

Version 1

**DEPARTMENT OF
THE AUDITOR GENERAL OF PAKISTAN**



**FINANCIAL AUDIT MANUAL (FAM)
Revised 2012**

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1 ORGANISATION AND PURPOSE OF THE MANUAL

1.1 Purpose of the Audit Manual

- 1.1.1 The purpose of this Audit Manual is to provide Department of the Auditor-General of Pakistan auditors with a set of modern auditing standards, concepts, techniques, and quality assurance arrangements that are consistent with international standards, for auditing entities in the Government of Pakistan. The Manual covers the entire audit cycle from planning to follow up. *Modern auditing standards, concepts, techniques, and quality assurance arrangements are consistent*
- 1.1.2 This Audit Manual lays out what is expected of the auditors of the DAGP. It provides the standards by which the audits are to be conducted. It provides guidance with regard to the methods and approaches to audit that can be applied by the auditors in carrying out their duties.

1.2 Types of audits dealt with

- 1.2.1 This Manual focuses on regularity audit, as defined by INTOSAI Auditing Standards, which have been adopted by the DAGP.
- 1.2.2 Regularity audit embraces:
- a) Attestation of financial accountability of accountable entities, involving examination of financial records and expression of opinions on financial statements;
 - b) Attestation of financial accountability of the government administration as a whole;
 - c) Audit of financial systems and transactions, including an evaluation of compliance with applicable statutes and regulations;
 - d) Audit of internal controls and internal audit functions;
 - e) Audit of the probity and propriety of administrative decisions taken within the audited entity; and,
 - f) Reporting of any other matters arising from or relating to the audit that DAGP considers should be disclosed.

1.3 Audit entities dealt with

- 1.3.1 DAGP's mandate includes the audit of federal, provincial and district government accounts which encompass government ministries, departments and agencies, self-accounting entities and exempt entities. The types of entities being audited include financial institutions, commercial entities, public utilities, and tax-collecting entities. *DAGP's mandate includes federal, provincial and district government*

1.4 Accounting Responsibility Structure of the Government of Pakistan

1.4.1 The following is a brief summary of the accounting structure of the Government of Pakistan.

- a) *Federal government.* The Controller General of Accounts (CGA) has primary responsibility for the completeness and accuracy of the Federation's financial statements. Reporting to the CGA, the Accountant General Pakistan Revenues (AGPR) is responsible for the centralised accounting and reporting of federal transactions. Additionally the AGPR is responsible for the consolidation of summarised financial information prepared by federal self-accounting entities.
- b) The AGPR receives accounts and reports from the sub-offices of the AGPR, district accounts officers, principal accounting officers of self accounting entities, federal treasuries and the State Bank of Pakistan/National Bank of Pakistan. The AGPR, in turn, provides annual accounts to the CGA.
- c) There are AGPR sub-offices in each of the provinces that act as the district accounts officers in respect of federal government transactions.
- d) *Provincial governments.* The CGA also has primary responsibility for the completeness and accuracy of the financial statements of the provincial governments.
- e) Reporting to the CGA, the accountant general of each province is responsible for the centralised accounting and reporting functions within his/her respective province.
- f) *District governments.* Each province is divided into districts. The district coordination officer of each district is the principal accounting officer of that district. The district coordination officer is supported by executive district officers who, in turn, supervise offices headed by drawing and disbursing officers.
- g) *Principal Accounting Officers (PAOs).* Each ministry and department has a PAO. For the self accounting entities, the PAOs have been delegated authority to maintain their own accounts. They provide monthly accounting data to the AGPR and to the accountant generals.
- h) *District Accounts Officers (DAOs).* The DAOs are responsible for the accounting functions of the districts. They have authority to pre-audit bills, issue payments, and record government transactions at the district level. They receive reports from the drawing and disbursing officers and bank scrolls from the State Bank of Pakistan/National Bank of Pakistan. They report district and provincial transactions to the Accountant General responsible for the province in which their districts are located. They also report federal transactions to the AGPR.
- i) *Departmental treasuries.* Departmental treasuries are established to record specific accounting transactions such as income and sales taxes and customs duties.

- j) *Drawing and Disbursing Officers (DDOs)*. The DDOs are responsible for the accounting, cash and personnel functions of specific entities. They submit bills for pre-audit to the district accounts officers, and report to the district coordination officer of each district. They also report to the principal accounting officer of his/her entity.

1.4.2 DAGP's mandate includes the audit of the entire process described above.

1.5 Stages of audit work dealt with

- 1.5.1 The manual covers the entire audit cycle for both the financial attestation and compliance with controls aspects of regularity audits, including planning, fieldwork, evaluation of findings, reporting and follow up. While many of the same procedures apply to both attestation and compliance audit activities, sometimes different approaches are required to meet specific audit objectives. Where this is the case, the different approaches are described. This Manual also deals with such quality assurance techniques as supervision and review.

The manual covers the entire Audit Cycle.

1.6 Organisation of the manual

- 1.6.1 The Manual begins with several Chapters that provide background material on audits in general, DAGP's mandate, and the auditing standards adopted by DAGP.
- 1.6.2 This is followed by a discussion of DAGP's management structure and the annual planning process by which DAGP establishes its departmental goals and resource needs.
- 1.6.3 The auditors' responsibilities through the complete audit cycle – the planning, fieldwork, evaluation, reporting and follow-up of individual audits – are presented using a framework which is based on professional standards issued by the International Standards of Supreme Audit Institutions, ISSAI.
- 1.6.4 Throughout the manual, various quality assurance procedures are introduced. The Manual concludes with a summary of these procedures.
- 1.6.5 The Manual also contains a number of annexes that provide additional details and guidance material on specific matters, as well as a glossary of the terms used.

1.7 Links to other guidance material

- 1.7.1 This manual is supported by a standard audit Working Papers Kit and a set of tailored audit programme guides / sectoral audit guidelines. This Manual also makes reference to other DAGP documentation in existence at the time that this manual was revised in year 2012.

1.8 Standard audit Working Papers Kit

- 1.8.1 The kit includes standard audit programme guides, checklists and forms, and a table of contents that follows a suggested standard working paper indexing scheme.
- 1.8.2 The kit also includes samples of the various supervision instruments used in DAGP.
- 1.8.3 Audit guidelines for specialised areas.
- 1.8.4 This Manual and the standard audit Working Papers Kit are applicable to the regularity audits of all audit areas. These documents are complemented by tailored audit programme guides that show how the concepts in the manual, and the programmes, checklists, forms and supervision instruments in the Working Papers Kit, are applied to perform financial audits in certain specific audit areas.

1.9 Need for professional judgment

Despite the guidance presented in this manual, professional judgement is always

- 1.9.1 Despite the detailed guidance presented in this manual, professional judgment is always required. It is not possible to present guidance material in sufficient detail to eliminate the need for professional judgment and general knowledge of auditing theory. Nor is it possible to select one audit approach and mandate its use in all circumstances.
- 1.9.2 There are many possible approaches to obtaining the required level of audit assurance, each appropriate in certain circumstances. The auditor must be prepared to consider the circumstances of each audit and determine the best approach.

1.10 Updating the Audit Manual

This manual should be periodically up-dated to ensure that it reflects the current

- 1.10.1 DAGP's work, like the work of any SAI, continues to evolve. Consequently, this Manual should be periodically up-dated to ensure that it reflects the current policies and procedures of the office and to provide the most appropriate assistance to the auditors. Each auditor is therefore encouraged to identify areas in which the Manual requires updating or enhancement.
- 1.10.2 With appropriate up-dating, this Manual will continue to provide a clear statement of the authorities, responsibilities and policies of DAGP and a practical guide to auditors as they carry out their responsibilities in a professional and conscientious manner.

ROLE OF THE AUDITOR-GENERAL

1.11 Parliamentary Control and Public Accountability

- 1.11.1** Accountability of elected officials and the public servants that implement their policies is a cornerstone of democratic government. In Pakistan, the government is formed of elected representatives of the people, and is required by the Constitution to seek a fresh mandate every five years.
- 1.11.2** To ensure the administrative machinery of the government performs its functions in accordance with the aspirations of the people, the National Assembly (lower house of the Parliament) and the four Provincial Assemblies constitute Standing Committees on Public Accounts (PACs). The PACs are mandated to oversee the implementation of government policies and programmes.
- 1.11.3** The Government departments and agencies are held accountable for any major departure from the approved budget and for significant violations of rules and regulations. The Auditor-General of Pakistan reviews the financial statements submitted by each Government department and agency and reports findings to the President and Provincial Governors who submit them to the National and Provincial Assemblies respectively. The legislatures assign these reports to the PACs for detailed scrutiny. Each PAC holds hearings at which secretaries of the ministry, divisions and departments submit their responses to the Auditor-General's observations. Based on this testimony, each PAC then makes its recommendations to the National Assembly. This process ensures that departments and agencies are accountable to government for implementation of policies in accordance with regulations.

Accountability of elected officials and the public servant is a cornerstone of democratic government.

1.12 Introduction to Auditing

- 1.12.1** Auditing is the process by which the Auditor-General of Pakistan (or such officer of the department as may be authorised in this regard by general or special order) evaluates the financial statements that have been submitted for audit by the ministries, departments and agencies, against the government's accounting and financial administration policies to enable him to prepare a report or state an opinion on the financial statements.
- 1.12.2** Section 3.4 of DAGP's Auditing Standards requires that a financial audit will include a test of compliance with applicable laws and regulations.
- 1.12.3** To ensure that an audit has value, it should be conducted in accordance with generally accepted auditing standards (GAAS). These standards have developed over many generations of auditors around the world to provide the basis for ensuring complete, accurate, honest and transparent reporting of financial operations.

The Auditor-General of Pakistan evaluates the financial statements submitted by ministries, department, and agencies

The Constitution of the Islamic Republic of Pakistan, Articles 168

Legislative Basis

- 1.13.1** The authority under which the Auditor-General of Pakistan conducts audits is given by Article 169 of the Constitution of the Islamic Republic of Pakistan. In addition, Articles 168 to 171 also relate to the work of the Auditor-General.
- 1.13.2** Until 1 July 2001, most of DAGP’s audit work was performed under Articles 168 to 171 of the Constitution, and the Pakistan (Audit and Accounts) Order, 1973.
- 1.13.3** Effective 1 July 2001, the Pakistan (Audit and Accounts) Order, 1973 was replaced by the following two ordinances:
- a) Auditor-General’s (Functions, Powers and Terms and Conditions of Service) Ordinance, 2001 (Auditor-General Ordinance); and
 - b) Controller General of Accounts (Appointment, Functions and Powers) Ordinance, 2001 (Controller General Ordinance).
- 1.13.4** Among other things, these ordinances elaborate on the functions, powers and responsibilities of the Auditor-General of Pakistan in line with the provisions of Article 169 of the Constitution.
- 1.13.5** Section 7 of the Auditor-General’s (Functions, Powers and Terms and Conditions of Service) Ordinance, 2001 (Auditor-General Ordinance) states that “The Auditor-General shall, on the basis of such audit as he may consider appropriate and necessary, certify the accounts” ... “of the Federation, of each Province and of each district”. A financial attestation audit leads to the certifications called for in Section 7 of the Auditor-General Ordinance.
- 1.13.6** In addition, Section 8 of the Auditor-General Ordinance mandates an audit of expenditures of the Federation and of each province and Section 12 of the Auditor-General Ordinance mandates an audit of the receipts of the Federal Government and of each Province and each district.

1.14 Vision, Mission and Values

- 1.14.1** DAGP has developed a set of guiding principles for the exercise of its mandate. These principles – the Vision, Mission and Values - are as follows:
- 1.14.2** The Vision of DAGP is to add value to public resources.
- 1.14.3** The Mission of DAGP is to develop our auditing and accounting capabilities to establish ourselves as a credible professional institution that promotes good governance and public accountability.
- 1.14.4** The Values held by DAGP are:
- a) *Accountability*. DAGP holds itself accountable for the achievement of its vision, mission, and these stated values.
 - b) *Professionalism*. DAGP conducts all of its activities in an open, transparent, disciplined and highly ethical manner that is worthy of professional respect and trust.

- c) *Integrity*. DAGP takes an objective, fair, honest and balanced approach to all of its activities.
- d) *Excellence*. DAGP strives for excellence in all of its activities.
- e) *Reliability*. DAGP produces high quality products that are timely, accurate, useful, clear and candid.
- f) *Cooperative and constructive spirit*. DAGP works with parliamentarians and with its audit entities, staff, suppliers, consultants and other parties with whom it deals in a professional, cooperative and constructive manner.
- g) *Innovative spirit*. DAGP constantly looks for ways to improve its audit practices, operations and other activities.
- h) *Making a difference*. DAGP constantly looks for ways to improve the operations of the entities that it audits.
- i) *Risk managers*. DAGP managers and staff are encouraged to accept challenges, and to take and manage the risks required for DAGP to achieve its vision, mission and stated values.
- j) *Open communications*. DAGP maintains open and timely communications with parliamentarians and with its audit entities, staff, suppliers, consultants and other parties with whom it deals.
- k) *A respectful workplace*. DAGP provides a workplace in which a diverse workforce can strive for excellence and professional competence, and where individuals can realise their full career potential.

THE JOB OF THE AUDITOR

1.15 Introduction

1.15.1 The auditor is a professional with a special role to play in ensuring the integrity of the operations of the Government of Pakistan and safeguarding its assets. As such the auditor must fulfill certain expectations with respect to performance of duties and ethical conduct. The auditor is employed pursuant to a set of formal conditions and should expect appropriate protection in the fulfillment of his or her responsibilities. These issues are outlined below.

The auditor must fulfil certain expectations with respect to performance of duties and

1.16 Expectations

1.16.1 Auditors work in teams. Audit teams perform their work in accordance with DAGP's Auditing Standards, which are described in detail in Chapter 2. The audit teams should fulfil a number of general expectations in performing their duties:

- a) At least one auditor within the audit team should be fully conversant with the rules and regulations concerning the accounts to be audited.
- b) The audit team should subject the audit entity to a complete and thorough check according to the audit programme within the constraints of the time available. Any failure to complete the prescribed audit programme must be reported clearly and fully to the Competent Authority.
- c) Each auditor is expected to use professional judgment in carrying out all aspects of an audit programme.
- d) Although it is not the responsibility of the auditor to detect fraud, every auditor is expected to take appropriate action wherever a situation of fraud is suspected.

1.17 Conditions of Employment

1.17.1 The conditions of employment of auditors within DAGP have been formally and extensively documented in the Auditor-General's Manual of Standing Orders. Please refer to the Manual of Standing Orders for details.

1.18 Code of Ethics

1.18.1 Concept, Background and Purpose of the Code of Ethics

1.18.2 The Auditor General of Pakistan (AGP) has deemed it essential to establish a Code of Ethics for auditors in the public sector.

- a) This Code of Ethics is a comprehensive statement of the values and principles which should guide the daily work of auditors. The independence, powers and responsibilities of the public sector auditor place high ethical demands on the DAGP and the staff deployed on audit work. This code of ethics for auditors in the public sector outlines the

ethical precepts of civil servants in general and the particular requirement of auditors, including the latter's professional obligations.

- b) With the Lima Declaration of Guidelines on Auditing Precepts as its foundation, this Code of Ethics should be seen as a necessary complement, reinforcing the Auditing Standards issued by the Auditor General of Pakistan in June 2002 in line with INTOSAI Code of Ethics and Auditing Standards.
- c) The Code Ethics is directed at the individual auditor, the Auditor-General of Pakistan, executive officers and all individuals working for or on behalf of the AGP who are involved in audit work.
- d) It is the responsibility of the AGP to ensure that all its auditors acquaint themselves with the values and principles contained in this Code of Ethics and act accordingly.
- e) The conduct of auditors should be beyond reproach at all times and in all circumstances. Any deficiency in their professional conduct or any improper conduct in their personal life places the integrity of auditors, The DAGP is looked upon with trust, confidence and credibility. The auditor promotes this by adopting and applying the ethical requirements of the concepts embodied in the key words Integrity, Independence and Objectivity, Confidentiality and Competence.

1.18.3 Trust, Confidence and Credibility

1.18.4 The legislative and/or executive authority, the general public and the audited entities are entitled to expect the conduct and approach of the officers and the staff of the DAGP to be above suspicion and reproach and worthy of respect and trust.

The general public and the audited entities expect the conduct and approach of the officers of the Department of the AGP to be above suspicion and reproach

- a) Auditors should conduct themselves in a manner which promotes co-operation and good relations among themselves and within the profession. The support of the profession by its members and their co-operation with one another are essential elements of professional character. The public confidence and respect that an auditor enjoys is largely the result of the cumulative accomplishments of all auditors, past and present. It is therefore in the interest of auditors, and the public, for auditors to conduct themselves in a fair and balanced way.
- b) The legislative and/or executive authority, the general public and the audited entities should be fully assured of the fairness and impartiality of all the work the Department of the AGP.
- c) In all parts of society there is a need for credibility. It is therefore essential that the reports and opinions of the Department of the AGP are considered to be thoroughly accurate and reliable by knowledgeable third parties.
- d) All work performed by the DAGP must stand the test of legislative and executive scrutiny, public judgments on propriety, and examination against this Code of Ethics.

1.18.5 Integrity

- a) Integrity is the core value of this Code of Ethics. Auditors have a duty to adhere to high standards of behaviour (e.g. honesty and candidness) in the course of their work and in their relationships with the staff of audited entities. In order to sustain public confidence, the conduct of auditors should be above suspicion and reproach.

Auditors have a duty to adhere to high standards of behaviour

- b) Integrity, including financial, moral, and intellectual integrity, can be measured in terms of what is right and just. Integrity requires auditors to observe both the form and the spirit of auditing and ethical standards. Integrity also requires auditors to observe the principles of independence and objectivity, maintain irreproachable standards professional conduct, make decisions with the public interest in mind, and apply absolute honesty in carrying out their work and in handling the resources of the DAGP.

1.18.6 Independence, Objectivity and Impartiality

- a) Independence from the audited entity and other outside interest groups is indispensable for auditors. This implies that auditors should behave in a way that increases, or in no way diminishes, their independence.
- b) Auditors should strive not only to be independent of audited entities and other interested groups, but also to be objective in dealing with the issues and topics under review.
- c) It is essential that auditors are independent and impartial, not only in fact but also in appearance.
- d) In all matters relating to the audit work, the independence of auditors should not be impaired by personal or external influence. Independence may be impaired, for example, by external pressure or influence on auditors; prejudices held by auditors about individuals, audited entities, projects or programmes; recent previous employment with the audited entity; or personal or financial dealings which might cause conflicts of loyalties or of interests. Auditors have an obligation to refrain from becoming involved in all matters in which they have a vested interest.
- e) There is need for objectivity and impartiality in all work conducted by auditors, particularly in their reports, which should be accurate and objective. Conclusions in opinions and reports should, therefore, be based exclusively on evidence obtained and assembled in accordance with the auditing standards of the DAGP.
- f) Auditors should make use of information brought forward by the audited entity and other parties. This information is to be taken into account in the opinions expressed by the auditors in an impartial way. The auditor should also gather information about the views of the audited entity and other parties. However, the auditor's own conclusions should not be affected by such views.

