entity's management on the change of scope.

Evidence must support audit statements directly. Evidence should not take the form of an implication. For example, statements that the manager is often absent does not necessarily imply that there is insufficient supervision. The linkage must be established by the auditor by obtaining sufficient relevant evidence to support the conclusion.

Evidence to support audit conclusions should, as far as possible, be timely. The relevance of audit findings generally diminishes over time. The auditor needs to focus as far as possible on current situations so that management can receive useful feedback and take corrective actions. For example, major capital projects may proceed through the planning stage, contracting and construction over many years. If the auditor identifies a weakness in the planning stage of a project now complete, the finding may not be applicable to other projects. The managers, or the systems, procedures and practices may have changed. Wherever possible, the auditor should review the current systems, procedures and practices and determine whether the weaknesses of the past still exist or have been corrected.

Reliable. The auditor has a professional responsibility to ensure that, as far as possible, the evidence obtained is reliable. That is to say, the evidence is:

- based on fact, not opinion;
- an accurate reflection of reality;
- from a reliable source;
- consistent with other evidence; and
- remains true for all situations within the audit domain.

Interviews are a source of useful evidence but the auditor should appreciate that often statements are based on opinions, are not necessarily accurate and may on occasion be intentionally false. Wherever possible, a statement from an interview should be checked against documented evidence. For example, if the auditor is informed that a particular transaction was delayed for some time, the documentation of the transaction should be sought to confirm what was said in the interview.

Occasionally, even documented evidence can be unreliable. The auditor should be continually reviewing, questioning and deciding on the reliability of the evidence. Where the auditor is not satisfied with the reliability of the evidence, and has not been able to resolve the problems, the best approach is to include statements to this effect in the draft report and seek management's assistance in getting the most reliable evidence.

Where there is a good system of internal control, the auditor can be more confident of the reliability of information produced by the entity than where the internal controls are weak.

A particular type of evidence is the non-existence of something – the lack of an anticipated event or expectation (a control, a study or some other matter that the auditor is expecting to see). The best the auditor can do is document on file the efforts made to find the evidence of what the auditor would expect to see in the particular circumstances. If the auditor does not

make the appropriate efforts to find what is considered missing, he/she can be criticised by management for not making reasonable effort. One approach is to use the "audit query" to seek management's assistance. Alternatively, through interviews, briefing and, if necessary, within the draft report, the auditor should draw attention to the fact that no evidence has been found of what the auditor was looking for.

Objective. To be admissible, evidence should be objective and free from bias. The auditor should always maintain an open mind with regard to the evidence collected. The auditor should guard against assuming that the initial findings or assumptions are the only interpretation of the situation. If not, there is the danger that the auditor, most likely inadvertently, seeks evidence that supports the original perception. Whenever there are contradictions in the evidence collected, the auditor should not reject certain evidence, but rather seek further evidence to determine which information is correct, or to obtain an explanation as to why the evidence is not consistent.

Evidence should be evaluated objectively; alternative interpretations of the same evidence should be considered and inconsistencies in the evidence resolved before reaching final conclusions. Wherever possible, the auditor should focus on the results and systems, not on the individuals involved. The auditor should endeavour to avoid being influenced by personalities.

9.4.2 Types of Evidence

Evidence can take the form of observation, documentation, analysis, interview responses, and confirmation through interview or written response.

Evidence can be classified according to the following:

- Documentary;
- Observational;
- Physical;
- Oral; or,
- Analytical.

Documentary. Although the auditor may rely on interviews for determining where to look and what to look for, the main source of audit evidence is usually documentary, in either physical or electronic form. Documentary evidence can be further broken down into internal or external. Internal documentary evidence originates within the entity and may include accounting records, copies of correspondence, budgets, internal reports and memoranda, personnel documents, appraisals, organisational charts, and internal policies. External documentary evidence may include letters or memoranda received by the entity, suppliers' invoices, leases, contracts and other reports, and third party confirmations.