Auditors should be independent and

1.18.7 Political neutrality

- a) It is important to maintain both the actual and perceived political neutrality of the DAGP. Therefore, it is important that auditors maintain their independence from political influence in order to discharge their audit responsibilities in an impartial way. This is relevant for auditors since DAGP works closely with the legislative authorities, which is empowered by law to consider the reports of the AGP.

It is important to maintain political neutrality of the Department

1.18.8 Conflicts of Interest

- a) When auditors are permitted to provide advice or services other than audit to an audited entity, care should be taken that these services do not lead to a conflict of interest. In particular, auditors should ensure that

Auditors should not be involved in management decisions

such advice or services do not include management responsibilities or powers, which must remain firmly with the management of the audited entity.

b) Auditors should protect their independence and avoid any possible conflict of interest by refusing gifts or gratuities that could influence or be perceived as influencing their independence and integrity. Government servants, Conduct Rules, 1964 shall also apply in this regard.

c) Auditors should avoid all relationships with managers and staff in the audited entity and other parties that may influence, compromise or threaten the ability of auditors to act and be seen to be acting independently.

d) Auditors should not use their official position for private purposes and should avoid relationships that involve the risk of corruption or may raise doubts about their objectivity and independence.

e) Auditors should not use information received in the performance of their duties as a means of securing personal benefit for themselves or for others. Neither should they divulge information that would provide unfair or unreasonable advantage to other individuals or organisations, nor should they use such information as means for harming others.

1.18.9 Professional Secrecy

a) Auditors should not disclose information obtained in the auditing process to third parties, either orally or in writing, except for the purposes of meeting the statutory or other identified responsibilities of the DAGP as part of its normal procedures or in accordance with relevant laws.

Auditors should not disclose information obtained in the auditing

1.18.10 Competence

a) Auditors have a duty to conduct themselves in a professional manner at all times and to apply high professional standards in carrying out their work to enable them to perform their duties competently and with impartiality.

b) Auditors must not undertake work they are not competent to perform.

c) Auditors should know and follow applicable auditing, accounting, and financial management standards, policies, procedures and practices. Likewise, they must possess a good understanding of the constitutional, legal and institutional principles and standards governing the operations of the audited entity.

Auditors should know auditing, accounting, and financial management standards, policies, procedures

1.18.11 Professional Development

1.18.12 Auditors should exercise due professional care in conducting and supervising the audit and in preparing related reports.

a) Auditors should use methods and practices of the highest possible quality in their audits. In the conduct of the audit and the issue of reports, auditors have a duty to adhere to basic principles and generally accepted auditing standards.

b) The DAGP has a continuous obligation to update and improve the skills of officers and staff in the discharge of their professional responsibilities.

1.19 Glossary

1.19.1 The terms used in this Code of Ethics have the same interpretation or definition as those used in the Auditing Standards.

1.20 Protection of the Auditor

1.20.1 Auditors must have the freedom to carry out audits in a conscientious and thorough manner. There is an onus on the auditor to carry out the audits in a fair, objective and courteous manner (and comply with the Code of Ethics presented in the Section above). In turn, the auditor expects to receive cooperation and courtesy from those being audited.

Attempts to hinder or impede the conduct of the audit should be brought to the attention of the

1.20.2 Any serious attempts to hinder or impede the conduct of the audit should be brought to the attention of the Competent Authority. Any concern of possible intimidation or threat to the auditor must be taken seriously both by the auditor and the management of DAGP. A formal process should be followed wherever the auditor, or the conduct of the audit, is threatened, or a risk of impedance is perceived. This process involves the following steps:

- a) Whenever the auditor senses any problems in the conduct of the audit, he/she should ensure that all meetings are held with at least two auditors present and that notes of these meetings are clearly documented;
- b) The auditor should inform his/her supervisor or Competent Authority in writing of any serious incidents or concerns with specific details of what transpired;
- c) A course of action is proposed by the Competent Authority, if necessary, in consultation with senior management within DAGP;
- d) Depending on the seriousness of the situation, and the nature of the problem, one or more of the following courses of action should be implemented:
 - The Competent Authority raises the issue with the Principal Accounting Officer, or equivalent;
 - A letter, signed by the Auditor-General or Deputy Auditor-General, is submitted to the Principal Accounting Officer, or equivalent, and/or sent to the Controller General;
 - The composition of the audit team is changed;
 - If necessary, after consultation with the Auditor-General, seek a legal opinion or other course of action; and
 - Whenever an individual auditor is not satisfied with the action taken, they have the right to report their concern to the Assistant Auditor-General, Personnel, a Deputy Auditor-General or the Auditor-General.

2 DAGP AUDIT STANDARDS

2.1 INTOSAI's Professional Standards

- 2.1.1** The purpose and authority of INTOSAI's Professional Standards
The International Organization of Supreme Audit Institutions (INTOSAI) provides an institutionalised framework for Supreme Audit Institutions to promote development and transfer of knowledge, improve public sector auditing worldwide and enhance the professional capacities, standing and influence of its members in their respective countries. Supreme Audit Institutions are national authorities with responsibility within the constitutional system for the auditing of publicly funded activities. The exchange of knowledge among INTOSAI members and the resulting findings and insights is a guarantee that public sector auditing continuously improves.
- 2.1.2** INTOSAI issues two sets of professional standards: The International Standards of Supreme Audit Institutions (ISSAIs) and the INTOSAI Guidance for Good Governance (INTOSAI GOV). The ISSAIs and INTOSAI GOVs convey the generally recognized principles and shared professional experiences of the international community of Supreme Audit Institutions. All ISSAIs and INTOSAI GOVs are developed and maintained in accordance with the Due Process for INTOSAI's Professional Standards and issued after a decision of final endorsement by all Supreme Audit Institutions at INTOSAI's congress (INCOSAI).
- 2.1.3** The general framework of the auditing standards of the Auditor General of Pakistan is based on the principles of the ISSAIs.

2.2 The International Standards of Supreme Audit Institutions (ISSAIs)

- 2.2.1** The ISSAIs aim to safeguard independent and effective auditing and support the members of INTOSAI in the development of their own professional approach on the basis of their specific mandate. INTOSAI has called upon its members to:
- a) Use the ISSAI framework as a common frame of reference for public sector auditing;
 - b) Measure their own performance and auditing guidance against the ISSAIs;
 - c) Implement the ISSAIs in accordance with their mandate and national legislation and regulations;
- 2.2.2** The ISSAIs form a hierarchy of official pronouncements with Four Levels and INTOSAI Guidance for Good Governance :
- 2.2.3** Level 1 - Founding Principles (ISSAI 1)
Level 1 of the ISSAI framework contains the founding principles of INTOSAI. ISSAI 1 the Lima Declaration from 1977 calls for the

establishment of effective Supreme Audit Institutions and provide guidelines on auditing precepts. The full set of ISSAIs draw and elaborate on this historical document.

2.2.4 Level 2 - Prerequisites for the Functioning of Supreme Audit Institutions (ISSAIs 10-99)

ISSAIs Level 2 contain INTOSAI's pronouncements on the necessary preconditions for the proper functioning and professional conduct of Supreme Audit Institutions. The prerequisites may concern the institution's mandate and further legislation as well as the established procedures and daily practices of the organization and its staff. By issuing pronouncements on these generally accepted prerequisites, INTOSAI aims to advance sound principles for the effective functioning of public sector auditing on an international level.

2.2.5 Level 3 - Fundamental Auditing Principles (ISSAIs 100-999)

ISSAIs Level 3 expresses the essence of public sector auditing. They contain the common pronouncements by INTOSAI's members of the generally recognized professional principles that underpin effective, independent auditing of public sector entities. The principles draw and elaborate on the founding principles of ISSAI 1 The Lima Declaration and provide the authoritative international frame of reference that defines public sector auditing in its contemporary forms. The purpose is to advance and safeguard good auditing practices, support the continued development of effective Supreme Audit Institutions and provide a common professional foundation for international cooperation within INTOSAI and its regional organizations. The principles should be pursued on the basis of the individual Supreme Audit Institution's mandate and strategies and applied as relevant and appropriate for the specific audit assignment taking cognizance of the prerequisites of independence, transparency and accountability, ethics and quality control.

2.2.6 Level 4 - Auditing Guidelines (ISSAIs 1000-4999)

The Auditing Guidelines translate the fundamental auditing principles into more specific, detailed and operational guidelines that can be used on a daily basis in the conduct of auditing tasks. The purpose of the guidelines is to provide a basis for the standards and manuals on public sector auditing which may be applied by the individual members of INTOSAI. Each guideline has a defined scope of application and may be adopted in full or adapted as necessary to reflect the individual circumstances of the jurisdiction. Such circumstances may include the legal mandate and further strategies and capacity of the Supreme Audit Institution as well as the specific purpose and character of the audit assignments. Some of the level 4 guidelines include specific requirements related to authority. The *General auditing guidelines* (ISSAIs 1000- 4999) contain the recommended requirements of financial, performance and compliance auditing and provide further guidance to the auditor. They are developed and continuously updated by specialized subcommittees and define the internationally recognized

best current practice within their general scope of application. The *Guidelines on specific subjects* (ISSAIs 5000-5999) provide supplementary guidance on the auditing of specific subject matters or other important issues which may require the special attention of Supreme Audit Institutions. These guidelines express the key lessons resulting from the sharing of knowledge and good practices among INTOSAI's experts.

2.2.7 The Financial Audit Guidelines draw on International Standards on Auditing developed by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC).

2.2.8 The INTOSAI Guidance for Good Governance (INTOSAI GOV) The INTOSAI GOVs form a separate group of pronouncements. They express INTOSAI's recommendations to governments and others with responsibility for the management of public funds and publicly funded activities. Their purpose is to advance good governance, including the establishment of effective systems of internal control, reliable internal auditing and adequate standards of accounting and reporting in the public sector. They may also serve to guide the Supreme Audit Institutions in their assessment of such measures. The INTOSAI GOVs are developed by specialized subcommittees and reflect the generally shared experiences of the experts within INTOSAI.

2.3 Fundamental Auditing Principles

The ISSAIs consist of four parts.

- a) Basic principles
- b) General standards
- c) Field standards
- d) Reporting standards

These standards have been developed to provide a framework for the establishment of procedures and practices to be followed in the conduct of an audit, including audits of computer-based systems. They should be viewed in the context of the particular constitutional and legal provisions applicable to the DAGP.

Basic Principles

2.3.1 The basic principles for auditing standards are basic assumptions, consistent premises, logical principles and requirements which help in developing auditing standards and serve the auditors in forming their opinions and reports, particularly in cases where no specific standards apply.

- 2.3.2** Auditing standards should be consistent with the principles of auditing: They also provide guidance for the auditor that helps determine the extent of auditing steps and procedures that should be applied in the audit. Auditing Standards constitute the criteria or yardsticks against which the quality of the audit results are evaluated.
- 2.3.3** Interpretations, explanation and amendments of these standards are the prerogative and responsibility of the AGP.
- 2.3.4** The basic principles are:
- a) The DAGP will ensure compliance with the auditing standards in all matters that are deemed material. These standards will be applied to ensure that the work is of consistently high quality.
 - i. In general terms, a matter may be judged material if knowledge of it would be likely to influence the user of the financial statements or the performance audit report.
 - ii. Materiality is often considered in terms of value but the inherent nature or characteristics of an item or group of items may also render a matter material—for example, where the law or regulation requires it to be disclosed separately regardless of the amount involved.
 - iii. In addition to materiality by value and by nature, a matter may be material because of the context in which it occurs. For example, considering an item in relation to:
 - a) The overall view given to the financial information;
 - b) The total of which it forms a part;
 - c) Associated terms and issues;
 - d) The corresponding amount in previous years.
 - iv. Sometimes the DAGP carries out activities that by strict definition do not qualify as audits, but which contribute to better government, e.g., (a) gathering data without conducting substantial analysis, (b) legal work, (c) an assistance mission for members of the elected Assemblies as regards investigations and consultations of files of the DAGP. These non-audit activities provide valuable information to decision-makers and should be of consistently high quality.
 - v. To ensure that high quality work is done, appropriate standards must be followed. The objectives of the particular type of work or the particular assignment should dictate the specific standards that are followed. The DAGP shall establish a policy for implementing these standards to ensure that the work and products are of high quality.
 - b) The DAGP shall apply its own judgment to the diverse situations that arise in the course of government auditing.
 - i. Audit evidence plays an important part in the auditor’s decision concerning the selection of issues and areas for the audit and the nature, timing and extent of audit tests and procedures.
 - ii. The terms of the audit mandate with which the DAGP is endowed override any accounting or auditing conventions with which they conflict, and hence have a crucial bearing on the auditing standards that the Department applies.
 - iii. The DAGP must judge the extent to which external auditing standards are compatible with the fulfilment of its mandate.

- iv. For some elements of the mandate of the AGP, particularly in regard to the audit of financial statements, the audit objectives may be akin to the objectives of audits in the private sector. Correspondingly, private sector standards for the financial statements auditing which are promulgated by official regularity bodies might be applicable to the government auditor.
- c) With increased public consciousness, the demand for public accountability of persons or entities managing public resources has become increasingly evident so that there is a need for the accountability process to be in place and operating effectively.
 - i. Public enterprises are also required to fulfil public accountability obligations. Public enterprises may include commercial undertakings, e.g. entities established by statute or executive order or in which the Government has a controlling interest. Irrespective of the manner in which they are constituted, their functions, degree of autonomy or funding arrangements, such entities are ultimately accountable to the respective legislature.
- d) Development of adequate information, control, evaluation and reporting systems within the government will facilitate the accountability process. Management is responsible for correctness and sufficiency of the form and content of the financial reports and other information
 - i. The correctness and sufficiency of the financial reports and statements are the entity's expression of the financial position and the results of operations. It is also the entity's obligation to design a practical system which will provide relevant and reliable information.
- e) Appropriate authorities should ensure the promulgation of acceptable accounting standards for financial reporting and disclosure relevant to the need of the government, and audited entities should develop specific and measurable objectives and performance targets
 - i. The DAGP shall work with the accounting standards setting organisations to help ensure that proper accounting standards are issued for the government.
 - ii. The DAGP shall also recommend to the audited entities that measurable and clearly stated objectives be established and that performance targets be set for these objectives.
- f) Consistent application of acceptable accounting standards should result in the fair presentation of the financial position and the results of operations
 - i. The assumption that consistency in application of accounting standards is a prerequisite of fairness means that an audited entity must comply with accounting standards appropriate in the circumstances, as well as the requirements of applying such accounting standards in a consistent manner. An auditor should not consider compliance with accounting standards in a consistent manner as a definitive proof of presenting fairly the various financial reports. Fairness is an expression of an auditor's opinion that goes beyond the limits of consistent application of accounting standards. Such an assumption emphasises that the auditing standards are no more than

the minimum requirements for an auditor's obligation. Going beyond that minimum is for the auditor's judgment.

- g) The existence of an adequate system of internal control minimises the risk of errors and irregularities.
 - i. It is the responsibility of the audited entity to develop adequate internal control systems to protect its resources. It is not the auditor's responsibility. It is also the obligation of the audited entity to ensure that controls are in place and functioning to help ensure that applicable statutes and regulations are complied with, and that probity and propriety are observed in decision making. However, this does not relieve the auditor from submitting proposals and recommendations to the audited entity where controls are found to be inadequate or missing.
- h) Legislative enactments would facilitate the co-operation of audited entities in maintaining and providing access to all relevant data necessary for a comprehensive assessment of the activities under audit.
 - i. The DAGP must have access to the sources of information and data as well as access to officials and employees of the audited entity in order to carry out properly its audit responsibilities. Enactment of legislative requirements for access by the auditor to such information and personnel will help minimise future problems in this area.
- i) All audit activities should be within the audit mandate of the Auditor General of Pakistan
 - i. The essential function of the DAGP is to uphold and promote public accountability. This jurisdictional function requires the Department to make sure that whoever is charged with dealing with public funds is accountable to it and is in this regard subject to its jurisdiction.
 - ii. There exists an important complementarity between this jurisdictional authority and the other characteristics of audit. This characteristic should be viewed as a part of the logic of the general objective pursued by external audit and more particularly those which relate to accounting management.
 - iii. The full scope of government auditing includes regularity and performance audit.
 - iv. Regularity audit embraces:
 - a) Attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions of financial statements;
 - b) Attestation of financial accountability of the government administration as a whole;
 - c) Audit of financial systems and transactions including an evaluation of compliance with applicable statutes and regulations;
 - d) Audit of internal control and audit functions;
 - e) Audit of the probity of administrative decisions taken within the audited entity; and
 - f) Reporting of any other matters arising from or relating to the audit that the DAGP considers should be disclosed.

- v. Performance audit is concerned with the audit of economy, efficiency and effectiveness and embraces:
 - a) Audit of the economy of administrative activities in accordance with sound administrative principle and practices, and management policies;
 - b) Audit of the efficiency of utilisation of human, financial and other resources, including examination of information systems, performance measures and monitoring arrangements, and procedures followed by audited entities for remedying identified deficiencies; and
 - c) Audit of the effectiveness of performance in relation to the achievement of the objectives of the audited entity, and audit of the actual impact of activities compared with the intended impact.

- vi. In practice there can be an overlap between regularity and performance auditing, and in such cases classification of a particular audit will depend on the primary purpose of that audit.
- vii. The mandate of the DAGP shall clearly delineate its powers and responsibilities in relation to performance auditing in all areas of government activity, among other things to facilitate the application of appropriate auditing standards.
- viii. Public accountability will be more effectively promoted where the mandate enables the DAGP to conduct, or direct the conduct of, regularity and performance auditing of all public enterprises.

- j) The DAGP shall work towards improving techniques for auditing the validity of performance measures.
 - i. The DAGP shall work towards improving techniques for auditing the validity of performance measures.
 - ii. The expanding audit role of the auditors will require them to improve and develop new techniques and methodologies to assess whether reasonable and valid performance measures are used by the audited entity. The auditors should avail themselves of techniques and methodologies of other disciplines.
 - iii. The scope of the audit mandate will determine the scope of the standards to be applied by the DAGP.

General Standards

2.3.5 This section deals with general standards in government auditing. The general auditing standards describe the qualifications of the auditor and/or the auditing institution so that they may carry out the tasks related to field and reporting standards in a competent and effective manner.

2.3.6 The general auditing standards are that the DAGP shall adopt policies and procedures to:

- a) Recruit personnel with suitable qualifications
 - i. Personnel of the DAGP shall possess suitable academic qualifications and be equipped with appropriate training and experience. The Department shall establish, and regularly review, minimum educational requirements for the appointment of auditors.

- b) Develop and train employees of the DAGP to enable them to perform their tasks effectively, and to define the basis for the advancement of auditors and other staff.
- i. The Department shall take adequate steps to provide for continuing professional development of its personnel, including, as appropriate, provision of in-house training and encouragement of attendance at external courses.
 - ii. The Department shall maintain an inventory of skills of personnel to assist in the planning of audits as well as to identify professional development needs.
 - iii. The Department shall establish and regularly review criteria, including educational requirements, for the advancement of auditors and other staff of the SAI.
 - iv. The Department shall also establish and maintain policies and procedures for the professional development of audit staff regarding the audit techniques and methodologies applicable to the range of audits it undertakes.
 - v. Personnel of the DAGP shall have a good understanding of the government environment, including such aspects as the role of the legislature, the legal and institutional arrangements governing the operations of the executive and the charters of the public enterprises. Likewise, trained audit staff must possess an adequate knowledge of the Department's auditing standards, policies, procedures and practices.
 - vi. Audit of financial systems, accounting records and financial statements requires training in accounting and related disciplines as well as a knowledge of applicable legislation and executive orders affecting the accountability of the audited entity. Further, the conduct of performance audits may require, in addition to the above, training in such areas as administration, management, economics and the social sciences.
 - vii. The Department shall encourage its personnel to become members of a professional body relevant to their work and to participate in that body's activities.
- c) Prepare manual and other written guidance and instructions concerning the conduct of audit.
- i. Communication to staff of the DAGP by means of circulars containing guidance, and the maintenance of an up-to-date audit manual setting out its policies, standards and practices, is important in maintaining the quality of audits.
- d) Support the skills and experience available within the DAGP and identify the skills which are absent; provide a good distribution of skills to auditing tasks and assign a sufficient number of persons for the audit; and have proper planning and supervision to achieve its goals at the required level of due care and concern
- i. Resources required to undertake each audit need to be assessed so that suitably skilled staff may be assigned to the work and a control placed on staff resources to be applied to the audit.
 - ii. The extent to which academic attainment should be related specifically to the audit task varies with the type of auditing

undertaken. It is not necessary that each auditor possess competence in all aspects of the audit mandate. However, policies and procedures governing the assignment of personnel to audit tasks should aim at deploying personnel who have the auditing skills required by the nature of the audit task so that the team involved on a particular audit collectively possesses the necessary skills and expertise.

- iii. It shall be open to the DAGP to acquire specialised skills from external sources if the successful conduct of an audit so requires in order that the audit findings, conclusions and recommendations are perceptive and soundly based and reflect an adequate understanding of the subject area of the audit. It is for the DAGP to judge, in its particular circumstances, to what extent its requirements are best met by in-house expertise as against employment of outside experts.
- iv. Policies and procedures governing supervision of audits are important factors in the performance of the SAI's role at an appropriate level of competence. The DAGP shall ensure that audits are planned and supervised by auditors who are competent, knowledgeable in the standards and methodologies, and equipped with an understanding of the specialities and peculiarities of the environment.
- v. For the audit of financial statements which cover the executive branch of government as a whole, the audit teams deployed shall be equipped to undertake a co-ordinated evaluation of departmental accounting systems, as well as of central agency co-ordination arrangement and control mechanisms. Teams will require a knowledge of the relevant government accounting and control systems, and an adequate expertise in the auditing techniques applied by the Department to this type of audit.
- vi. Unless the Department is equipped to undertake, within a reasonable time-scale, all relevant audits, including performance audits covering the whole of every audited entity's operations, criteria shall be needed for determining the range of audit activities which, within the audit period or cycle, will give the maximum practicable assurance regarding performance of public accountability obligations by each audited entity.
- vii. In determining the allocation of its resources among different audit activities, the Department shall give priority to any audit tasks which must, by law, be completed within a specified time frame. Careful attention shall be given to strategic planning so as to identify an appropriate order of priority for discretionary audits to be undertaken.
- viii. Assignment of priorities compatible with maintaining the quality of performance across the mandate involve the exercise of judgment by the DAGP in the light of available information. Maintenance of a portfolio of data pertaining to the structure, functions and operations of audited entities will assist the department in identifying areas of materiality and vulnerability and areas holding potential for improvements in administration.
- ix. Before each audit is undertaken proper authorisation for its commencement shall be given by designated personnel within the DAGP. This authorisation shall include a clear statement of the objectives of the audit, its scope and focus, resources to be applied to

the audit in terms of skills and quantum, arrangements for reviews of progress at appropriate points, and the dates by which fieldwork is to be completed and a report on the audit is to be provided.

- e) Review the efficiency and effectiveness of the Department internal standards and procedures.
 - i. Because of the importance of ensuring a high standard of work by the DAGP it shall pay particular attention to quality assurance programmes in order to improve audit performance and results. The benefits to be derived from such programmes make it essential for appropriate resources to be available for this purpose. It is important that the use of these resources be matched against the benefits to be obtained.
 - ii. The DAGP shall establish systems and procedures to:
 - a. Confirm that integral quality assurance processes have operated satisfactorily.
 - b. Ensure the quality of the audit report; and
 - c. Secure improvements and avoid repetition of weaknesses.
 - iii. As a further means of ensuring quality of performance, additional to the review of audit activity by personnel having line responsibility for the audits concerned, the Department shall establish its own quality assurance arrangements. That is, planning, conduct and reporting in relation to a sample of audits may be reviewed in depth by suitably qualified personnel of the Department not involved in those audits, in consultation with the relevant audit line management regarding the outcome of the internal quality assurance arrangements and periodic reporting to the top management of the Department.
 - iv. It is appropriate for the DAGP to institute their own internal audit function with a wide charter to assist it to achieve effective management of its own operations and sustain the quality of its performance.
 - v. The quality of the work of the Department shall be enhanced by strengthening internal review and by independent appraisal of its work.
 - vi. The Department shall ensure that applicable standards are followed on all audits and that deviations from the standards which are determined to be appropriate are documented.

Standards with Ethical Significance

2.3.7 The general auditing standards include

- a) The auditor and the DAGP must be independent

Independence

- i. Whatever the form of government, the need for independence and objectivity in audits is vital. An adequate degree of independence from both the legislature and the executive branch of government is essential to the conduct of audit and to the credibility of its results.

- ii. The legislature is one of the main users of the services of the DAGP. It is from the Constitution and the legislation that the SAI derives its mandate, and a frequent feature of the Department's function is its reporting to the legislature. The SAI can be expected to work closely with the legislature, including with any committees empowered by the legislature to consider its reports. Such liaison can contribute to effective follow-up of the Department's work.
- iii. The important results of audits of the carrying-out of the budget and of administration and disputes and disagreements with audited administrations shall be brought to the attention of the legislative body by way of report or special communication.
- iv. Special committees created within the legislative body may be charged with examining, in the presence of delegates from the audited services and other representatives, the comments in the reports and special communications of the DAGP.
- v. The DAGP may give members of the legislature factual briefings on audit reports, but it is important that it maintains its independence from political influence, in order to preserve an impartial approach to its audit responsibilities. This implies that the DAGP shall not be responsive, nor give the appearance of being responsive, to the wishes of particular political interests.
- vi. While the DAGP observes the laws enacted by the legislature, adequate independence requires that it not otherwise be subject to direction by the legislature in the programming, planning and conduct of its work in accordance with its mandate and adopt methodologies appropriate to audits. The DAGP needs freedom to set priorities and programme the audits to be undertaken.
- vii. In cases where the legislature requests the AGP to undertake any audit, the DAGP shall be free to determine the manner in which it conducts its work, including those tasks requested by the legislature.
- viii. It is appropriate for the legislation to specify minimum reporting requirements, including the matters to be subject to an audit opinion and a reasonable time within which reports should be made. Apart from that, flexible arrangements for the Department's reporting to the legislature, without restriction on content or timing of reports, would support the maintenance of independence.
- ix. It is necessary that the DAGP is provided with sufficient resources, for the effective exercise of its mandate.
- x. The executive branch of the government and the SAI do have common interests in the promotion of public accountability. But the essential relationship with the executive is that of external auditor. As such the reports of the AGP are expected to assist the executive by drawing attention to deficiencies in administration and recommending improvements. Care should be taken to avoid participation in the executive's functions of the kind that would militate against the independence and objectivity of the DAGP in the discharge of its mandate.
- xi. It is important for the independence of the DAGP that there be no power of direction by the executive in relation to the Department's performance of its mandate. The Department shall not be obliged to carry out, modify or refrain from carrying out, an audit or suppress or modify audit findings, conclusions and recommendations.

- xii. A degree of co-operation between the DAGP and the executive is desirable in some areas. The SAI shall be ready to advise the executive in such matters as accounting standards and policies and the form of financial statements. The Department must ensure that in giving such advice it avoids any explicit or implied commitment that would impair the independent exercise of its audit mandate.
- xiii. Maintenance of the independence of the DAGP does not preclude requests by the executive proposing matters for audits. But to enjoy adequate independence, the Department shall have the discretion to decline any such request. It is fundamental to the concept of SAI independence that decisions as to the audit tasks comprising the programme shall rest finally with the DAGP.
- xiv. A sensitive area in relationships between the DAGP and the executive concerns provision of resources to the Department. In varying degrees, reflecting constitutional and institutional differences, arrangements for the SAI's resource provision may be related to the executive branch of government's financial situation and general expenditure policies. As against that, effective promotion of public accountability requires that the DAGP be provided with sufficient resources to enable it to discharge its responsibilities in a reasonable manner.
- xv. Any imposition of resource or other restriction by the executive which would constrain the exercise of its mandate by the DAGP would be an appropriate matter for report by the Department to the legislature.
- xvi. The legal mandate should provide for full and free access by the DAGP to all premises and records relevant to audited entities and their operations and should provide adequate powers for the Department to obtain relevant information from persons or entities possessing it.
- xvii. Unless specifically prevented by law, the executive shall permit access by the DAGP to sensitive information which is necessary and relevant to the discharge of the responsibilities of the Department.
- xviii. The DAGP shall ensure that its mandate and its independent status is well understood in the community. The Department shall, as appropriate opportunities arise, undertake an educational role in that regard.
- xix. Functional independence of the DAGP need not preclude arrangements with executive entities in regard to its administration in matters such as personnel management, property management or common purchasing of equipment and stores, though executive entities shall not be in a position to take decisions that would jeopardise the independence of the Department in discharging its mandate.
- xx. The DAGP must remain independent from audited entities. It shall, however, seek to create among audited entities an understanding of its role and function, with a view to maintaining amicable relationships with them. Good relationships can help the department to obtain information freely and frankly and to conduct discussions in an atmosphere of mutual respect and understanding. In this spirit, the Department while retaining its independence can agree to be associated with reforms which are planned by the Administration in areas such as public accounts or financial legislation or agree to be

consulted about the preparation of draft laws or rules affecting its competence or its authority. In these cases it is not, however, a matter of the Department interfering in administrative management but a matter of co-operating with certain administrative services by giving them technical assistance or by putting financial management experience of the Department at their disposition.

- xxi. In contrast to private sector audit, where the auditor's agreed task is specified in an engagement letter, the audited entity is not in a entity relationship with the DAGP. The Department has to discharge its mandate freely and impartially, taking management views into consideration in forming audit opinions, conclusions and recommendations, but owing no responsibility to the management of the audited entity for the scope or nature of the audits undertaken.
 - xxii. The DAGP shall not participate in the management or operations of an audited entity. Audit personnel should not become members of management committees and, if audit advice is to be given, it shall be conveyed as audit advice or recommendation and acknowledged clearly as such.
 - xxiii. Any personnel of the DAGP having close affiliations with the management of an audited entity, such as social, kinship or other relationship conducive to a lessening of objectivity, shall not be assigned to audit that entity.
 - xxiv. Personnel of the DAGP should not become involved in instructing personnel of an audited entity as to their duties. In those instances where the Department decides to establish a resident office at the audited entity with the purpose of facilitating the ongoing review of its operations, programmes and activities, personnel of the DAGP shall not engage in any decision making or approval process which is considered the auditee's management responsibilities.
 - xxv. The DAGP may co-operate with academic institutions and enter formal relationships with professional bodies, provided the relationships do not inhibit its independence and objectivity, in order to avail itself of the advice of experienced members of the profession at large.
- b) The DAGP shall avoid conflict of interest between the auditor and the entity under audit

Conflict of interest

- i. The DAGP performs its role by carrying out audits of the accountable entities and reporting the results. To fulfil this role, the Department needs to maintain its independence and objectivity. The application of appropriate general auditing standards assists the Department to satisfy these requirements.
- c) The auditor and the DAGP must possess the required competence

Competence

- i. The mandate of the DAGP generally imposes a duty of forming and reporting audit opinions, conclusions and recommendations. This duty shall remain that of the heads of the Audit offices.
 - ii. Discussions within the SAI promote the objectivity and authority of opinions and decisions. Decision and opinions as such relating to conclusions, findings and recommendations in the Audit reports are taken in the name of the AGP.
 - iii. Since the duties and responsibilities thus borne by the DAGP are crucial to the concept of public accountability, the Department must apply to its audits, methodologies and practices of the highest quality. It is incumbent upon it to formulate procedures to secure effective exercise of its responsibilities for audit reports, unimpaired by less than full adherence by personnel or external experts to its standards, planning procedures methodologies and supervision.
 - iv. The DAGP needs to command the range of skills and experience necessary for effective discharge of the audit mandate. Whatever the nature of the audits to be undertaken under that mandate, the audit work shall be carried out by persons whose education and experience is commensurate with the nature, scope and complexities of the audit task. The department shall equip itself with the full range of up-to-date audit methodologies, including systems-based techniques, analytical review methods, statistical sampling and audit of automated information systems.
 - v. In view of the wide and discretionary nature of mandate of the DAGP, the task of the ensuring quality of performance across the whole mandate becomes more complex. The Department shall, therefore, ensure, within itself, a high standard of management.
- d) The auditor and the DAGP must exercise due care and concern in complying with these auditing standards. This embraces due care in planning, specifying, gathering and evaluating evidence, and in reporting findings, conclusions and recommendations

2.3.8 Due care

- i. The DAGP must be, and be seen to be, objective in its audit of entities and public enterprises. It should be fair in its evaluations and in its reporting of the outcome of audits.
- ii. Performance and exercise of technical skill should be of a quality appropriate to the complexities of a particular audit. Auditors need to be alert for situations, control weaknesses, inadequacies in record keeping, errors and unusual transactions or results which could be indicative of fraud, improper or unlawful expenditure, unauthorised operations, waste, inefficiency or lack of probity.
- iii. Where an authorised or recognised entity sets standards or guidelines for accounting and reporting by public enterprises, the DAGP may use such guidelines in the course of its examination.
- iv. If the DAGP employs external experts as consultants it must exercise due care to assure itself of the consultants' competence and aptitude for the particular tasks involved. This standard applies also where outside auditors are engaged on contract with the Department. In addition care must be taken to ensure that audit contracts include

- adequate provision for the SAI to determine the planning, the audit scope, the performing, and the reporting on the audit.
- v. Should the DAGP, in the performance of its functions, need to seek advice from specialists external to the Department, the standards for exercise of due care in such arrangements have a bearing also on the maintenance of quality of performance. Obtaining advice from an external expert does not relieve the Department of responsibility for the opinions formed or conclusions reached on the audit task.
 - vi. When the DAGP uses the work of another auditor(s), it must apply adequate procedures to provide assurance that the other auditor(s) has exercised due care and complied with relevant auditing standards, and may review the work of the other auditor(s) to satisfy itself as to the quality of that work.
 - vii. Information about an audited entity acquired in course of the auditor's work must not be used for purposes outside the scope of an audit and the formation of an opinion or in reporting in accordance with the auditor's responsibilities. It is essential that the DAGP maintain confidentiality regarding audit matters and information arising from its audit task. However, the Department must be entitled to report offences against the law to proper prosecuting authorities.

Field Standards

- 2.3.9** The purpose of field standards is to establish the criteria or overall framework for the purposeful, systematic and balanced steps or actions that the auditor has to follow. These steps and actions represent the rules of research that the auditor, as a seeker of audit evidence, implements to achieve a specific result.
- 2.3.10** The field standards establish the framework for conducting and managing audit work. They are related to the general auditing standards, which set out the basic requirements for undertaking the tasks covered by the field standards. They are also related to the reporting standards, which cover the communication aspect of auditing, as the result of carrying out the field standards constitute the main source for the contents of the opinion or report.
- 2.3.11** The field standards applicable to all types of audit are:
- a) The auditor shall plan the audit in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way and in a timely manner
- 2.3.12** Planning
- i. The DAGP shall give priority to any audit tasks which must be undertaken by law and assess priorities for discretionary areas within mandate of the AGP.
 - ii. In planning an audit, the auditor should:
 - a. Identify important aspects of the environment in which the audited entity operates;
 - b. Develop an understanding of the accountability relationships;

- c. Consider the form, content and users of audit opinions, conclusions or reports;
 - d. Specify the audit objectives and the tests necessary to meet them;
 - e. Identify key management systems and controls and carry out a preliminary assessment to identify both their strengths and weakness;
 - f. Determine the materiality of matters to be considered;
 - g. Review the internal audit of the audited entity and its work programme;
 - h. Assess the extent of the reliance that might be placed on other auditors, for example, internal audit;
 - i. Determine the most efficient and effective audit approach;
 - j. Provide for a review to determine whether appropriate action has been taken on previously reported audit findings and recommendations; and
 - k. Provide for appropriate documentation of the audit plan and for the proposed fieldwork.
- iii. The following planning steps are normally included in an audit;
- a. Collect information about the audited entity and its organisation in order to assess risk and to determine materiality;
 - b. Define the objective and scope of the audit;
 - c. Undertake preliminary analysis to determine the approach to be adopted and the nature and extent of enquiries to be made later;
 - d. Highlight special problems foreseen when planning the audit;
 - e. Prepare a budget and a schedule for the audit;
 - f. Identify staff requirements and a team for the audit; and
 - g. Familiarise the audited entity about the scope, objectives and the assessment criteria of the audit and discuss with them as necessary.
- iv. The SAI may revise the plan during the audit when necessary.
- b) The work of the audit staff at each level and audit phase shall be properly supervised during the audit; and documented work shall be reviewed by a senior member of the audit staff

2.3.13 Supervision and Review

- i. 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 the individual auditors.
- ii. Supervision should be directed both to the substance and to the method of auditing. It involves ensuring that:
 - a. The members of the audit team have a clear and consistent understanding of the audit plan;
 - b. The audit is carried out in accordance with the auditing standards and practices of the DAGP.
 - c. The audit plan and action steps specified in that plan are followed unless a variation is authorised;

- d. Working papers contain evidence adequately supporting all conclusions, recommendations and opinions;
 - e. The auditor achieves the stated audit objectives; and
 - f. The audit report includes the audit conclusions, recommendations and opinions, as appropriate.
- iii. All audit work should be reviewed by a senior member of the audit staff before the audit opinions or reports are finalised. It should be carried out as each part of the audit progresses. Review brings more than one level of experience and judgment to the audit task and should ensure that:
- a. All evaluations and conclusions are soundly based and are supported by competent, reliable, relevant and reasonable audit evidence as the foundation for the final audit opinion or report;
 - b. all errors, deficiencies and unusual matters have been properly identified, documented and either satisfactorily resolved or brought to the attention of the more senior officer(s) of the department; and
 - c. 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
- c) The auditor, in determining the extent and scope of the audit, shall study and evaluate the reliability of internal control

2.3.14 Study and Evaluation of Internal Control

- i. The study and evaluation of internal control should be carried out according to the type of audit undertaken. In the case of a regularity (financial) audit, study and evaluation are made mainly on controls that assist in safeguarding assets and resources, and assure the accuracy and completeness of accounting records. In the case of regularity (compliance) audit, study and evaluation are made mainly on controls that assist management in complying with laws and regulations. In the case of performance audit, they are made on controls that assist in conducting the business of the audited entity in an economic, efficient and effective manner, ensuring adherence to management policies, and producing timely and reliable financial and management information.
 - ii. The extent of the study and evaluation of internal control depends on the objectives of the audit and on the degree of reliance intended.
 - iii. Where accounting or other information systems are computerised, the auditor should determine whether internal controls are functioning properly to ensure the integrity, reliability and completeness of the data, and the information system.
- d) In conducting regularity (financial) audits, a test should be made of compliance with applicable laws and regulations. The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of

regularity audits. The auditor also should be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of regularity audits.