Auditors should be wary of possible errors or misstatements in documentary evidence. Their reliability depends on how the source data are collected and manipulated. Although electronic processing is far less prone to error, and errors that are generated are likely to be systematic, the data input to the electronic systems are frequently manual and therefore prone to human error. Various analytical tests can be made to confirm consistency and increase the auditor's assurance of their reliability.

Observational. Observational evidence is obtained by observing people and events or by examining property. All observations obtained by the auditor should be recorded, either in the form of notes to file, photographs, or other pictorial representations. The evidence is strengthened if it is obtained by two auditors, if the observation takes place several times as opposed to only once, or is discussed at the time of observation with a representative of the entity, preferably someone responsible for the activities or properties being audited.

An important form of evidence is the confirmation of information contained in records through a physical count of the actual amount or number of items (such as cash, pieces of equipment, inventory). Inspection of equipment should include spot checks to ensure that the equipment is complete and in good working order.

Physical. The main physical evidence that would be used by an auditor would be a photograph, for example showing the condition of a building or piece of equipment. Generally, physical evidence, except of course documents, is not collected by auditors. In the case of documents, some standards require that the auditor examine an original rather than a copy, but in most cases, the evidence collected is a copy of a document, or part of a document. The auditor must clearly identify the source of the document.

Oral. Oral evidence takes the form of statements usually made in response to enquiries or interviews. Interviews can provide important leads not always obtainable through other forms of audit work. There are many sources of oral evidence:

- Various levels of management;
- Personnel directly involved in operations;
- Suppliers and contractors;
- Recipients of government services;
- Members of the general public;
- Other ministries/departments/agencies; and
- Experts and consultants.

The auditor must take care to follow appropriate protocol and procedures when approaching individuals from inside and outside the entity. Generally, the management in charge of a particular part of the entity should be notified before the auditor approaches staff within their area. It is appropriate in most cases to clear with management of the entity before approaching personnel outside of the entity to discuss matters pertaining to the entity. When approaching experts or consultants to discuss aspects of the entity, care should be taken to avoid placing them in a position of conflict.

The auditor should always prepare a written summary of the interview. Interviews must be well documented. The auditor should not normally "quote" a specific individual nor indicate the source of oral information in a report or briefing. If, for any reason, a person is to be quoted, then the auditor should obtain that person's agreement. Wherever possible, the auditor should obtain corroborating oral information from more than one source. The reason for this is that:

- This increases the reliability of the information, particularly where the sources are independent;
- The source of the information is less likely to be traceable to one particular individual;

- A stronger statement can be made, such as “the majority of those interviewed commented that …”, or “x% of managers responded …”; and
- The auditor cannot be accused of placing too much emphasis on a source that could be biased.

One way of strengthening oral evidence, and confirming other forms of evidence, is to produce a list of observations to discuss at an exit interview with the person responsible for the area. The auditor does not need to divulge the source of the information; only confirmation of its correctness is discussed during the exit interview. If further documentation of these findings is required, then minutes of this meeting can be sent for confirmation.

Analytical. Analysis of data can provide conclusions that are not necessarily directly available from lists of data, reports, studies or other sources. An auditor with strong analytical skills can uncover information that may not be known already to managers of the entity.

There are many uses for evidence derived from analysis. These can include:

- Checking that data from different sources are consistent, and conducting reconciliations;
- Calculating variability in levels of efficiency;
- Calculating averages to compare performance;
- Ensuring interest payments are properly calculated;
- Confirming payroll and other expenditures are accurate, and comply with regulations, agreements and other controls on payments; and
- In general, confirming written and oral statements.

Analysis can be time-consuming but the results can prove valuable. Wherever possible, the auditor should start with a quick approximation rather than conduct detailed analyses. If the quick approximations suggest that there are problems or potentially important findings, then the auditor should design a detailed process for obtaining accurate evidence.

9.4.3 Procedures for Gathering Audit Evidence

Broad Approach. At the start of an audit, usually during the planning stage, the auditor takes a broad approach to the collection of evidence. Interviews are often of a more general nature and questions are more open-ended than specific. The auditor takes the approach of **scanning** at this stage. Materials are scanned quickly to obtain a general understanding. The auditor searches for significant events or transactions that may require further review.