- i. In conducting performance audits, an assessment should be made of compliance with applicable laws and regulations when necessary to satisfy the audit objectives. The auditor should design the audit to provide reasonable assurance of detecting illegal acts that could significantly affect audit objectives. The auditor also should be alert to situations or transactions that could be indicative of illegal acts that may have an indirect effect on the audit results.
- ii. Any indications that an irregularity, illegal act, fraud or error may have occurred which could have a material effect on the audit should cause the auditor to extend procedures to confirm or dispel such suspicions.
- iii. The regularity audit is an essential aspect of government auditing. One important objective which this type of audit assigns to the DAGP is to make sure, by all the means put at its disposal, that the Government budget and accounts are complete and valid. This will provide legislature and other users of the audit report with assurance about the size and development of the financial obligations of the Government. To achieve this objective the Department will examine the accounts and financial statements of the administration with a view to assuring that all operations have been correctly undertaken, completed, passed, paid and registered. The audit procedure normally results, in the absence of irregularity, in the granting of an unqualified certificate.
- iv. Reviewing compliance with laws and regulations is especially important when auditing government programmes because decision makers need to know if the laws and regulations are being followed, whether they are having the desired results, and, if not, what revisions are necessary. Additionally government organisation, programmes, services, activities, and functions are created by laws and are subject to more specific rules and regulations.
- v. Those planning the audit need to be knowledgeable of the compliance requirements that apply to the entity being audited. Because the laws and regulations that may apply to a specific audit are often numerous, the auditors need to exercise professional judgment in determining those laws and regulations that might have a significant impact on the audit objectives.
- vi. The auditor should also be alert to situations or transactions that could be indicative of illegal acts that may indirectly impact the results of the audit. When audit steps and procedures indicate that illegal acts have or may have occurred, the auditor shall determine the extent to which these acts affect the audit results.
- vii. In conducting audits in accordance with this standard, the auditors should choose and perform audit steps and procedures that, in their professional judgment, are appropriate in the circumstances. These audit steps and procedures should be designed to obtain sufficient, competent, reliable, and relevant evidence that will provide a reasonable basis for their judgments and conclusions.

- viii. Generally, management is responsible for establishing an effective system of internal controls to ensure compliance with laws and regulations. In designing steps and procedures to test or assess compliance, auditors should evaluate the entity's internal controls and assess the risk that the control structure might not prevent or detect non-compliance.
 - ix. Without affecting the independence of the DAGP, the auditors should exercise due professional care and caution in extending audit steps and procedures relative to illegal acts so as not to interfere with potential future investigations or legal proceedings. Due care would include consulting appropriate legal counsel and the applicable law enforcement organisation/agencies to determine the audit steps and procedures to be followed.
- e) Competent, reliable, relevant and reasonable evidence should be obtained to support the auditor's judgment and conclusion regarding the organisation, programme, activity or function under audit

2.3.15 Audit Evidence

- i. The audit findings, conclusions and recommendations must be based on evidence. Since auditors seldom have the opportunity of considering all information about the audited entity, it is crucial that the data collection and sampling techniques are carefully chosen. When computer-based system data are an important part of the audit and the data reliability is crucial to accomplishing the audit objective, auditors need to satisfy themselves that the data are reliable and relevant.
- ii. Auditors should have a sound understanding of techniques and procedures such as inspection, observation, enquiry and confirmation, to collect audit evidence. The DAGP shall ensure that the techniques employed are sufficient to reasonably detect all quantitatively material errors and irregularities.
- iii. In choosing approaches and procedures, consideration should be given to the quality of evidence, i.e., the evidence should be competent, reliable, relevant and reasonable.
- iv. 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.
- v. Adequate documentation is important for several reasons. It will:
 - a. Confirm and support the auditor's opinions and reports;
 - b. Increase the efficiency and effectiveness of the audit;
 - c. Serve as a source of information for preparing reports or answering any enquiries from the audited entity, legislature and its committees or from any other party;
 - d. Serve as evidence of the auditor's compliance with Auditing Standards;
 - e. Facilitate planning and supervision;
 - f. Help the auditor's professional development;
 - g. Help to ensure that delegated work has been satisfactorily performed; and

- h. Provide evidence of work done for future reference.
- vi. The auditor should bear in mind that the content and arrangement of the working papers reflect the degree of the auditor's proficiency, experience and knowledge. Working papers should be sufficiently complete and detailed to enable an experienced auditor having no previous connection with the audit subsequently to ascertain from them what work was performed to support the conclusions.
- f) In regularity (financial) audit, and in other types of audit when applicable, auditors should analyse the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with. Analysis of financial statements should be performed to such a degree that a rational basis is obtained to express an opinion on financial statements

2.3.16 Analysis of Financial Statements

- i. Financial statement analysis aims at ascertaining the existence of the expected relationship within and between the various elements of the financial statements, identifying any unexpected relationships and any unusual trends. The auditor should therefore thoroughly analyse the financial statements and ascertain whether:
 - a. Financial statements are prepared in accordance with acceptable accounting standards;
 - b. Financial statements are presented with due consideration to the circumstances of the audited entity;
 - c. Sufficient disclosures are presented about various elements of financial statements; and
 - d. The various elements of financial statements are properly evaluated, measured and presented.
- ii. The methods and techniques of financial analysis depend to a large degree on the nature, scope and objective of the audit, and on the knowledge and judgment of the auditor.
- iii. If required to report on the execution of budgetary laws, audit by the DAGP shall include:
 - a. For revenue accounts, ascertaining whether forecasts are those of the initial budget, and whether the audits of taxes and duties recorded, and imputed receipts, can be carried out by comparison with the annual financial statements of the audited activity;
 - b. For expenditure accounts, verifying credits to assist budgets, adjustment laws and, for carryovers, the previous year's financial statements.

Reporting Standards

- 2.3.17** It is not practical to lay down a rule for reporting on every special situation. This standard is to assist and not to supersede the prudent judgment of the auditor in making an opinion or report.
- 2.3.18** The expression “reporting” embraces both the auditor’s opinion and other remarks on a set of financial statements as a result of a regularity (financial) audit and the auditor’s report on completion of a performance audit.
- 2.3.19** The auditor’s opinion on a set of financial statements shall generally be in concise, standardised format to reflect the results of a wide range of tests and other audit work. There is a requirement to report as to the compliance of transactions with laws and regulations and to report on matters such as inadequate systems of control, illegal acts and fraud. The constitutional or statutory obligations require the AGP to report specifically on the execution of budgetary laws, reconciling budgetary estimates and authorisation to the results set out in the financial statements.
- 2.3.20** In a performance audit, the auditor reports on the economy and efficiency with which resources are required and used, and the effectiveness with which objectives are met. Such reports may vary considerably in scope and nature, for example, covering whether resources have been applied in a sound manner, commenting on the impact of policies and programmes and recommending changes designed to result in improvements.
- 2.3.21** In order to recognise reasonable user needs, the auditor’s report in both regularity and performance auditing may need to have regard to expanded reporting periods or cycles and relevant and appropriate disclosure requirements.
- 2.3.22** For ease of reference in this chapter, the word “opinion” is used to mean the auditor’s conclusions as a result of a regularity (financial) audit, and may embrace the matters described in paragraph 4.6.3.d (i).
- 2.3.23** The reporting standards are:
- a) At the end of each audit the auditor shall prepare a written opinion or report, as appropriate, setting out the findings in an appropriate form; its content should be easy to understand and free from vagueness or ambiguity, include only information which is supported by competent, reliable, and relevant audit evidence, and be independent, objective, fair and constructive.
 - b) It is for the DAGP to decide finally on the action to be taken in relation to fraudulent practices or serious irregularities discovered by the auditors.

2.3.24 With regards to regularity audits, the auditor shall prepare a written report, which may either be a part of the report on the financial statements or a separate report, on the test of compliance with applicable laws and regulations. The report shall contain a statement of positive assurance on those tested for compliance and negative assurance on those items not tested.

2.3.25 With regard to performance audits, the report shall include all significant instances of non-compliance that are pertinent to the audit objectives.

2.3.26 The form and content of all audit opinions and reports are founded on the following general principles.

a) **Title.** The opinion or report shall be preceded by a suitable title or heading, helping the reader to distinguish it from statements and information issued by others.

b) **Signature and date.** The opinion or reports shall be properly signed. The inclusion of a date informs the reader that consideration has been given to the effect of events or transactions about which the auditor became aware up to that date (which, in the case of regularity (financial) audits, may be beyond the period of the financial statements).

c) **Objectives and scope.** The opinion or report shall include reference to the objectives and scope of the audit. This information establishes the purpose and boundaries of the audit.

d) **Completeness.** Opinions shall be appended to and published with the financial statements to which they relate, but performance reports may be free standing. The auditor's opinions and reports shall be presented as prepared by the auditor. In exercising its independence the Department shall be able to include whatever it sees fit, but it may acquire information from time to time which in the national interest cannot be freely disclosed. This can affect the completeness of the audit report. In this situation the auditor retains a responsibility for considering the need to make a report, possibly including confidential or sensitive material in a separate, unpublished report.

e) **Addressee.** The opinion or report shall be addressed as per requirements of applicable laws and procedures.

f) **Identification of subject matter.** The opinion or report shall identify the financial statements (in the case of regularity (financial) audits) or area (in the case of performance audits) to which it relates. This includes information such as the name of the audited entity, the date and period covered by the financial statements and the subject matter that has been audited.

g) **Legal basis.** Audited opinions and reports shall identify the legislation or other authority providing for the audit.

- h) **Compliance with standards:** Audit opinions and reports shall indicate the auditing standards or practices followed in conducting the audits, thus providing the reader with an assurance the audit has been carried out in accordance with generally accepted procedures.
- i) **Timelines:** The audit opinion or report shall be available promptly to be of greatest use to readers and users, particularly those who have to take necessary action.

2.3.27 An audit opinion is normally in a standard format, relating to the financial statements as a whole, thus avoiding the need to state at length what lies behind it but conveying by its nature a general understanding among readers as to its meaning. The nature of these words will be influenced by the legal framework for the audit, but the content of the opinion shall indicate unambiguously whether it is unqualified or qualified and, if the latter, whether it is qualified in certain respects or is adverse or a disclaimer of opinion.

2.3.28 An unqualified opinion is given when the auditor is satisfied in all material respects that:

- a) The financial statements have been prepared using acceptable accounting bases and policies which have been consistently applied;
- b) The statements comply with statutory requirements and relevant regulations;
- c) The view presented by the financial statements is consistent with the auditor's knowledge of the audited entity; and
- d) There is adequate disclosure of all material matters relevant to the financial statements

2.3.29 Emphasis of Matter. In certain circumstances the auditor may consider that the reader will not obtain a proper understanding of the financial statements unless attention is drawn to unusual or important matters. As a general principle the auditor issuing an unqualified opinion does not make reference to specific aspects of financial statements in the opinion in case this should be misconstrued as being a qualification. In order to avoid giving that impression, references which are meant as "emphasis of matter" are contained in a separate paragraph from the opinion. However, the auditor shall not make use of an emphasis of matter to rectify a lack of appropriate disclosure in the financial statements, nor as an alternative to, or a substitute for, qualifying the opinion.

2.3.30 An auditor may not be able to express an unqualified opinion when any of the following circumstances exist and, in the auditor's judgment, their effect is or may be material to the financial statements:

- a) There has been limitation on the scope of the audit;
- b) The auditor considers that the statements are incomplete or misleading or there is an unjustified departure from acceptable accounting standards; or
- c) There is uncertainty affecting the financial statements.

- 2.3.31 Qualified Opinion.** Where the auditor disagrees with or is uncertain about one or more particular items in the financial statements which are material but not fundamental to an understanding of the statements, a qualified opinion should be given. The wording of the opinion normally indicates a satisfactory outcome to the audit subject to a clear and concise statement of the matters of disagreement or uncertainty giving rise to the qualified opinion. It helps the users of the statements if the financial effect of the uncertainty or disagreement is quantified by the auditor although this is not always practicable or relevant.
- 2.3.32 Adverse Opinion.** Where the auditor is unable to form an opinion on the financial statements taken as a whole due to disagreement which is so fundamental that it undermines the position presented to the extent that an opinion which is qualified in certain respects would not be adequate, an adverse opinion is given. The wording of such an opinion makes clear that the financial statements are not fairly stated, specifying clearly and concisely all the matters of disagreement. Again, it is helpful if the financial effect on the financial statements is quantified where relevant and practicable.
- 2.3.33 Disclaimer of Opinion.** Where the auditor is unable to arrive at an opinion regarding the financial statements taken as a whole due to an uncertainty or scope restriction which is so fundamental that an opinion which is qualified in certain respects would not be adequate, a disclaimer is given. The wording of such a disclaimer makes clear that an opinion cannot be given, specifying clearly and concisely all matters of uncertainty.
- 2.3.34** The auditor shall provide a detailed report amplifying the opinion in circumstances in which it has been unable to give an unqualified opinion.
- 2.3.35** In addition, regularity audits often require that reports are made where weaknesses exist in systems of financial control or accounting (as distinct from performance audit aspects). This may occur not only where weaknesses affect the audited entity's own procedures but also where they relate to its control over the activities of others. The auditor shall also report on significant irregularities, whether perceived or potential, on inconsistency of application of regulations or on fraud and corrupt practices.
- 2.3.36** In reporting on irregularities or instances of non-compliance with laws or regulations, the auditors should be careful to place their findings in the proper perspective. The extent of non-compliance can be related to the number of cases examined or quantified monetarily.
- 2.3.37** Reports on irregularities shall be prepared irrespective of a qualification of the auditor's opinion. By their nature they tend to contain significant criticisms, but in order to be constructive they shall also address future remedial action by incorporating statements by the audited entity or by the auditor, including conclusions or recommendations.

- 2.3.38** In contrast to regularity audit, which is subject to fairly specific requirements and expectations, performance audit is wide-ranging in nature and is more open to judgment and interpretation; coverage is also more selective and may be carried out over a cycle of several years, rather than in one financial period; and it does not normally relate to particular financial or other statements. As a consequence performance audit reports are varied and contain more decisions and reasoned argument.
- 2.3.39** The performance audit report should state clearly the objectives and scope of the audit. Reports may include criticism (for example where, in the public interest or on grounds of public accountability, matters of serious waste, extravagance or inefficiency are drawn to attention) or may make no significant criticism but give independent information, advice or assurance as to whether and to what extent economy, efficiency and effectiveness are being or have been achieved.
- 2.3.40** The auditor is not normally expected to provide an overall opinion on the achievement of economy, efficiency and effectiveness by an audited entity in the same way as the opinion on financial statements. Where the nature of the audit allows this to be done in relation to specific areas of entity's activities, the auditor shall provide a report which describes the circumstances and arrives at a specific conclusion rather than a standardised statement. Where the audit is confined to consideration of whether sufficient controls exist to secure economy, efficiency or effectiveness, the auditor shall provide a more general opinion.
- 2.3.41** Auditors should recognise that their judgments are being applied to actions resulting from past management decisions. Care should therefore be exercised in making such judgments, and the report should indicate the nature and extent of information reasonably available (or which ought to have been available) to the audited entity at the time the decisions were taken. By stating clearly the scope, objectives and findings of the audit, the report demonstrates to the reader that the auditor is being fair. Fairness also implies the presentation of weaknesses or critical findings in such a way as to encourage correction, and to improve systems and guidance within the audited entity. Accordingly the facts are generally agreed with the audited entity in order to ensure that they are complete, accurate and fairly presented in the audit report. There may also be a need to include the audited entity's responses to the matters raised, either verbatim or in summary, especially where the DAGP presents its own views or recommendations.
- 2.3.42** Performance reports should not concentrate solely on criticism of the past but should be constructive. The auditor's conclusion and recommendations are an important aspect of the audit and, where appropriate, are written as a guide for action. Generally these recommendations suggest what improvements are needed rather than how to achieve them, though circumstances sometimes arise which warrant a specific recommendation, for example to correct a defect in the law in order to bring about an administrative improvement.

- 2.3.43 In formulating and following up recommendations, the auditor shall maintain objectivity and independence and thus focus on whether identified weaknesses are corrected rather than on whether specific recommendations are adopted.
- 2.3.44 In formulating the audit opinion or report, the auditor shall have regard to the materiality of the matter in the context of the financial statements (regularity (financial) audit) or the nature of the audited entity or activity (performance audit).
- 2.3.45 For regularity (financial) audits, if the auditor concludes that, judged against the criteria most appropriate in the circumstances, the matter does not materially affect the view given by the financial statements, the opinion should not be qualified. Where the auditor decides that a matter is material the opinion should be qualified, having determined the type of qualification.
- 2.3.46 In the case of performance audits that judgment will be more subjective as the report does not relate so directly to financial or other statements. Consequently the auditor may find materiality by nature or by context is a more important consideration than materiality by amount.

2.4 Level 4 - Auditing Guidelines (ISSAIs 1000-4999)

- 2.4.1 Level 4 of INTOSAI Auditing Standards consists of two sets of Guidelines, (i) the General auditing guidelines (ISSAIs 1000- 4999) which contain the recommended requirements of financial, performance and compliance auditing, and (ii) the Guidelines on specific subjects (ISSAIs 5000-5999) which provide supplementary guidance on the auditing of specific subject matters or other important issues which may require the special attention of Supreme Audit Institutions. Complete set of standards and related guidelines are available at www.issai.org.
- 2.4.2 Only Financial and Compliance auditing guidelines are discussed in FAM. For Performance auditing guidelines please refer to Performance Audit Manual. For Guidelines on specific subjects (ISSAIs 5000-5999) please refer to ISSAIs directly or other relevant guidelines issued by the DAGP.
- 2.4.3 The INTOSAI Financial Audit Guidelines
- 2.4.4 ISSAIs 1000-2999 are applicable to auditors of public sector entities in their role as auditors of financial statements. Brief descriptions of ISSAI Financial Auditing Guidelines and their Public Sector Perspective are given as follows.
- 2.4.5 ISSAI 1000: General Introduction to the INTOSAI Financial Audit Guidelines

- 2.4.6** The INTOSAI Financial Audit Guidelines include the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). These guidelines are part of General auditing guidelines and they draw on International Standards on Auditing developed by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC).
- 2.4.7** ISSAI 1003: Glossary of Terms to the INTOSAI Financial Audit Guidelines
- 2.4.8** The standard contains the glossary of terms used within financial audit guidelines.
- 2.4.9** ISSAI 1200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards of Auditing

Guidance on Public Sector Issues

ISA 200 contains application and other explanatory material with considerations specific to audits in the public sector in paragraphs A11 and A57 of the ISA. In the public sector, reference to relevant auditing standards can be made in one of the following ways depending on the standards applied:

- (a) In accordance with the ISAs; which means full compliance with all relevant ISAs and if relevant, with the additional guidance set out in the INTOSAI Practice Notes to the ISAs;
- (b) In accordance with the INTOSAI Fundamental Auditing Principles, but not full compliance with the ISAs which are presently included as part of the INTOSAI Financial Audit Guidelines (ISSAIs 1000-2999); or
- (c) In accordance with other national and relevant Auditing Standards.

- 2.4.10** ISSAI 1210: Terms of an Engagement

Guidance on Public Sector Issues

ISA 210 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A27 and A37. The terms of an audit engagement in the public sector are normally mandated and therefore not subject to requests from, and agreement with, management. Therefore the requirements in the ISA, when applied in the public sector context, are useful in establishing a common, formal understanding of the respective roles and responsibilities of management and the auditor. Since the public sector auditor is normally engaged by and reports to the legislature, agreements often need to be reached with both the legislature and management.

- 2.4.11** ISSAI 1220: Quality Control for Audits of Historical Financial Information

Guidance on Public Sector Issues

ISA 220 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A7, A9, A12, A30 and A31 of the ISA. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

- a) Discussion of significant matters with the head of the FAO;
- b) Review of the financial statements and the proposed auditor's report;
- c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
- d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-A27, A29-A31)

2.4.12 The engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

- a) The engagement team's evaluation of the DAGP's independence in relation to the audit engagement;
- b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
- c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached. (Ref: Para. A28-A31)

2.4.13 ISSAI: 1230 Audit Documentation

Guidance on Public Sector Issues

Paragraph 8(c) of the ISA requires the auditor to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. Paragraph A8 of the ISA explains that judging the significance of a matter requires an objective analysis of the facts and circumstances, and provides examples of significant matters. Public sector auditors may be required to report on a broad range of significant matters which may not be part of their report on the financial statement audit, or matters that may not result in material misstatement of the financial information or related disclosures. Examples of such matters include lack of compliance with legislation or approved mandate, violations of contract provisions or grant agreements, unauthorized or inappropriate expenditures, execution of the budget, certification of the annual deficit/surplus, assessments of program funding and costs, and information on performance indicators.

2.4.14 ISSAI 1240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Guidance on Public Sector Issues

ISA 240 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A6, A57 and A67 of the ISA. Three conditions are normally present when fraud occurs.

These conditions are often present in various ways in the public sector.

These include:

- a) Incentive or pressure (placed on or perceived by management or employees giving them a reason to commit fraud) – public sector employees are often under pressure to deliver high quality services with few resources and to meet budget expectations. This may be especially relevant in tough economic conditions where there is pressure to maintain user charges and tax rates, resulting in incentives to overstate revenues and understate expenditures. There may also exist incentives to spend the available budget by the end of the financial year;
- b) Opportunity (characteristics or circumstances related to an entity allowing for the perpetration of fraud) – a difficult recruitment environment or a lack of sufficient qualified personnel may be more prevalent in the public sector. Such situations may often result in deficiencies in internal control creating the opportunity for fraud. The widespread use of high volume, low value cash transactions in certain public sector entities such as cash transactions at police departments or health clinics may add to those risks. Although monetary values may be small, such situations may lead to violation of public trust, expectations and accountability; and
- c) Rationalization or attitude (Behavior, character or ethical values that allow individuals to justify their reasons for committing fraud)- generally lower salary levels in the public sector compared to the private sector may lead employees to believe that they can justify misuse of funds. As above, this may violate principles of public trust, expectations and accountability.

2.4.15 ISSAI 1250: Consideration of Laws and Regulations in an Audit of Financial Statements

Guidance on Public Sector Issues

ISA 250 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A6 and A20 of the ISA. The ISA deals with the auditor's responsibility to consider laws and regulations in an audit of financial statements. The ISA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations. Public sector auditors with such additional responsibilities may consider ISSAIs 4000 and 4200.

2.4.16 ISSAI 1260: Communication with those charged with Governance

Guidance on Public Sector Issues

The objectives of a financial statement audit in the public sector are often broader than to express an opinion whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework (i.e. the scope of the ISAs). The audit mandate, or obligations for public sector entities, arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature may result in additional objectives. These additional objectives may include audit and reporting responsibilities, for example, relating to reporting

whether the auditor found any instances of non-compliance with authorities including budget and accountability and/or reporting on the effectiveness of internal control. Paragraph 3 of ISA 260 acknowledges that further matters may be required to be communicated to those charged with governance as a result of law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement.

2.4.17 ISSAI 1265: Communication of Deficiencies in Internal Control to Those charged with Governance

Guidance on Public Sector Issues

ISA 265 contains application and other explanatory material with considerations specific to public sector entities in paragraph A27 of the ISA. The ISA deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.

2.4.18 ISSAI 1300: Planning an Audit of Financial Statements

Guidance on Public Sector Issues

The Practice Note within ISSAI 1300 provides additional guidance for public sector auditors related to:

- (a) Overall Considerations.
- (b) The Role and Timing of Planning.
- (c) Preliminary Engagement Activities.
- (d) Planning Activities.
- (e) Considerations Specific to Smaller Entities.
- (f) Documentation.
- (g) Additional Considerations in Initial Audit Engagements.

2.4.19 ISSAI 1315: Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

Guidance on Public Sector Issues

ISA 315 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A21, A35, A65 and A113 of the ISA. In obtaining the understanding of the entity and its environment, public sector auditors take into account that:

- (a) Decisions may be initiated outside the entity as a result of political processes. Such decisions influence management's activities. Examples include:
 - New geographic locations or closures of existing locations;
 - Reorganizations, including transfer of activities to other entities;
 - New program areas; and
 - Budgetary constraints or cut backs.
- (b) Relevant regularity factors include specific laws and regulations to which the entity is subject and the potential impact of non-compliance with these;

- (c) Other external factors, including the applicable financial reporting framework, may influence specific reporting objectives;
- (d) Understanding the business operations may include knowledge of the government activities carried out, including relevant programs;
- (e) Program objectives and strategies may include public policy elements and therefore may have implications for the risk assessment;
- (f) Ownership of public sector entities may not have the same relevance as in the private sector. In the public sector, focus is on those charged with governance in their role as representatives of the citizens;
- (g) Governance structures are affected by the legal structure of the entity, for example whether the entity is a ministry, department, agency or other type of entity; and
- (h) Issues related to management's assumptions ongoing concern may not be relevant.

2.4.20 ISSAI 1320: Materiality in Planning and Performing an Audit

Guidance on Public Sector Issues

ISA 320 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A2 and A9 of the ISA. Additional responsibilities related to compliance with authorities, are dealt with in the INTOSAI Compliance Audit Guidelines ISSAI 4000 and 4200. Public sector auditors with such additional responsibilities may consider ISSAIs 4000 and 4200.

2.4.21 ISSAI 1330: Auditor's Responses to Assessed Risks

Guidance on Public Sector Issues

ISA 330 contains application and other explanatory material with considerations specific to public sector entities in paragraph A17 of the ISA. Additional objectives may lead public sector auditors to identify and assess additional risks of material misstatement, and to design and implement overall responses to address the assessed risks at the financial statement level and to design and perform further audit procedures to respond to the assessed risks at the assertion level. However, even where there are no such additional objectives, there may be general public expectations in regard to public sector auditors' reporting of non-compliance with authorities or reporting on effectiveness of internal control. Therefore, public sector auditors keep such expectations in mind, and are alert to the need to respond to assessed risks of non-compliance or risks relating to effectiveness of internal control.

2.4.22 ISSAI 1402: Audit Considerations Relating to Entities Using Service Organisations

Guidance on Public Sector Issues

ISA 402 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A10 and A11 of the ISA. When an entity uses a service organization, public sector auditors keep such expectations in mind and are alert to risks of noncompliance with authorities or a lack of effective internal control.

2.4.23 ISSAI 1450: Evaluation of Misstatements Identified during the Audit

Guidance on Public Sector Issues

ISA 450 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A19 and A20 of the ISA. In addition to evaluating misstatements, public sector auditors may also evaluate instances of non-compliance with authorities and report on the effectiveness of internal control. When public sector auditors have such additional reporting responsibilities, each reporting responsibility is evaluated separately.

2.4.24 ISSAI 1500: Audit Evidence

Guidance on Public Sector Issues

Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In the case of financial statements in the public sector management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of a financial audit. Public sector auditors may consider sources as independent of the entity even though they ultimately report to the same authority e.g. operationally independent government agencies reporting to the same authority. The nature of benchmarking data in the public sector may include other sources e.g. comparisons between similar programs, or performance indicators. Public sector auditors may also consider evidence obtained in performance audits or other audit activities relevant to the entity.

Audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance. When relying on evidence obtained in previous performance audits, public sector auditors evaluate whether the assertions used and tests performed are adequate for the purpose of the financial statement audit. When the audit mandate includes objectives related to the regularity of transactions the public sector auditors may need to consider the nature and timing of audit procedures as explained in paragraph A12 of the ISA. Public sector entities will usually have established internal controls designed to secure the regularity of transactions. However, where the audited entity is responsible for giving grants or other financial assistance to other parties, it is often the case that the regularity of the transaction will depend, in part, on the other parties satisfying the criteria and meeting the terms for receiving assistance. Evidence might then be required on the entity's exercise of its responsibilities to satisfy itself about the transactions of these other parties.

2.4.25 ISSAI 1501: Audit Evidence-Specific Consideration for Selected Items

Guidance on Public Sector Issues

Inventory

Inventory in the public sector is often different from inventory in the private sector. For example, inventory in the public sector is often held for use rather than for resale; therefore, the nature of internal controls and the

assessed risk of material misstatement may be different. Public sector auditors may have other objectives and assertions to consider in addition to existence and condition.

Litigation and Claims

Public sector auditors may have additional responsibilities in relation to litigation and claims. These responsibilities may include identifying probable future claims and the potential wider consequences of those claims on the public sector. Due to the complexity and structure of public sector organizations, public sector auditors may need to inquire of other public sector organizations in addition to management of the audited public sector entity. Public sector auditors may need to consider other sources of information when performing audit procedures to identify litigation and claims involving the entity such as:

- Media reports;
- General public and stakeholder feedback;
- Other information obtained by regulators, officials, public prosecutors, or other investigative agencies;
- Information from complaints officials and whistle-blowers; and
- Outcomes of performance or other audits.

Segment Information

Presentation and disclosure of segment information may not be required by certain financial reporting frameworks or relevant in the context of certain public sector entities. However, there may be other information similar to segment information required by laws or regulations or by the applicable financial reporting framework.

2.4.26 ISSAI 1505: External Confirmations

Guidance on Public Sector Issues

Confirmations can be used to obtain evidence about the presence or absence of certain conditions. In addition to assertions related to the audit of financial statements, public sector auditors may find confirmations useful in obtaining evidence related to additional audit objectives stipulated by their audit mandate or arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature.

Corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from evidence within the accounting records or from representations made by management. Given the size and complexity of governments, public sector auditors need to be vigilant to ensure that external confirmation requests are directed to third parties who are independent of the audited entity and the responses are reliable in light of the relationship between the entity and the confirming party.

2.4.27 ISSAI 1510: Initial Audit Engagements-Opening Balances

Guidance on Public Sector Issues

ISA 510 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A1 and A2 of the ISA. An initial audit might occur when an entity is nationalized without resulting in the formation of a new entity or when the public sector auditor's mandate is changed to include a new audit of an already existing entity. An initial audit may also occur when a public sector entity is created, and legislation, regulation or framework require the appropriation of all or parts of prior balances of a predecessor public sector entity, which have been audited by a predecessor auditor.

2.4.28 ISSAI 1520: Analytical Procedures

Guidance on Public Sector Issues

ISA 520 contains application and other explanatory material with considerations specific to public sector entities in paragraph A11 of the ISA. Analytical procedures related to program expenditure within the public sector are likely to include comparisons with non-financial data because there is normally less comparable financial information to perform analytical procedures. Therefore, the evaluation of controls over the reliability of non-financial data used in the analytical procedures is important within the public sector.

2.4.29 ISSAI 1530: Audit Sampling

Guidance on Public Sector Issues

Public sector auditors may use sampling for additional responsibilities in addition to providing an opinion on the financial statements. The use of audit sampling for testing compliance with authorities is similar to other uses of audit sampling in that public sector auditors:

- Determine sample design and audit parameters, including materiality, desired confidence level, and sample selection method;
- Perform relevant audit procedures on each item selected;
- Investigate the nature and causes of non-compliance; and
- Evaluate the results, including projecting the results across the population if the sample was selected using statistical procedures.

2.4.30 ISSAI 1540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures

Guidance on Public Sector Issues

ISA 540 contains application and other explanatory material with considerations specific to public sector entities in paragraph A11 of the ISA. When and how public sector entities' use accounting estimates depends on the types of financial items reported and the applicable financial reporting framework. Some important estimates in the public sector may relate to assets, liabilities and disclosure items, such as:

- Social insurance programs;
- Government employee pension programs;
- Health care programs;
- Veterans' benefits programs;
- Government guarantees programs;
- Environmental liabilities;

- Tax revenue and receivables; and
- Certain property and equipment such as specialized military equipment and heritage assets.

2.4.31 ISSAI 1550: Related Parties

Guidance on Public Sector Issues

ISA 550 contains application and other explanatory material with considerations specific to public sector entities in paragraph A8 of the ISA. Public sector entities may also be subject to specific restrictions on the nature and scope of the transactions that they can have with related parties. The restrictions may prohibit transactions or practices that might be permissible in related party relationships outside the public sector.

2.4.32 ISSAI 1560: Subsequent Events

Guidance on Public Sector Issues

ISA 560 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A5, A10, A14 and A17 of the ISA. Public sector requirements with regard to subsequent events may be different as to the date of the auditor's report and other requirements as stipulated by relevant legislation. Public sector auditors familiarize themselves with applicable legislation in regard to subsequent events. When the audit mandate includes objectives on regularity of transactions the public sector auditors may need to consider subsequent events which may provide additional evidence on the regularity of transactions such as the outcome of a court case.

2.4.33 ISSAI 1570: Going Concern

Guidance on Public Sector Issues

ISA 570 contains application and other explanatory material with considerations specific to public sector entities in paragraph A1 of the ISA. Management's use of the going concern assumption is also relevant to public sector entities. Sovereign governments, and in particular, sovereign central governments, ordinarily do not become legally insolvent or bankrupt because these governments have wide-ranging powers to levy rates, fees or taxes and so are able to adjust their revenues to meet their obligations. Nevertheless, in some cases governments may have substantial net liabilities relative to the size of the economy or their ability to levy rates, fees, or taxes, or may be substantially dependent upon assistance from other governments. While not common, sovereign governments, including sovereign central governments, can become insolvent in the sense of not being able to meet their obligations when they become due when, for example, the rescheduling of obligations is not possible. The inability of a government to discharge its obligations may also be affected by the extent to which the currency issued by the government, or on its behalf by its central bank, continues to be accepted as a medium of exchange to discharge its financial obligations.

2.4.34 ISSAI 1580: Written Representations

Guidance on Public Sector Issues

ISA 580 contains application and other explanatory material with considerations specific to public sector entities in paragraph A9 of the ISA. In the public sector management's responsibilities may also be broader than those responsibilities in the private sector. When requesting written representations about management's responsibilities, public sector auditors take this broader premise into account.

2.4.35 ISSAI 1600: Special Considerations –Audits of Group Financial Statements (Inc.The Work of Components Auditors)

Guidance on Public Sector Issues

There may be public expectations in regard to compliance with authorities or to the effectiveness of internal controls, and the auditor's attention to such matters. Therefore, public sector group auditors keep such expectations in mind, are alert throughout the audit to areas that may give rise to such non-compliance and communicate with component auditors regarding such expectations. In some public sector environments it may be required by law or regulation or common practice to make reference to a component auditor in the group auditor's report on the group financial statements. In these situations, if the group auditors' report does not clearly indicate that the reference does not diminish the group auditors' responsibility for the group audit opinion, the audit is not in compliance with paragraph 11 of the ISA.

2.4.36 ISSAI 1610: Using the Work of Internal Auditors

Guidance on Public Sector Issues

Public sector auditors may find activities carried out by the internal audit function relating to the entity's non-compliance with authorities including budget and accountability and the entity's effectiveness of internal control relevant to the audit. In such cases public sector auditors may use the work of the internal auditors to supplement the external audit work in these areas.

2.4.37 ISSAI 1620: Using the Work of an Auditor's Expert and Management

Guidance on Public Sector Issues

Public sector auditors may consider using the work of an expert in light of additional responsibilities. ISA 620 deals with the auditor's responsibilities relating to the work of an individual or organization in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.

2.4.38 ISSAI 1700: Forming an Opinion and Reporting on Financial Statements

Guidance on Public Sector Issues

There may be general public expectations in regard to public sector auditors' reporting of non-compliance with authorities or reporting on

effectiveness of internal control. Such additional responsibilities would be reported in a separate section of the auditor's report.

Web Address:

[http://www.issai.org/media\(763,1033\)/ISSAI_1700_E_Endorsement.pdf](http://www.issai.org/media(763,1033)/ISSAI_1700_E_Endorsement.pdf)

2.4.39 ISSAI 1705: Modifications to the Opinion in the Independent Auditor's Report

Guidance on Public Sector Issues

ISA 705 contains application and other explanatory material with considerations specific to public sector entities in paragraph A14 of the ISA. It provides guidance regarding the auditor's judgment about how the nature of matters giving rise to a modification, and the pervasiveness of their effects or possible effects, influence the type of opinion on non-compliance with authorities to be expressed.