It is usually more efficient to obtain explanations through **inquiry**, and then later seek to validate these explanations, than for the auditor to try to find explanations directly by sifting through quantities of detailed evidence. Sometimes, managers are happy to direct the auditor to those areas in greatest need of examination while others will evade or even misdirect the auditor in hope that weaknesses will not be discovered.

Specific Approach. Before the main examination phase of the audit, the auditor will have developed a detailed audit programme. Here the audit objectives have been defined, and the standards or audit criteria against which the observations are compared have been structured. A set of specific questions may be identified, either in the form of a modified internal control questionnaire or audit guide, or by an analysis of what information is required to answer the audit objectives and confirm compliance or lack of compliance with the standards/criteria.

Expanded Approach. As the evidence is collected, however, further questions arise and new areas for enquiry are often discovered. The auditor needs to apply judgement as to what evidence to collect and what to ignore. Cause-and-effect analysis (see below) will usually raise questions about further evidence.

Experience will guide the auditor in deciding whether the evidence obtained to a certain point can stand on its own or further support is required to confirm the validity of the evidence. This further support could include:

- Corroborating evidence with independent third parties;
- Physical checks to verify that an asset or liability exists;
- Analysis to ensure that the evidence is reliable; and
- Verifying that procedures actually operate as claimed by management.

9.5 Matters to deal with during fieldwork

Auditors need to obtain and record relevant, reliable, sufficient and convincing audit evidence to support their audit findings, conclusions and recommendations.

In the process of obtaining this evidence, auditors often need to deal with matters that require the use of professional judgment. These matters are discussed in this section.

9.5.1 Unanticipated matters

Although the audit programmes are approved at the detailed planning stage, the auditor performing the work should not assume that the programmes cannot be changed. The auditor is likely to encounter matters not anticipated in the audit plan. For example, the entity may have new assets, liabilities, receipts or expenditures that were not known at the planning stage, or may be operating under new legislation. Similarly, the entity may have entered into significant contracts since the audit was planned.

The auditor should also be alert for matters arising during the fieldwork phase that indicate changes may be required to the general planning parameters. For example, the audit approach may call for high reliance on the internal control structure. However, if the auditor's tests of internal control reveal a larger than expected number of internal control deviations, then the sources of assurance, and the nature, extent and timing of the auditor's substantive tests, may need reconsideration.

To detect matters such as these, the auditor should not be blind to evidence beyond the audit programme. The auditor needs to be on the lookout for these unanticipated matters, and to consider their implications for the audit.

If audit work is performed at an interim date, this can alert the auditor to unanticipated matters at an earlier date. The auditor could then make the required changes to the audit planning memorandum, audit programmes, etc.

Should an unanticipated matter be relatively minor, requiring the addition of only one or two audit procedures to an existing audit programme, the auditor should be able to make the change without going through a formal approval process. However, if the matter is more significant, such as one that calls for developing new audit programmes or re-considering the

sources of audit assurance, the auditor should discuss the situation with the audit supervisor. The auditor should then prepare an addendum to the audit planning memorandum. This addendum should follow the same review and approval process as is used for the audit planning memorandum itself.

In addition, if the matter requires the auditor to pursue an area of investigation substantially outside of the initial audit scope, it would be appropriate to brief entity officials on the change of scope. This could be done through an addendum to the entity communication letter.

9.5.2 The substance of the transaction

Auditors should be satisfied with the nature, adequacy and relevance of audit evidence before placing reliance upon it. One aspect of this is to consider the substance of a particular transaction that is being supported by the documentary evidence.

There may be a significant difference between the form of the transaction and its substance. For example, a bribe may be disguised as a commission, or a purchase may be disguised as a long-term lease. The auditor needs to ensure that the documentary evidence is clear enough to determine the real substance of the transaction.

If the auditor suspects that the substance of a transaction is different from its form, the auditor should consider what the real substance is. The auditor should discuss his/her findings and conclusions with entity officials. Should the auditor still believe that the substance of the transaction is different from its form, the auditor should record the most likely error that arises from the difference on the Summary of Unadjusted Differences.

9.5.3 Inadequately supported transactions

Inadequately supported transactions often reflect missing documents. They may also indicate the entity's accounting or control system does not call for the documentation that the auditor would consider appropriate.

When a document is missing, the auditor should make a reasonable effort to locate it. If the auditor does not make the appropriate efforts, entity officials could criticise the auditor, particularly if the officials found the document at a later date.

If the document cannot be found, the auditor should consider if other evidence exists to support the transaction. For example, assume the entity has paid for a particular piece of equipment. Assume also that the auditor can find the supplier invoice and purchase order, but not the receiving report or other documentation indicating that the item was received. In this case, the auditor may be able to physically examine the piece of equipment, and query its operator as to when it was received. These procedures may provide the auditor with sufficient assurance as to the validity of the purchase transaction.

Sometimes the auditor will not be able to find relevant, reliable, sufficient and convincing audit evidence to compensate for the missing documentation. Using the above example, the auditor may not be able to identify the particular piece of equipment that has been delivered, or to obtain independent evidence as to its delivery date. In such cases, the transaction should be considered to be in error, and the most likely error should be recorded on the Summary of Unadjusted Differences.

In addition, the auditor should document the efforts to locate the missing receiving report, and to otherwise support the validity of the transaction. This documentation should include discussions with entity officials, and the steps that the officials were to have taken. This will reduce the risk of the auditor being criticised should the missing document be found at a later date.

9.5.4 Conflicting audit evidence

Conflicting audit evidence occurs when the auditor receives evidence regarding a particular balance, transaction or event that is not consistent with other evidence. Examples of conflicting audit evidence are when:

- The auditor's analytical procedures indicate that material error exists in a particular component, while substantive tests of details indicate that there are no errors in the component.
- One entity official provides the auditor with information or an explanation that is inconsistent with the information provided by another entity official.
- The auditor identifies what appears to be a material error and asks entity officials to investigate. The officials respond with an analysis or explanation indicating that no error exists.

The first step the auditor should take is to re-evaluate the evidence received. The auditor should maintain an open mind, and guard against assuming that the initial findings are the only interpretation of the situation. Evidence should be evaluated objectively, and alternative interpretations of the evidence should be considered.

It is *not* appropriate for the auditor to disregard some of the evidence received. For example, in the first illustration it would not be appropriate for the auditor to ignore the results of analytical procedures. The auditor should seek further evidence to determine whether the results of the analytical procedures or the results of the substantive tests of details are correct.

Input from entity officials is often helpful. For example, entity officials may be able to provide the auditor with additional information that helps to explain the fluctuation identified by analytical procedures.

Where the auditor receives conflicting information from officials, the auditor should determine whether:

- there are legitimate reasons why the two officials would have provided different information or explanations; and
- the information or explanations received from each individual are reliable.

It may be appropriate for the auditor to seek corroborating information or explanation from a third or even a fourth individual to determine which of the two original providers of the information or explanation appears to be incorrect.

Where subsequent analysis by the entity management does not support the auditor's estimate of error, the auditor should audit the entity's analysis and supporting documentation to determine if the further analysis:

- deals directly with the matter at hand;
- was sufficient and appropriate, and done correctly; and

- explains why the auditor's original estimation of the error was not correct.

Until the conflicting audit evidence is satisfactorily resolved, the auditor should not take any assurance from any of the affected audit procedures.

9.6 Cause and Effect Analysis

Wherever possible, the auditor should determine the underlying cause(s) of an observed weaknesses or error. Normally, there is at least one major underlying cause for the weakness or error, such as:

- Inexperienced individual carrying out the transaction;
- Insufficient training of that individual;
- Lack of proper systems and procedures;
- Insufficient management involvement / scrutiny; or
- Unclear accountability.