2.4.40 ISSAI 1706: Emphasis of Matter Paragraphs and other Matter(s) Paragraphs in the Independent Auditor's Report

Guidance on Public Sector Issues

In the public sector audit mandates or expectations may expand circumstances relevant for reporting by public sector auditors in an Emphasis of Matter paragraph. Additional examples that may be relevant to report in an Emphasis of Matter paragraph, if properly disclosed in the financial statements may, in addition to paragraph A1 of the ISA include:

- Legislative actions on programs or the budget;
- Contradictive laws, regulations or directives with a significant effect on the entity;
- Fraud, abuse or losses;
- Significant transactions;
- Significant internal control deficiencies;
- Questionable business practices;
- Transactions entered into without due regard for economy;
- Prior period restatements;
- Lack of fiscal sustainability;
- Environmental issues;
- Corporate social responsibility issues;
- Ethical issues (proper behavior by public officials); or
- Ineffective and uneconomical use of public assets.
- Public sector auditors may also decide to include an Emphasis of Matter paragraph for matters relating to non-compliance with authorities that have been accurately accounted for and/or disclosed in the financial statements. An example of such matter is improper stewardship of funds. However, an Emphasis of Matter paragraph related to non-compliance may only be relevant if there is no requirement to provide a separate opinion on compliance with authorities.

2.4.41 ISSAI 1710 Comparative Information –Corresponding Figures and Comparative Financial Statements

Guidance on Public Sector Issues

The approach to be adopted in regard to reporting responsibilities in respect of comparative information is often specified by laws or regulations. Public sector auditors therefore need to consider the audit mandate in addition to any terms of the engagement.

2.4.42 ISSAI 1720: The Auditors Responsibilities Relating To Other Information In Documents Containing Audited Financial Statements.

Guidance on Public Sector Issues

ISA720 contains application and other explanatory material with considerations specific to public sector entities in paragraph A7 of the ISA. The ISA deals with the auditor's responsibilities relating to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated. However, the auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information.

2.4.43 ISSAI 1800: Special Considerations-Audits of Special Purpose Financial Statements.

Guidance on Public Sector Issues

Engagements to report on financial statements prepared in accordance with special purpose frameworks may also include additional objectives. Even in cases where there are no additional objectives, there may be general public expectations in regard to public sector auditors' reporting of non-compliance with authorities or reporting on effectiveness of internal control. Therefore, public sector auditors keep such expectations in mind, and are alert to areas that may give rise to non-compliance with authorities or the effectiveness of internal control when performing audits of financial statements prepared in accordance with special purpose frameworks.

2.4.44 ISSAI 1805: Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement.

Guidance on Public Sector Issues

Engagements to report on a single financial statement or a specific element, account or item of a financial statement may also include additional objectives. Even in cases where there are no such additional objectives, there may be general public expectations in regard to public sector auditor's reporting of non-compliance with authorities or reporting on effectiveness of internal control. Therefore, public sector auditors keep such expectations in mind, and are alert to areas that may give rise to non-compliance with authorities or the effectiveness of internal control when performing an audit of a single financial statement or a specific element, account or item of a financial statement.

2.4.45 ISSAI 1810: Engagement to Report on Summary Financial Statements

Guidance on Public Sector Issues

In reporting on the financial statements from which the summary financial statements have been derived, public sector auditors might have expressed an opinion in addition to the opinion whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework. For example, public sector auditors might have reported on whether they have found any instances of non-compliance with authorities including budget and accountability, or expressed an opinion on the effectiveness of internal control. In such cases, in addition to the requirements set out in paragraph 14 of the ISA, public sector auditors include a reference to such an additional opinion in the auditor's report on the summary financial statements.

2.4.46 The INTOSAI Compliance Audit Guidelines

The INTOSAI Compliance Audit Guidelines have been developed to assist SAIs in applying the INTOSAI Auditing Standards, particularly in their work on reporting on compliance. Brief descriptions of ISSAI Compliance Auditing Guidelines are given as follows.

2.4.47 ISSAI 4000 General Introduction to Guidelines on Compliance Audit

The objective, scope and nature of a particular compliance audit depend on a number of factors, including the mandate and constitutional role of the SAI, as well as laws and regulations that are relevant to the audited entity. However, in general, the objective of compliance auditing is to enable the SAI to report to the appropriate bodies on the audited entity's compliance with a particular set of criteria. Such criteria may be derived from relevant financial reporting frameworks, laws, regulations, parliamentary decisions, terms of contracts or agreements, or may be other criteria deemed by the auditor to be suitable criteria.

Compliance audit deals with the responsibility of the SAI to audit whether the activities of public sector entities are in accordance with the relevant laws, regulations and authorities that govern such entities. This involves reporting on the degree to which the audited entity is accountable for its actions and exercises good public governance. More specifically, these elements may involve auditing to what extent the audited entity follows rules, laws and regulation, budgetary resolutions, policy, established codes, or agreed upon terms, such as the terms of a contract or the terms of a funding agreement. Compliance audit tasks performed by SAIs may cover a wide range of subject matters and may vary widely on an international basis. The Compliance Audit Guidelines are written from two main perspectives;

ISSAI 4100 deals with compliance audit performed separately from the audit of financial statements, for example as a separate audit task or related to performance audit

ISSAI 4200 deals with compliance audit related to the audit of financial statements

The two ISSAIs are written as consistent, stand-alone documents. Much of the material related to planning and performing compliance audit is therefore very similar or even the same. However, where there is a need to differentiate, the guidance has been tailored to the specific purposes.

2.4.48 ISSAI 4100 Compliance Audit Guidelines for Audits Performed Separately from the Audit of Financial Statements

These guidelines deal with compliance audit as an audit type of its own or as a part of performance audit, and not when specifically performed together with an audit of financial statements. They build upon INTOSAI's Fundamental Auditing Principles (referenced within this document as ISSAI 100 – ISSAI 400) and have been designed to assist public sector auditors and SAIs in applying these principles.

2.4.49 ISSAI 4200 Compliance Audit Guidelines Related to Audit of Financial Statements

These guidelines concern situations where compliance audit is performed together with an audit of financial statements. They build upon INTOSAI's Fundamental Auditing Principles and have been designed to assist Public sector auditors and SAIs in applying these principles. These guidelines supplement, and should be read together with, INTOSAI's Financial Audit Guidelines (ISSAI 1000-2999, referred to in this document as the 'Financial Audit Guidelines').

3 DAGP'S ANNUAL PLANNING PROCESS

3.1 DAGP Strategic Audit Objectives

- 3.1.1 The Auditor-General's mandate is established by legislation – Auditor-General's (Functions, Powers and Terms and Conditions of Service) Ordinance, 2001 (Auditor General's Ordinance). Two key sections are:
- 3.1.2 Section 7 of Auditor-General's (Functions, Powers and Terms and Conditions of Service) Ordinance, 2001 (Auditor General's Ordinance) states that "The Auditor-General shall, on the basis of such audit as he may consider appropriate and necessary, certify the accounts" ... "of the Federation, of each Province and of each District".
- 3.1.3 Section 8 of the Auditor-General Ordinance mandates an audit of expenditures of the Federation and of each Province, and Section 12 of the Auditor-General Ordinance mandates an audit of the receipts of the Federal Government and of each Province and District.
- 3.1.4 These sections establish the two primary objectives of DAGP audits: financial attest/certification audits and compliance with authority audits to ensure entities within all three levels of government properly comply with all rules and regulations pertaining to expenses and revenues.
- 3.1.5 Note that all attest/certification audits will include a compliance component in accordance with international auditing standards and that DAGP may also perform independent compliance with authority audits in any areas which the Auditor-General considers it important to review. Accordingly compliance audit activities will be a major aspect of DAGP plans for any given time period.

3.2 DAGP Audit Scope

- 3.2.1 In determining the scope of audit work the Auditor-General has wide discretion.
- 3.2.2 For attest/certification audits 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, to certify the financial statements of the Federation, the entity to be audited is the aggregate of all of the ministries, departments, agencies, etc. that the accounting policies require to be included in the financial statements of the Federation. Whether to perform audit activities in every single entity within the federation is a matter for the Auditor-General to decide. At a minimum, audit activities should cover all entities whose operations are material in the context of the financial statements of the Federation. In addition, the Auditor-General may plan to extend the audit activities to any other entities he considers significant.

Whether to perform audit activities in every single entity within the federation is a matter for the Auditor-General to decide. At a minimum, audit activities should cover all entities whose operations

- 3.2.3** In the case of compliance with authority audits, the Auditor-General has complete discretion as to which entities (whether organisational entities, such as agencies, DAOs, DDOs etc., functional entities, such as the payroll function or the purchasing function; or accounting entities, such as objects of expenditure, grants or appropriations) will be subject to audit and how often audits will be conducted.

3.3 DAGP Strategic Audit Plans

- 3.3.1** The Auditor-General is responsible for deciding what audit work is necessary to fulfil his mandate. Under his direction, DAGP produces a multi-year strategic plan for DAGP audit activities. The audits included in the strategic plan will include:
- 3.3.2** Mandatory and centrally led. These are audits required by DAGP's mandate to be performed each year, where the work performed by an individual directorate is part of a larger audit. An example of such an audit is the annual audit of the financial statements of the Federation.
- 3.3.3** Not mandatory and centrally led. These are audits where DAGP's mandate does not require that they be performed each year, and the work performed by the directorate is part of a larger audit exercise. An example of this type of audit could be a government-wide audit of contracting.
- 3.3.4** Mandatory and not centrally led. Those audits that are required by DAGP's mandate to be performed each year, where the work is not part of a larger audit. An example of such an audit is the annual audit of the financial statements of a specific commercial entity or a foreign-aided project for which the directorate is required to issue an audit opinion.
- 3.3.5** In these cases, the Auditor-General schedules the activities and delegates audit work to the audit directorates.
- 3.3.6** Consolidating the plans for all these audits produces the DAGP strategic audit programme.

3.4 The annual planning process

- 3.4.1** Each audit directorate is responsible for the audit of a pre-determined group of entities. The scheduling of this work is at the discretion of the audit directorates:
- 3.4.2** Not mandatory and not centrally led. These are audits that are not required by DAGP's mandate to be performed each year, and which are not part of a larger audit. An example of such an audit is the compliance with authority work being performed by the directorate on the entities for which it is responsible.

- 3.4.3** Each directorate prepares an annual audit plan for its audit activities which includes the audit activities required by the Auditor-General, plus the discretionary audits planned by the directorate, and submits it to the Auditor-General for approval. Once approved, the annual plans from all directorates are consolidated into DAGP's annual Corporate Audit Plan.
- 3.4.4** The annual audit plans contain:
- 3.4.5** A summary of the directorate's mandate.
- 3.4.6** A status report on the current year indicating the extent to which the planned coverage for the current year is being achieved.
- 3.4.7** A summary of the audits that the directorate intends to perform in the following year, categorised by:
- Financial audits (including related compliance with authority audit);
 - Compliance with authority audits (where additional compliance with authority work is planned);
 - Audits of internal controls;
 - Audits of foreign-aided projects;
 - Performance audits;
 - Other functional, systems, programme and fraud audits; and
 - Special assignments.
- 3.4.8** Details with respect to each of the planned audits for the following year. These details include, for each audit:
- The revenue and expenditure to be audited;
 - The person days required;
 - The staff members to be assigned to the audit (and any shortfall in the staffing);
 - The travel and daily allowances that are required;
 - A time schedule showing the dates by which each audit will be planned, executed, reported, etc.
- 3.4.9** A summary of the unallocated resources available within the directorate or the audit work for which staff is not available.
- 3.4.10** Audit management software is useful for developing this plan.
- 3.4.11** With respect to centrally led audits, each directorate will estimate the number of hours required to perform the work, the staff to be assigned to the work, and the timing of the work, and provide this information to the responsible central team. The central team, in turn, will be responsible for the overall budget of the audit.
- 3.4.12** This process is discussed further in Section 5.6 below.

- 3.4.13** As noted, some audits are not required each year. This provides the audit teams with some flexibility in scheduling work, so work loads can be balanced to reflect the number of resources available after taking into account resource assignments to mandatory audit work.
- 3.4.14** For example, the nature, extent and timing of the work that DAGP performs on its compliance with authority audits is somewhat discretionary. DAGP auditors can decide to perform extensive tests of compliance with authorities or more limited tests. As such, the budget for a given compliance with authority audit can be increased or decreased as required to match the available resources.
- 3.4.15** When deciding on the nature, extent and timing of the work that each directorate performs on compliance with authority audits, audits of internal controls and performance audits, the directorate should take into consideration the annually required work that it is performing, and integrate the audits to the extent possible. This is discussed in more detail in below.
- 3.4.16** Each directorate should ensure that it has sufficient staff with necessary skills to accomplish the work required by the Auditor-General Ordinance to be performed each year. Only plans for the work that is not required to be performed each year may reflect staff shortfalls.
- 3.4.17** Where staffing shortages are evident, senior management within DAGP will attempt to match one directorate's staff shortfall with unallocated staff in another directorate. Overall, though, the planned workload cannot exceed the available resources. Should the sum of the required resources exceed the available resources, the discretionary audit work must be decreased.

3.5 Integration of Audit Work

- 3.5.1** Under DAGP's annual planning approach, each directorate has discretion over work that is not required by the Auditor-General Ordinance to be performed annually. The directorate can decide, for example, which entities it wishes to audit, and the types of audits it wishes to perform (compliance with authority, internal controls, performance, etc.). However, to improve the efficiency and effectiveness of the work, DAGP recommends that each directorate integrate its compliance with authority, internal control and performance audit work that is not required to be performed each year with the work being performed on the mandated annual audits, such as the annual audits of financial statements. This integration could include:
- a) Performing the work at the same time; and
 - b) Re-using the sample items selected for the financial audit work when performing the compliance with authority, internal controls and performance audit work. (Additional items could be selected if considered necessary.)

- 3.5.2** Synchronising the timing of compliance with authority work and other discretionary work to better match the timing of financial audit work, would create the following benefits:
- a) Samples for financial audit and compliance with authority purposes could be integrated, reducing the total amount of audit work being performed.
 - b) When doing the financial audit work, the auditors could rely on the normally larger amount of work done for compliance with authority purposes. When the compliance with authority audit work is done several years later, this reliance is not possible.
 - c) With auditors performing compliance with authority audit work on Year 1 transactions in Year 4, there is a risk that the auditors could discover, in Year 4, significant errors with respect to the accounts for Year 1. DAGP could then be in the embarrassing position of having to amend and reissue its certificate on the Year 1 financial statements. Doing all of the work in Year 1 would eliminate this problem.
- 3.5.3** In addition to these benefits, doing the compliance with authority work more frequently, and covering fewer years during each audit, could benefit the compliance with authority work itself, as follows:
- a) There would be more timely identification of deficiencies, which could lead to a quicker improvement of the related controls. This, in turn, should significantly reduce compliance with authority violations in subsequent years;
 - b) Having auditors on the premises provides a deterrence factor – entity officials are less likely to commit frauds or perform sloppy work when auditors are present. More frequent visits will multiply this effect.
 - c) Entity officials would no longer be required to find vouchers and other documents that are several years old. This could make it easier for them to find the required documents.
- 3.5.4** There are some disadvantages to amending the rotational audit approach for compliance with authorities. The most significant one is that auditors will spend less time at each location during each visit. This could increase the coordination effort, travel time, start-up time, etc.
- 3.5.5** Because of these disadvantages, and because directorates may have other very valid reasons for not following the recommended approach, that DAGP has chosen not to mandate any one approach. However, directorates not following the recommended approach may be asked to justify the reasons for not doing so.

3.6 Approval Process for the Budget Of Centrally-Led Audits

- 3.6.1** As noted above, the first two categories of audits are centrally led. Each directorate will need to discuss the number of hours required to perform the work, the staff to be assigned to the work, and the timing of the work, with the responsible central team. The central team, in turn, will be responsible for the overall budget of the audit.

- 3.6.2** One of the responsibilities of the central team is to set the budget (both person days and costs) and the deadline dates for this audit. To do so, the central team will adhere to the following process:
- a) First estimate the number of hours and costs required to perform the audit, and the approximate timing of the work;
 - b) Then allocate the estimated hours of work to the central team, and each audit directorate;
 - c) Meet with each directorate to ensure that the directorate can perform the work within the proposed budgets and by the required deadline dates. Obtain the list of staff members from the audit directorate who will perform the work, and the proposed scheduling for each of those staff members;
 - d) Following the discussions with each directorate, update the budget for each directorate, and the overall budget for the audit;
 - e) Obtain the approval of the Auditor General for this budget; and
 - f) Once the central team has received the required approval, each directorate will set aside the agreed-upon person days, dates, and staff members for the performance of the audit.

4 THE AUDIT CYCLE

4.1 Introduction

4.1.1 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.

Efficient and effective collection of evidence depends on a clear audit plan.

4.1.2 The audit plan should include:

- a) A clear statement of the audit objective(s);
- b) 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;
- c) Summary of significant issues and results of an initial risk assessment;
- d) 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.
- e) Budget and schedule;
- f) Audit steps; and
- g) Assigned audit responsibilities.