It is usually a matter of judgment as to which factor, or combination of factors, is generally regarded as the underlying cause(s).

These underlying causes need to be addressed by entity management to obtain long-term improvement of the operations. The auditors' recommendations for improvement should address these items.

The auditor needs to identify the actual, or potential, effect of the observation. Wherever possible, the auditor should seek examples of the effects resulting from a weakness observed. However, such evidence may not be readily available. If this is the case, the auditor should be able to demonstrate the risk associated with the continuation of the current situation. The risk should be plausible and convincing to management. If not, the auditor will likely find it difficult to get management support for recommended changes to reduce or eliminate the weaknesses observed.

Cause and effect analysis can be difficult. Sometimes clear relationships between observations and the underlying causes cannot be proved. This is where the auditor's knowledge, experience and communication skills are important. Management needs to have confidence in the auditor to accept the recommendations for change.

If the underlying causes of weaknesses are not addressed, the auditor can expect to note the same problems each time the area is audited. Except to the extent required as part of a follow-up audit, there is no point in repeating audits and coming up with the same observations. Either the weaknesses are too small to matter, in which case the auditor should not be concerned with the issues, or there is need to correct the problems.

Cause and effect analysis ensures that we direct our effort towards the areas that matter and produce meaningful and significant audit observations. This analysis also ensures that we understand the underlying causes, so that we can develop recommendations that address the most important areas. These need to be addressed in the audit report – see Chapter 12.

Cause and effect analysis requires the auditor to:

- identify the fundamental cause(s) of the deficiency. This is important in developing a basis for recommending remedial actions. Often there is more than one cause and the auditor's challenge is to determine which ones are the most relevant.
- assess and quantify the effect, or the potential effect, of the deficiency. Quantifying the effect of a problem is an important step in determining the significance of the deficiency. In many cases, the effects can only be described in terms of risks as opposed to actual losses, or other negative effects, that have occurred.

9.7 Developing Conclusions and Recommendations

In theory, the auditor compares an actual finding with an expected finding (the accounting standard or audit criterion) and identifies any deviations.

Reality is generally more complex. In collecting evidence, the auditor frequently discovers unanticipated findings. The structure of the audit may not have fully anticipated the complexity of the activities and transactions. When the auditor discovers an unanticipated weakness in a particular transaction, he/she should determine whether this is a single occurrence or part of a pattern.

Conversely, one or more of the standards or criteria may not be applicable to the operations being examined. If this part of the audit is addressing a control or activity that is not significant, there is no need for any assurance in this area. Audit effort should be directed to more significant issues.

Conclusions should focus on significant issues. These are generally concerned with:

- Inefficient or ineffective operations, or examples of not achieving intended results; and,
- Failures to measure and report on the efficiency of operations and the effectiveness of the programmes.

Performance audits are also concerned with:

- Failures to acquire resources economically and to safeguard assets;
- Lack of accountability;
- Inadequate controls and excessive risks to the entity; and
- Inefficiencies, errors, waste, and misuse.

Issues relating to these concerns should have been identified during the planning stage of the audit.

The auditor should avoid any implication of deceit in dealing with the management of the entity. If the audit objective(s) state one thing and the auditor focuses on issues that are unrelated, entity management has reason to be concerned. As far as possible, the auditor should have identified during the planning stage what needs to be examined. A well-planned audit should not require the auditor to stray far beyond the plan. On the other hand, the auditor should be careful not to conduct the audit in a mechanical manner, ignoring anything that does not fit within the precise structure of the audit programme.

9.7.1 Significant Findings and Conclusions

The auditor should ensure that the audit report provides a few key messages rather than a long list of relatively small matters. Good managers are used to focusing on key areas and may not have the time or inclination to get into details that do not appear significant. In developing conclusions, the auditor must be able to identify the key matters for management attention. Details of the findings should be used only to support these key conclusions. These details may need to be communicated to lower levels of management to help them address the errors.

The auditor may discover many findings that at first glance do not seem to be related or significant. With experience, the auditor will recognise patterns of findings that are indicative of a serious or general weakness. Thus the auditor is able to take clusters of small findings to form significant observations.

In developing findings, the auditor needs to:

- Determine the frequency of the identified weakness. This is important in assessing whether the deficiency is an isolated instance or represents a systemic or general weakness;
- Assess the significance of the weakness, in terms of frequency and impact;
- Develop one or more examples, for inclusion in the report, to clearly illustrate the nature of the deficiency;
- Clearly communicate the actual or potential impact of the identified deficiencies; and
- Determine whether management is aware of the deficiency and if corrective action is underway. A deficiency that is being corrected is less significant for reporting purposes than a previously unknown and unresolved deficiency.

These steps are necessary to determine reporting strategy and to ensure fairness and balance of the report.

Development of Recommendations. As the auditors clear findings with the different levels of management within the entity, they should explore potential recommendations. Recommendations that are supported by management are much more likely to get implemented than those that are simply the opinions of the auditor.

Recommendations should address the underlying causes of errors or deficiencies. The auditor must focus on the underlying weaknesses in controls, or other causes of the errors, to increase the likelihood that management will take steps to prevent further errors from occurring.

When developing recommendations, the auditor should consider:

- The most significant causes of the weaknesses observed (through cause and effect analysis) and what needs to be done to strengthen the management framework to correct the underlying cause(s);
- The feasibility and cost of adopting a recommendation (i.e., the benefits of a recommendation should outweigh the cost of implementing it);
- Alternative courses for remedial action; and
- Effects, both positive and negative, that may arise if the recommendations are adopted.

9.8 Keeping entity officials informed

To successfully complete the fieldwork, the auditor should:

- Have effective communication skills, both oral and written; and
- Establish and maintain good working relationships with entity officials.

Good working relationships are highly dependent on good communications. Entity officials must have complete confidence in the integrity, independence and capability of the auditors. Auditors must be, and be seen to be, honest, fair, discreet and tactful.

Entity management and staff should be kept informed of the progress of the audit. Conflicts between an audit team and entity officials can be avoided by timely intervention.

Except in the case of a fraud, or suspected fraud, the auditor should strive to conduct a "no-surprises audit". This means honest communications and keeping entity officials aware of the progress of the audit and the findings to date. The auditor should ensure that the findings about an area of audit are not reported to a more senior manager before the manager at the lower level has been informed of the findings and given an opportunity to rebut, correct or explain.

It is good practice, at the end of the fieldwork at a particular location, to arrange a meeting to discuss the findings with the senior manager of the area being audited. This meeting is an opportunity to confirm the audit findings and explore possible recommendations with the manager. Minutes of the meeting can form useful audit evidence.

The auditors should also seek, where appropriate, to have regular communications with the internal audit unit within the entity. As discussed in earlier sections, coordination of the external and internal audit work can ensure adequate audit coverage, while at the same time minimising duplicate efforts.

9.9 Documenting the work performed

Paragraph 3.5.5 of DAGP's Auditing Standards requires: *"Auditors should adequately document the audit evidence in working papers, including the basis and extent of the planning, work performed and the findings of the audit."*

The content and arrangement of the working papers reflect the auditor's proficiency, experience and knowledge.

Adequate documentation is important for several reasons. It will:

- serve as evidence of the auditor's compliance with DAGP's Auditing Standards;
- help to ensure that delegated work has been satisfactorily performed;
- increase the efficiency and effectiveness of the audit;
- help the auditor's professional development;
- serve as a source of information for preparing reports;
- provide information to answer enquiries from entity officials, the Legislature and its committees, or from any other party;
- assist in the planning of the audit for the following year; and

- help auditors in the following year to perform their work.

9.9.1 Documentation standards

The auditor should diligently document all the work that has been performed. The working papers should provide a record of the nature, extent and timing of the audit procedures performed, and the results of those procedures.

Working papers should be sufficiently complete and detailed to enable an experienced auditor having no previous connection with the audit to subsequently ascertain what work was performed to support the conclusions.