4.1.3 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:

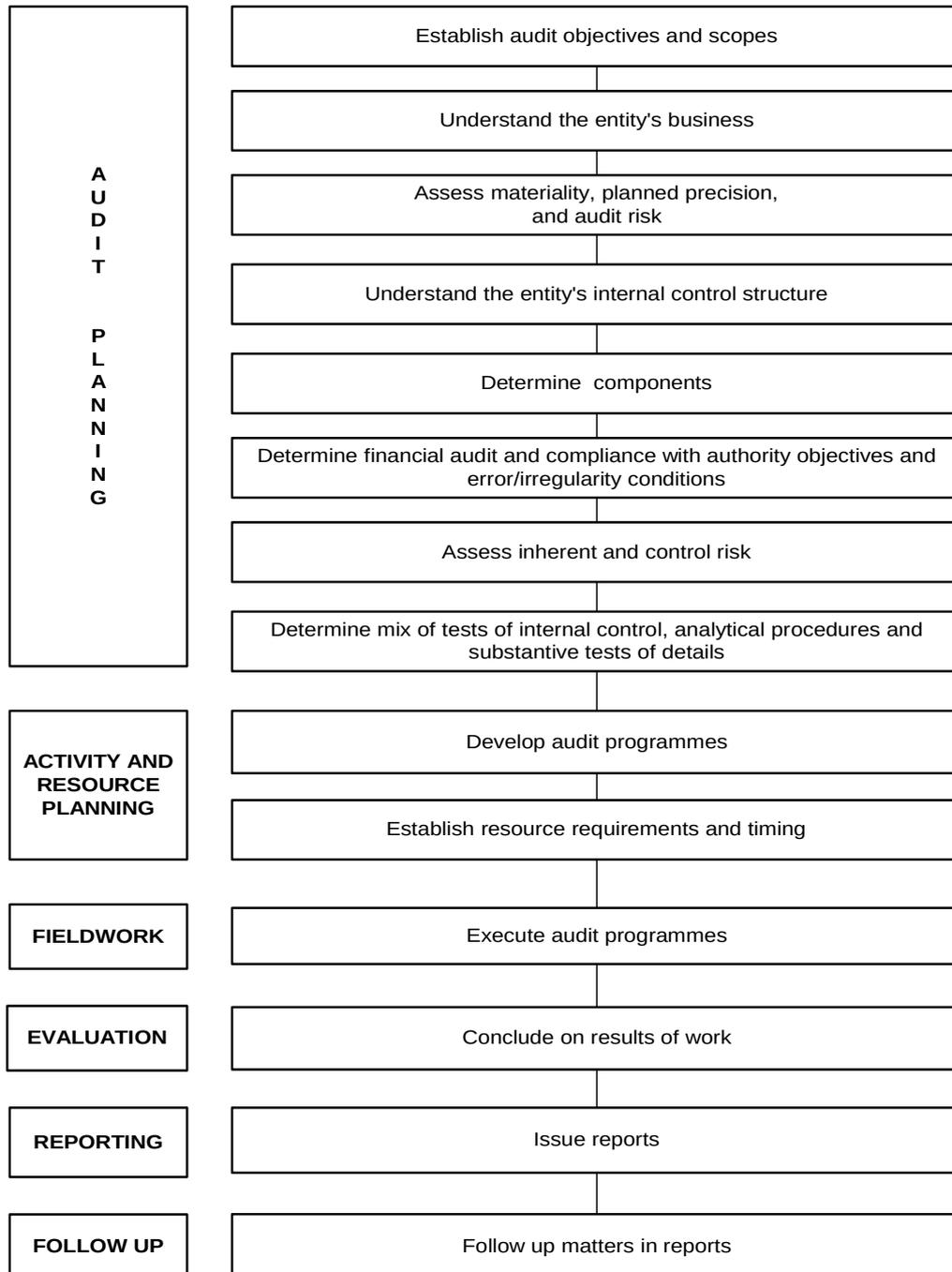
- a) Understand the audit entity;
- b) Conduct a risk assessment;
- c) Define audit objectives and scope;
- d) Develop an audit programme
- e) Test the controls;
- f) Determine sample size (for statistical or non-statistical);
- g) Conduct substantive tests;
- h) Report; and
- i) Follow up.

DAGP audit teams should plan audits that encompass both financial attest and compliance

- 4.1.4** 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).
- 4.1.5** 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.
- 4.1.6** The audit cycle is shown in Figure 6.1. It contains six basic phases:
- a) General audit planning;
 - b) Detailed activity and resource planning;
 - c) Fieldwork;
 - d) Evaluation;
 - e) Reporting; and
 - f) Follow-up.
- 4.1.7** These phases are discussed in more detail below.
- 4.1.8** 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.
- 4.1.9** 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.
- 4.1.10** 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.
- 4.1.11** 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.
- 4.1.12** It is important for the auditor to avoid creating an adversarial relationship with entity officials. To facilitate good relations the auditor should:
- a) Be fully aware of all other audit activities being undertaken;

- b) Plan to minimise impact on the audit entity; and
- c) Ensure that all discussions with entity officials take place at an appropriate and reasonable level, and at an appropriate and reasonable time.

Figure 4.1: Audit Cycle for Individual Audits



4.2 General audit planning

4.2.1 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 Assessment inherent risk and control risk; and
- Step 8 Determine mix of tests of internal control, analytical procedures and substantive tests of details.

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

Step 1 – Establish overall audit objectives and scope

4.2.3 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.

4.2.4 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.

4.2.5 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).

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

4.2.7 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

4.2.8 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.

The audit objective should be a clear statement of

Objectives should be defined for

Audit scope is a statement of what areas will be looked at, what work must be done

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

- 4.2.9** 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, planned precision and audit risk are key concepts*
- 4.2.10** *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. *The auditor must determine what amount is considered material.*
- 4.2.11** *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.
- 4.2.12** *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”.
- 4.2.13** 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%.
- 4.2.14** 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

The auditor must have an understanding of the entity’s internal control structure

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

4.2.16 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

4.2.17 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.

4.2.18 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.

4.2.19 Sometimes the financial statements include several different groupings of the same total amount. For example, expenditures may be grouped by:

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

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

4.2.21 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

4.2.22 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.

4.2.23 *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.

- 4.2.24** 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.”
- 4.2.25** 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.
- 4.2.26** The following compliance with authority objectives are considered to be applicable:
- 4.2.27** Spend:
- a) The services were performed or the goods received;
 - b) The expenditure was consistent with the nature of the appropriation to which it was charged;
 - c) The expenditure is in accordance with applicable legislation and the rules and regulations issued by such legislation; and
 - d) The expenditure does not result in the total approved expenditure being exceeded.
- 4.2.28** Borrow:
- The amount and debt terms (period, interest rates, repayment schedule, etc.) are in accordance with applicable legislation, and related rules and regulations.
- 4.2.29** Raise revenue:
- a) The cash received was for an approved tax or other approved source;
 - b) The cash received is in accordance with applicable legislation and associated rules and regulations.
- 4.2.30** *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.
- 4.2.31** 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.
- 4.2.32** 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.
- 4.2.33** 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.

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

- a) The work being performed was not properly approved; and
- b) The payments were not properly approved.

4.2.35 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

4.2.36 *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.

4.2.37 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).

4.2.38 *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.

4.2.39 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

4.2.40 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.

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

- a) 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;
- b) 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
- c) selecting a sample of payroll transactions and performing various substantive tests of details on those transactions.

- 4.2.42 These methods can be used in different combinations. For example:
- 4.2.43 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,
- 4.2.44 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 and/or select a larger sample of payroll transactions for substantive tests of details.
- 4.2.45 When deciding which combination to use, the auditor should consider several factors, including the cost of each combination in terms of audit resources.

4.3 Activity and Resource Planning

- 4.3.1 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.
- 4.3.2 These steps are introduced below, and are discussed in more detail later.

Develop audit programmes

- 4.3.3 The audit programmes provide the auditor with a list of all the procedures to perform.
- 4.3.4 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.
- 4.3.5 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

- 4.3.6 For each audit determine:
- a) the number of auditors with required level of seniority and skill sets;
 - b) related out-of-pocket expense budgets; and,
 - c) timing of the work.
- 4.3.7 The resource requirements are based on the audit programmes. Resource allocations from previous audits of the entity may provide a helpful starting point.

Fieldwork

4.3.8 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 appropriate working paper files.

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

Evaluation

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

4.3.11 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, and/or identifies specific irregularities and general systemic weaknesses based on compliance with authority tests.

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

Reporting

4.3.13 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:

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

4.3.15 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.

4.3.16 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.

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

Follow up

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

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

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

4.4 Roles and Responsibilities

General Roles and Responsibilities

- 4.4.1 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. *Key planning decisions impact the nature, extent*
- 4.4.2 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.
- 4.4.3 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.
- 4.4.4 To encourage consistency, Figure 4.2 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.

Centrally Led Audits

- 4.4.5 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.
- 4.4.6 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.

- 4.4.7** 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.
- 4.4.8** 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.
- 4.4.9** With a centrally led audit, some of the roles and responsibilities that, according to Figure 4.2, 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 4.2.
- 4.4.10** To ensure that everyone is aware of their roles and responsibilities, the central team will provide a schedule similar to Figure 4.2 that clearly lays out the roles and responsibilities of individuals within the central team, and within each audit directorate.

Figure 4.2: Roles and Responsibilities

<i>Step</i>	Auditor-General	DAG (Senior) or DAG	Director General		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.

<i>Step</i>	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.

<i>Step</i>	Auditor-General	DAG (Senior) or DAG	Director General		Deputy Director or Asst. Director	Audit Officer
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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.

5 PLANNING THE AUDIT

5.1 Introduction

- 5.1.1 Individual audits must be properly planned to ensure:
- Appropriate and sufficient evidence is obtained to support the auditor's opinion;
 - DAGP's auditing standards are complied with; and
 - Only necessary work is performed.
- 5.1.2 This chapter contains guidelines that the auditor can use to plan the audit. These guidelines do not replace the use of professional judgment.

Individual audits must be properly planned.

5.2 Step 1 - Establish Audit Objectives and Scope

- 5.2.1 It is a general principle of DAGP's audit activities that no audit entity should be subject to more than one audit in a given year. Accordingly, any individual audit may have to fulfil multiple audit objectives, so it is important that the audit is well-planned in terms of audit objectives and audit scope.
- 5.2.2 The step also involves communicating with the entity to ensure management is fully aware of the audit objectives and audit scope.

Overall Audit Objectives

- 5.2.3 Each audit will be designed to address one or more of the following objectives:
- Expressing an opinion on financial statements;
 - Expressing an opinion regarding compliance with authorities;
 - Testing compliance with authority or controls on selected transactions with no opinion being expressed; and
 - Evaluating operational performance.
- 5.2.4 To express an opinion on financial statements the auditor needs to design audit procedures to obtain a reasonable level of assurance that the financial statements are not materially misstated. This means reaching a conclusion as to whether the account balances are valid, are complete, are properly valued, etc.
- 5.2.5 For compliance with authority work where an opinion is being expressed, the auditor will design audit procedures to obtain a reasonable level of assurance that the selected transactions in a given period are in compliance with applicable statutes and regulations. The types of irregularities that the auditor needs to look for will reflect the objectives of the compliance audit.
- 5.2.6 For compliance with authority audit work where there is no expression of an opinion the auditor need not plan the audit to obtain a specified minimum level of overall audit assurance.

The auditor needs to design audit procedures to obtain a reasonable level of assurance that the

- 5.2.7 Where the audit is to evaluate operational performance the auditor is concerned with economy, efficiency and effectiveness the auditor will develop specific audit objectives and conclude on the management framework and/or level of performance.
- 5.2.8 In summary, the nature and extent of the work that the auditor needs to perform will vary according to the objectives of the audit. Therefore, a first step in the planning process is to determine the objectives for the year.

Audit Scope

- 5.2.9 The auditor also needs to determine the overall audit scope – the total population on which to express an opinion, from which to select transactions, etc. For financial audit purpose, this total population is referred to as the “audit entity”. The audit entity determines the scope of the audit, and is generally defined by the audit mandate. For financial statement audits that are required under Section 7 of the Auditor-General Ordinance (see Chapter 2), the entity to be audited will be defined by the applicable accounting policies of the government.
- 5.2.10 For example, the accounting policies for the Federation state, “The financial statements have been prepared by consolidating the accounts of all Centralised and Self Accounting Entities Commercial entities owned or controlled by the Government prepare their own financial statements, which are not included in these financial statements.” Based on this accounting policy, the audit entity would include all centralised and self-accounting entities, but would exclude the commercial entities.
- 5.2.11 For other financial audits, the entity to be audited may need to be carefully determined. For example, a ministry may make use of a special operating agency to perform some of its functions. In this situation, the auditor will need to determine whether or not the agency falls under the scope of the audit.
- 5.2.12 In some cases, the scope of the audit can be at the auditor’s discretion, or can be negotiated with entity management. For example, DAGP may have planned to audit a particular civil works project. If the internal audit unit in that entity is planning to do a detailed audit of the project one year later, it may suggest that DAGP defer its audit by a year so the two audits could be coordinated. DAGP might decide to do so.
- 5.2.13 The first consideration in defining the scope of audit is to ensure that the work required to complete the financial attest audit is covered. In determining what else should be audited, it is important that scarce audit resources be focused on the most important aspects of the operations of the government. The first step in deciding what to examine is to identify matters of significance, both within the government as a whole and within the audit entity under examination.
- 5.2.14 Matters of significance can include one or more of the following:
- a) Large expenditures or large revenues;
 - b) Areas of high risk (significant control weaknesses, potential for large losses/negative impacts);

The auditor needs to determine the overall audit scope.

- c) Matters of propriety, or probity (even if not of high materiality or risk);
- d) Important aspects of the programme's performance;
- e) Politically sensitive areas, where the reputation of the government could be adversely affected;
- f) Substantial errors or misrepresentations in financial and other management reports;
- g) Serious problems of compliance, especially regarding laws and regulations; and
- h) Areas where the audit is likely to identify opportunities for significant improvement.

5.2.15 The auditor may decide to address one or more of these or to limit audit coverage to financial attest requirements together with the more critical aspects of compliance with key laws and regulations. Ultimately the decision as to what sub-entities are significant and should be included in a particular audit is a matter for DAGP management. As noted in Chapter 5, there are various entities that DAGP may decide to include in any specific audit. Entities may be organisational units, such as agencies, DAOs, DDOs etc., functional areas, such as the payroll function or the purchasing function, or accounting entities, such as objects of expenditure, grants or appropriations. DAGP may determine that all entities should be reviewed in a particular audit, for example ensuring complete coverage of all DDOs or grants and appropriations, and the planning phase for individual audits will be guided by this direction from management.

5.2.16 In determining what areas are significant, an understanding of the audit entity and its business is important. In selecting matters of significance for performance audits, the auditor should not focus only on the potential of negative findings. It is also important that key aspects of the programme are examined even if they are well managed. Providing the Legislature, the public, and also management, with assurances that programmes are well administered can be of value. When providing an assurance, the auditor must obtain sufficient evidence to conclude that there is a low risk that any significant problem has gone undetected. This usually requires much more audit effort than is required for finding weaknesses.

Entity Communication Letters

5.2.17 DAGP has a legal mandate to perform its audit work. This mandate permits it to determine the nature, extent and timing of its work. As such, DAGP does not need to negotiate the scope of its work with the entity, or to make use of formal engagement letters.

5.2.18 Nevertheless, there are benefits to discussing the nature, extent and timing of the work with entity officials. These benefits include:

- a) The introduction of annual financial audit work has changed the nature of the audit work that the auditors are performing. Entity communication letters can be used to help the audit entities to better understand the nature of the work that is being performed, and the types of reports that may be issued at the completion of the work.

- b) While much of the financial audit work will be performed annually, other work that DAGP performs will continue to be performed on a rotational basis. Entity communication letters can be used to advise the entity of the nature, extent and timing of the rotational audit work that will be performed in the coming year.
- c) Input from entity management may help improve the planned scope of the audit and the rotational audit plan. For example, the auditors may discover that the entity's internal audit unit is planning a detailed review of the entity's internal control structure. DAGP and internal auditors could then coordinate their work, and the DAGP auditors may be able to rely on the work performed by the internal auditors.
- d) Input from entity management may also improve the efficiency of the audit work. For example, the auditors could advise entity officials of the planned start and completion dates of each audit, and the information that the auditors will require to perform their audit. Entity officials would then be able to locate the required information, arrange for suitable office space, etc. prior to the start of the audit.

5.2.19 An entity communication letter is a useful way to document the nature, extent and timing of the audit work that will be performed in the following year. A sample letter is included in the Standard Audit Working Papers Kit.

Minimum terms of auditing engagement

5.2.20 The form and content of entity communication letter may vary according to type of audit, but they would generally include reference to:

- a) The objective of the audit;
- b) Management's responsibility;
- c) The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres;
- d) The form of any reports or other communication of results of the engagement;
- e) The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatement may remain undiscovered; and
- f) Unrestricted access to whatever records, documentation and other information requested in connection with the audit.

5.2.21 The auditor may also wish to include the following in the letter:

- a) Arrangements regarding the planning and performance of the audit.
- b) Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- c) Request for the auditee to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
- d) Description of any other letters or reports the auditor expects to issue to the auditee.
- e) When relevant, the following points could also be made:
- f) Arrangements concerning the involvement of other auditors, internal auditors, predecessor auditors and experts in some aspects of the audit.
- g) Any restriction of the auditor's liability when such possibility exists.

- h) A reference to any further agreements between the auditor and the engagement entity.

5.3 Step 2 - Understand the Entity's Business

Information Requirements

- 5.3.1 Audit objectives are developed on the basis of an understanding of the entity's business. However, the auditor does not need to have a complete understanding of all of the entity's activities. The auditor only needs to have a detailed knowledge of those aspects of the entity's business that relate to the audit.
- 5.3.2 For example, when performing a financial statement audit, the auditor may not need to have a detailed understanding of all of the entity's human resource policies. However, should the auditor be performing a compliance with authority or a performance audit on the staffing and promotion processes, a more detailed understanding of the human resource policies may be required.
- 5.3.3 The auditor should assemble the following information for most audits:
 - a) government's plans and priorities;
 - b) entity's strategic plans;
 - c) users of the entity's services;
 - d) legislative authorities affecting the entity's operations;
 - e) industry in which the entity operates, including any specialised accounting practices followed by that industry;
 - f) activities in which the entity engages (constructing buildings, providing grants and contributions, collecting taxes, etc.);
 - g) size of the entity (its total assets, liabilities, revenue and expenditure);
 - h) types of transactions and documents that the entity processes;
 - i) entity's internal control structure; and
 - j) economic trends that can affect the valuation of significant assets and liabilities (those held in foreign currencies, for example).
- 5.3.4 The Standard Audit Working Papers Kit includes forms to help the auditor update his/her understanding of each of these knowledge areas.
- 5.3.5 Sufficient knowledge of these matters is required by the auditor to:
 - a) assess materiality, planned precision and audit risk;
 - b) understand the internal control structure;
 - c) determine components and understand how the various components and activities fit together;
 - d) identify error conditions;
 - e) assess inherent risk and control risk;
 - f) understand the substance of transactions, as opposed to their form;
 - g) identify the nature and sources of audit evidence that are available;
 - h) update audit programmes;
 - i) assess whether sufficient appropriate audit evidence has been obtained;
 - j) assess the appropriateness of the accounting policies being used; and
 - k) evaluate the presentation of financial statements and the reasonableness of the overall results.

- 5.3.6** There is a link between these knowledge areas and the tasks to be performed, as follows:
- a) an understanding of the users of the entity's services and the size of the entity is needed to assess materiality;
 - b) an understanding of the legislative authorities affecting the entity's operations, the activities in which the entity engages, and the types of transactions and documents that the entity processes is needed to determine what components to audit;
 - c) an understanding of the industry in which the entity operates, the activities in which the entity engages, the size of the entity, the types of transactions and documents that the entity processes, and economic trends are needed to assess inherent risk.

Level of Effort

5.3.7 Building an understanding of the entity's business can be a significant undertaking especially where the audit scope is large, like the audit of the Federal Government. The level of effort in collecting and documenting the understanding will be high, especially when this is being done for the first time. Practically, DAGP will probably have to approach this effort incrementally over the course of the first few audit cycles. However, this should be done according to a plan that will ensure adequate depth of understanding of priority issues to provide a foundation upon which subsequent audit cycles can build.

5.3.8 There are a number of factors that can legitimately reduce the effort required:

- a) Much of the required knowledge will have already been gathered during prior compliance with authority work. This can be used when planning the audit.
- b) With a financial audit, the depth of knowledge required of each ministry, department etc. is relative to the materiality of that organisational unit to the overall audit scope. Therefore, the knowledge required will be small for less material agencies and will be of lower priority, so it can be deferred until more priority units have been covered.
- c) The depth of knowledge required also reflects the extent of intended reliance on internal controls as a source of audit assurance. If the auditor intends to place little reliance upon internal controls, then a lower level of knowledge is required than when significant reliance is to be placed on controls.