To achieve this objective, the fieldwork, evaluation and reporting files should include:

- evidence that all of the planned audit work was performed;
- an indication as to who performed the audit procedures and when they were performed;
- evidence that the work performed by lower level staff was supervised and reviewed;
- copies of communication with experts and other third parties;
- copies of letters or notes concerning audit matters communicated to or discussed with the entity; and
- copies of the auditor's reports.

To illustrate, assume that:

- the auditor selected a sample of 20 supplier invoices and performed numerous procedures on them;
- one of the procedures was to trace the supplier invoices to receiving reports or to other evidence that the goods were received or the services were performed;
- in one case there was no receiving report; and
- the auditor was unable to find other evidence to support the validity of the expenditure.

In this illustration, as a minimum the audit working papers would need to include:

- a description of the sampling procedure used – the population from which the sample was selected, the parameters used to determine the sample size, etc.;
- sufficient information with respect to the 20 supplier invoices for the auditor to be able to find the 20 invoices again if he/she had to;
- sufficient additional information with respect to the one supplier invoice whose validity could not be adequately verified to support the amount being recorded on the Summary of Unadjusted Differences;
- description of the efforts made by the auditor to locate the missing receiving report, and to otherwise support the validity of the transaction; and
- an indication, through a signed audit programme and/or a completed sample control schedule, that all of the work called for in the audit programme has been completed.

The Standard Audit Working Paper Kit includes a sample control schedule that the auditor can use.

The minimum documentation called for above does *not* call for photocopies of the 20 supplier invoices and the supporting documentation. However, the auditor may be asked to include this additional information in the working papers if:

- the auditor is very inexperienced, and his/her supervisor believes that it is necessary to duplicate the auditor's work to check the auditor's conclusions with respect to the other 19 sample items; or
- on-the-job supervision has been very limited, and the supervisor believes that it is necessary to duplicate the auditor's work to make up for this lack of supervision.

9.9.2 Standards for working paper files

Every working paper should clearly show:

- the name of the audit entity and audit area;
- the period covered by the audit;
- the date the work was performed;
- initials of the preparer;
- the source from which information or explanations were obtained;
- cross-references to schedules, notes and other documents that support the working papers;
- cross-references of all amounts and other information in the audit report to the working papers supporting the amounts and information;
- evidence that the audit procedures were performed;
- an explanation of any pencilled in notations that appear on the working paper; and
- the date and initials of the reviewer.

Working papers should be organised in a logical fashion. To assist in this process, the Standard Audit Working Paper Kit contains a file index that can be used on most financial audits.

Working papers should be neat and easily readable. The auditor should:

- write or print legibly or type up the notes;
- avoid crowding on a page;
- write on one side of the working paper;
- use correct grammar, spelling and punctuation;
- spell the names of individuals or organisations correctly;
- when appropriate, identify the titles of persons referred to; and
- remove all non-evidential matter from the working papers on the completion of the assignment (rough notes in the margins, etc.).

9.10 Custody and maintenance of working paper files

Working paper files are confidential and are the property of DAGP. They are not for general disclosure. However, they should be shared with other auditors as appropriate and be available for any independent review.

Access to the working paper files should be controlled and secure. Material should not be removed from the files without the specific authority of the responsible Director General.

Audit files should be kept for the length of time specified by DAGP's file retention policy.

9.11 Quality assurance during fieldwork

Paragraph 3.2.1 of DAGP's Auditing Standards requires, *"The work of the audit staff at each level and audit phase should be properly supervised during the audit, and documented work should be reviewed by a senior member of the audit staff."*

This section discusses the role of supervision and review. It also discusses the need for effective time reporting.

9.11.1 Supervision

As noted in paragraph 3.2.2 of DAGP's Auditing Standards, *"Supervision is essential to ensure the fulfilment of audit objectives and the maintenance of the quality of the audit work. Proper supervision and control is therefore necessary in all cases, regardless of the competence of individual auditors."*

The Directors and Directors General must ensure that the audit is carried out efficiently, effectively, and with a high standard of professional competence. This requires auditors to be properly supervised during each audit assignment.

The extent of the required supervision will vary from situation to situation. In general:

- Junior staff should be supervised more closely than senior staff;
- Auditors who are not familiar with the entity or the audit procedures being performed should be supervised more closely than auditors who are familiar with the entity and the specific audit procedures; and
- Auditors performing procedures that require a great deal of experience and professional judgment should be supervised more closely than auditors performing simple, routine audit procedures.

Supervision involves ensuring that:

- The members of the audit team fully understand all of the planning decisions before commencing the fieldwork;
- The fieldwork is performed in accordance with DAGP's Auditing Standards;
- The audit programmes are completed as planned, unless changes are required;
- If changes are required to the audit plan, the additional areas that require examination, or the areas that require additional examination, are properly planned and the work is properly performed;

- Only essential work is performed;
- Sufficient evidence will have been obtained when the work is completed;
- Audit findings and conclusions are being adequately supported by evidence in the working papers;
- The audit is performed within the time budget and by the deadline dates set; and
- The work is being done in a strong team environment, which promotes the success of the audit and the development of audit skills within the team.

It is difficult to supervise staff from a distance. Supervision is most effective when the supervisor is on the job with the audit team.

While each audit situation is different, it would normally be appropriate for the supervisors of the lowest level staff to be on the job on a full-time basis. Supervisors of more senior staff could be on the job less frequently.

9.11.2 Review of working paper files

At the completion of each section of the audit work, the supervisor should review the work performed.

This should include a thorough review of the working paper files to provide further assurance that the matters noted above are adequately dealt with. In addition, the review of the working paper files helps to ensure that:

- all evaluations and conclusions are soundly based and are supported by competent, reliable, relevant and reasonable audit evidence;
- all errors, deficiencies and unusual matters have been properly identified, documented and evaluated; and
- changes and improvements necessary to the conduct of future audits are identified, recorded and taken into account in later audit plans and in staff development activities.

While the working paper files need to be reviewed at the completion of the audit work, there is no need for the reviewer to wait until then before commencing a review. A preliminary review at an interim date could detect problems with the work at an earlier date, allowing for speedier correction and saving valuable audit hours.

To improve the learning experience, the reviewer should provide the auditor with feedback on his/her performance shortly after the file review, as opposed to waiting until after the reporting phase.

9.11.3 Time reporting and monitoring

The purpose of supervision and review is not only to ensure that the work is being done to the required standards. It is also to ensure that the work is being performed efficiently, within budget, and will be completed by the required deadline date.

To assist in this process, auditors should be required to complete a daily time schedule, indicating the number of hours that they spend each day on each component of the work. The

Standard Audit Working Paper Kit includes a daily time schedule that is applicable to most audits.

At regular intervals, the supervisor should review the daily time schedule and request the auditors to provide an estimate of the number of hours required to complete the work. This process will help to ensure that the audit is on schedule and in budget.

If the audit is not on track, remedial action is necessary. Existing staff may need to be assigned to the audit for longer periods of time than originally planned, or additional staff may need to be assigned to the audit to complete it on schedule. In either case, the planning for other audits in the directorate may be affected. As a result, it is good practice for the directors on all audits to report their progress to the Director General on a regular basis.

Audit management software can be used for this purpose.

All variances from the audit budget should be explained. This process will not only help the supervisor to evaluate the auditor's work during the current year, but could also help the auditor to:

- Set the budget for the following year; and
- Refine the optimum combination of tests of internal control, analytical procedures and substantive tests of details.

To illustrate, assume that the auditor has used more resources than planned on tests of internal control of purchases and payments, and that the cause of this is a change to the internal control structure that will permanently increase the time required to perform the tests of internal control. In this case, the auditor could decide, when planning the audit for the following year, to increase the budget for the tests of internal control, or to reduce the reliance on the internal control structure and increase work on substantive tests.