5.3.9 These factors can reduce the level of knowledge needed, and can render the data gathering exercise more manageable.

5.3.10 Once the required level of knowledge has been reached, over the course of several audit cycles, subsequent audits need only be concerned with confirming the knowledge is current and updating specific issues where necessary.

5.3.11 Clearly, knowledge of the business is important to all phases of the audit. The auditor should therefore be sure to update his/her knowledge of the entity's business throughout the audit. Analytical procedures are often used at the general planning phase to identify large fluctuations in the accounts from the previous year. These fluctuations, in turn, may indicate changes in the entity's operations.

5.3.12 Analytical procedures are discussed in more detail below.

5.4 Step 3 - Assess materiality, planned precision, and audit risk

Materiality

5.4.1 *Definition of materiality:* When the auditor states that the financial statements "properly present, in all material respects", he/she is stating that the financial statements are not materially misstated. This introduces the concept of materiality.

5.4.2 Materiality can be defined as follows: "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".

An error is material if the error is big enough to influence the users of the financial statements.

5.4.3 Materiality is important in the context of the auditor's report on the financial statements. 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] ..."

5.4.4 *Guidelines:* To determine materiality the auditor should perform the following steps:

1. Identify the probable users of the financial statements.
2. Identify the information in the financial statements that is expected to be the most important to each of these users (e.g., total expenditures, total assets or the annual surplus or deficit). One or more of these amounts may serve as the base amount(s) for computing materiality.
3. Estimate the highest percentage(s) by which the base amount(s) could be misstated without significantly affecting the decisions of the users of the financial statements.
4. Multiply the percentage(s) times the base amount(s).
5. Select the lowest amount – this is the materiality amount. Errors exceeding this value are material.

5.4.5 The auditor normally selects the lowest amount that results from each of these guidelines, and uses that amount for the audit of the financial statements as a whole. This is because errors often affect more than one component. For example, an error in cash may also represent an error in expenditures. As a result, the auditor cannot use a higher materiality amount to audit cash than he/she uses to audit expenditures.

- 5.4.6** Note that the materiality amount determined at this step in the general planning phase is used for the audit of all components. There is no need to allocate the amount to the various financial statement components. If materiality is set at Rs. 3,000,000 for the financial statements as a whole, the same Rs. 3,000,000 can be used for each financial statement component, and for each specific financial audit objective, related compliance with authority objective, and error condition.
- 5.4.7** There are some guidelines that can be used to determine the base amount(s) and the appropriate percentage(s). While guidelines should not replace the use of professional judgment, the following may be useful, depending on the nature of the entity being audited:
- 5.4.8** Percentage of total expenditures.
This method is the most widely used method for not-for-profit public sector entities. The percentages used generally range from 2% for "small" entities to 0.5% for "large" entities.
- 5.4.9** Percentage of normalised pre-tax income.
This method is the most used method for profit-oriented public sector entities (e.g., state-owned enterprises with a mandate to earn a return on their investments). The percentages used generally range from 5% for entities with "large" pre-tax incomes to 10% for entities with "small" pre-tax incomes.
- 5.4.10** Percentage of total revenue.
The same 2% to 0.5% range that is generally used for expenditures (see above) is often recommended.
- 5.4.11** Percentage of equity.
Usually 1% is suggested. This method would be appropriate only for entities following full accrual accounting and hence recording such assets as receivables, stocks and fixed assets. Without these assets, the entity would most likely be in an accumulated deficit position, and the equity amount might not be meaningful to the users.
- 5.4.12** Percentage of assets.
Usually 0.5% is suggested, which achieves the same materiality amount as the amount in Percentage of Equity if the debt-to-equity ratio is 1 to 1.
- 5.4.13** Percentage of the annual surplus or deficit.
For public sector entities, the most often quoted amount in the media is the annual surplus or deficit. It would therefore seem logical to base materiality on a percentage of the entity's annual surplus or deficit.

- 5.4.14** However, there are weaknesses in the latter approach. The main weakness with basing materiality on a percentage of the annual surplus or deficit is the fact that the amount may not represent the "true" size of the entity. An entity with an extremely small annual deficit relative to its total expenditures and revenues would have an extremely small materiality amount, and an entity with a very large annual deficit would have a very large materiality amount. In fact, basing materiality on the annual surplus or deficit could result in the materiality amount decreasing year after year even though the size of the entity being audited is increasing.
- 5.4.15** Because of these problems, a percentage of the annual surplus or deficit is normally only used as a reasonableness check on the materiality amount determined by a percentage of total expenditures or revenues.
- 5.4.16** It is not necessary to use a percentage of total expenditures or revenue to audit the statement of expenditures and revenues, a percentage of total assets when auditing the balance sheet, etc. Instead, the auditor selects the lowest amount that results from each of these guidelines and uses that amount for the audit of the financial statements as a whole. That is because errors often affect more than one component.
- 5.4.17** Also note that available audit resources should not be a factor in setting materiality. Materiality is determined with the users in mind, and it is up to the auditor to ensure that it has the resources that are required to perform the work.
- 5.4.18** The Standard Audit Working Papers Kit contains a form that can be used to assess the materiality amount.
- 5.4.19** Ultimately, the establishment of an appropriate materiality amount is a matter for the auditor's professional judgment. For this reason, it is normally not appropriate to use the same materiality amount for the audit of different entities (i.e. the materiality calculated for the Federal Government as one entity, will be different from the materiality for a self-accounting commercial enterprise), and materiality should be calculated separately for each audit. In addition if, based on the knowledge of the entity and an understanding of the circumstances, the auditor believes that the monetary amount determined by the above process appears unreasonable, additional relevant factors should be considered and the materiality amount revised accordingly.
- 5.4.20** *Qualitative aspects.* In addition to the quantitative aspects of materiality discussed above, there is also a qualitative aspect. The inherent nature or a characteristic of an error may render the error material, even if its value is not. For example, a small error that is designed to conceal the over-expenditure of a government appropriation could be considered to be material by the users.

5.4.21 Auditors are not expected to plan financial audits to detect all of these qualitative errors. The cost of such an audit would be too high. Consequently, auditors normally ignore the qualitative aspects of errors when planning their audits. However, when reporting on the results of the audit work, they take into account the qualitative aspects of the errors that they have found when assessing whether the financial statements taken as a whole are presented fairly.

Planned Precision

5.4.22 Planned precision is the auditor’s planned allowance for further possible errors.

5.4.23 By testing a sample, the auditor can determine the Most Likely Error (MLE) in the population. However, because the auditor has only selected a sample, there is a chance that the actual error in the population is larger than that. The auditor needs to ensure there is sufficient assurance that the maximum possible error in the population is less than the materiality amount.

5.4.24 To do this, when planning and performing many analytical procedures and substantive tests of details, the auditor reduces the materiality amount by his/her estimate of the most likely error that will exist in the financial statements as a whole. This estimate is referred to as the “expected aggregate error.” Planned precision is equal to materiality less the expected aggregate error.

5.4.25 To determine the expected aggregate error, the auditor should consider:

- a) The errors found in previous years;
- b) Changes the entity has made to the internal control structure to prevent these errors from recurring; and
- c) Other changes to the entity’s business or its internal control structure that could affect the size of the errors.

5.4.26 If the auditor’s estimate of the expected aggregate error had been set at the planning stage at Rs. 816,500, the auditor would have calculated planned precision as follows:

	Rs.
Materiality	<u>3,000,000</u>
Expected aggregate error in financial statements	<u>816,500</u>
Planned precision	<u>2,183,500</u>

- 5.4.27 As noted in the discussion on materiality, the materiality amount determined at this step of the general planning phase is used for the audit of all components within the same audit. There is no need to allocate the amount to the various financial statement components. Consistent with this approach, the expected aggregate error being used for a particular test is the expected aggregate error in the financial statements as a whole, and not just the expected error in the population being audited. When auditing the completeness of income tax receipts, for example, the auditor would need to allow for errors not only in that test, but for errors found in other income tax receipts tests and for errors found in other financial statement components.

Audit Risk

- 5.4.28 *Definition:* 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 the results of operations (i.e. they 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. Generally accepted auditing standards (GAAS) refer to this degree of assurance as "reasonable assurance".

- 5.4.29 Stated another way, the auditor is taking some risk of issuing an unqualified opinion on financial statements that are materially misstated. This risk is referred to as "audit risk".

- 5.4.30 For example, 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 is therefore 5%.

- 5.4.31 Using the audit risk and the materiality amount, when the auditor states, "In my opinion, these financial statements present fairly, in all material respects ...", the auditor is stating, "I have x% assurance that the financial statements are not misstated by more than the materiality amount".

Risk Assessment

- 5.4.32 The audit should focus on the areas of greatest materiality, significance and risk. An understanding of the risk associated with each audit entity is therefore critical to the development of an audit plan. The auditor should develop this understanding by conducting a risk assessment as part of planning an audit assignment.

- 5.4.33 In the case of a **financial attest audit**, the auditor is concerned with the risk that material misstatements exist in the financial statements that will not be detected, either by management or by audit procedures.

An understanding of risk is critical to the development of an audit plan.

The auditor is not absolutely certain that the financial statements are not materially misstated. The auditor has some degree of

- 5.4.34** In the case of **compliance audits**, the auditor is concerned with the risk that certain material, or significant, transactions have occurred in a manner that contravene the laws, regulations and management procedures applying to the area of audit.
- 5.4.35** In considering audit risk, there are three categories of risk that are normally considered: Inherent Risk, Control Risk, and Detection Risk. These are discussed below.

Inherent risk

- 5.4.36** This is the susceptibility to material/significant error or loss unrelated to any internal control system. Assessing inherent risk requires the evaluation of numerous judgmental factors, relating to the nature of the entity and its business environment taken as a whole.
- 5.4.37** This is done by asking what could go wrong and what would be the likely consequences. If the likelihood of occurrence is low and the significance of the consequence is low, the auditor need not be concerned. Where the likelihood is high and the significance is high, then inherent risk is high. In this situation, the auditor must be assured that either the internal controls are strong enough to detect and prevent such occurrences or the substantive audit coverage is sufficient to detect such occurrences with a high level of assurance.

Control risk

- 5.4.38** This is the risk that material/significant error or loss is not prevented or detected on a timely basis by the internal control structure. Control risk is a function of the effectiveness of the design and operation of the internal controls. In order to assess control risk, the auditor should obtain evidence to support the effectiveness of internal control policies and procedures in preventing or detecting material error or loss. The auditor should recognise that there are risks of error or loss that cannot be detected or prevented in a timely manner whatever the controls in place. Further, the auditor should recognise that the costs of certain controls cannot be justified when compared to the potential losses they are guarding against.
- 5.4.39** The auditor should identify and evaluate both the control environment and the effectiveness of the individual internal controls that are in place. Indicators of a positive control environment include:
- a) policies and procedures relating to internal controls and to the need for maintaining a proper control environment exist and are documented;
 - b) an appropriate organisational structure with clearly identified roles and responsibilities relating to the administration of internal controls exists; staff are selected and trained to ensure their competence and dedication in key control positions;
 - c) senior management is involved in identifying control risks and monitoring performance;
 - d) actions are taken to correct any identified control deficiencies with an appropriate level of priority; and

- e) management displays positive attitudes towards the maintenance of sound internal controls, such as: recognising dedicated effort; positively responding to audits and reviews of controls; and taking disciplinary action in response to poor performance.

5.4.40 The auditor is referred to the Control Environment Worksheet in the Standard Audit Working Papers Kit.

5.4.41 To review the effectiveness of controls the auditor should make use of the Internal Control Questionnaires which are presented in the audit programme guides as part of the Standard Audit Working Papers Kit. The auditor should expect stronger controls where risks are highest. For example, there should be strong controls in place to ensure contracts involving large expenditures are well managed: for the selection of the contractor, for drawing up the contract; and for the control of performance under the contract. On the other hand, there should be minimal effort applied to controlling small items of inventory where the risk of loss, damage or theft is low.

5.4.42 The auditor should determine how the controls are applied, assess their adequacy, and identify significant control gaps.

5.4.43 The trend in modern government is to “let the managers manage” and take reasonable risks in order to achieve results with reduced resources. Consequently, the auditor should be conscious of the need for reasonable, but not excessive, internal controls. The cost of controls should not exceed the potential losses that could occur without those controls.

Detection risk

5.4.44 This is the risk of material/significant error or loss going undetected by the auditor’s substantive audit procedures. It is a function of the effectiveness of the substantive audit procedures and audit effort.

5.4.45 Also, less experienced or less knowledgeable auditors are more likely to miss detecting errors than the experienced auditor. Therefore, without careful supervision, the employment of less experienced auditors increases detection risk.

5.4.46 **Audit risk** is a composite of these three risks. When planning an audit there is a trade off between the overall risk that the auditor will accept and the cost of the audit – the lower the overall risk that the auditor is prepared to take, the more extensive the required work and the more costly the audit becomes. Thus the risk assessment process is particularly important in determining the extent to which the audit will examine the systems, procedures, practices and transactions that govern matters at the lower end of the objective and control hierarchy.

Identification of Risk

5.4.47 The auditor needs to develop the ability to identify risks. This requires an understanding of what constitutes risk and how to recognise it. There is a set of steps that the auditor can take, but experience, imagination and judgment are also critical.

5.4.48 The steps to follow are:

- 1 List the programme objectives, assets to be safeguarded and other results that management need to achieve;
- 2 Identify threats which could prevent achievement of these objectives;
- 3 Rate the risks, with the probability of occurrence, assuming no management controls (the inherent risks);
- 4 List controls and assurances which exist within the systems and practices in place (environment controls and internal controls);
- 5 Identify missing controls and assurances;
- 6 Identify risks that could occur even with the existing controls in place (control risk); and
- 7 Recommend improved controls and assurances (based on an assessment of the trade-off of the cost of the controls against the potential savings of lost and waste without the new controls in place).

5.4.49 This activity should be documented on the audit file.

Indicators of Risk

5.4.50 There are certain indicators that can alert the auditor to potential risk situations. Analysis of data may produce information that does not look right. Managers are often aware of high-risk situations and will assist the auditor to identify areas needing examination. This is more likely if the manager sees the auditor as an ally rather than a critic and feels comfortable confiding with the auditor.

5.4.51 Some examples of risk that can be encountered are:

- a) Processing risk;
- b) Programme risk;
- c) Regularity risk; or
- d) Risk of fraud.

5.4.52 **Processing risk.** Errors can occur inadvertently, especially in situations such as the following:

- a) A new government programme where there is little experience in administering it, or the entity has taken over responsibilities for a new function and the previous administrators are no longer involved.
- b) New systems or procedures are introduced, especially a new computerised system.
- c) There have been recent changes in management or there is a high turnover of staff (in other words, there is a poor corporate memory), particularly if administrative procedures are poorly documented.
- d) There are unclear responsibilities.

5.4.53 If the process involves large transactions, the risk of inadvertent loss or waste can be serious.

- 5.4.54 Programme risk. Certain government programmes are particularly susceptible to significant losses, either intended (fraud) or unintended (the result of poor administration).
- 5.4.55 Examples of programmes that should be given a careful assessment of risk are:
- a) Loans or guarantees, which, by their very nature, usually place the government at risk.
 - b) Programmes delivered by means of contracts, especially where there are unclear terms and conditions, insufficient specifications / performance requirements.
 - c) Research and development projects, where often the results are difficult to predict (especially non-standard software development).
 - d) Programmes with vague outputs or outcomes, where in return for the government's expenditures, the benefits are difficult to identify.
- 5.4.56 Large expenditures in programmes of such nature should be a high priority for the auditor to examine.
- 5.4.57 Another aspect of risk relating to programme performance is the risk that adverse publicity can arise. The danger of criticism of a programme can be out of proportion with the potential or actual loss occurring due to some weakness in the administration of the programme. There is often a trade-off between the economic and efficient management of a programme and the cautious avoidance or mistakes that can lead to embarrassment. The auditor should be sensitive to this and be able to judge what are appropriate levels of control.
- 5.4.58 **Regularity risk.** One means of implementing government policy is through regularity activities. The usual purpose of regulations is to protect the public – whether this is health protection, ensuring fair trade practices, transportation safety, or other law enforcement.
- 5.4.59 Failures in a government's regularity programme can occur at various points within the regularity system. For example, regularity risk can derive from:
- a) inadequate laws;
 - b) inadequate inspection/detection (insufficient resources available; untrained inspectors; poor supervision of the inspectors);
 - c) inadequate penalties or other deterrents;
 - d) poor records and inadequate statistics; and/or
 - e) environmental factors outside of the regularity process that impact on the effectiveness of the regularity programme.
- 5.4.60 The impact of regularity weaknesses on government operations can be significant, although not as obvious as misappropriations of funds, waste or loss of monies. For example, the non-collection of taxes can represent a huge loss to the government. Therefore the auditor must focus on regularity activities just as much as on expenditures.

5.4.61 Risk of fraud. There are many classical indicators of weaknesses that can contribute to fraud. Some of these are:

- a) Insufficient separation of duties;
- b) Only one person with access to financial information, particularly if this person exhibits defensive or guarded behaviour;
- c) Weak controls;
- d) Inadequate management supervision, inspection, challenge or review;
- e) Inadequate or untimely reports; and,
- f) Late or non-existent reconciliations.

5.4.62 It is often beneficial to provide all auditors with some training in fraud awareness and investigation, and to provide extensive Forensic Audit training to one or a few auditors. Then one of those who have had extensive training and experience can be consulted wherever any serious case of fraud has been identified or is suspected.

Factors Affecting Audit Risk

5.4.63 To determine how much risk the auditor should accept that an unqualified opinion may be issued on financial statements that are materially misstated, the auditor would consider such matters as professional exposure, reporting considerations and ease of audit.

Professional Exposure

5.4.64 This is the risk of loss or injury to the auditor's reputation from litigation, adverse publicity or other events arising in connection with the financial statements reported upon.

5.4.65 Professional exposure risk is often considered to be highest when there is a good chance that the financial statements and the audit report thereon will undergo a lot of scrutiny. This could occur in special situations such as when an entity is:

- a) Receiving a lot of bad publicity for an authority violation or other matter;
- b) Being privatised, transferred to another level of government, or turned into a special operating agency;
- c) Issuing new debt; and/or
- d) Getting into financial difficulty.

5.4.66 For audit entities such as these, the auditor may elect to reduce their audit risk to reduce their professional exposure risk.

Reporting Considerations

5.4.67 These considerations usually include the number of users and the extent to which they rely on the entity's financial statements and audit report.

Ease of Auditing

5.4.68 Factors to be considered here could include the practical availability of audit evidence and the existence of an audit trail.

Determining Audit Risk

5.4.69 Even though the determination of audit risk is the auditor's responsibility and not the financial statement users, it may be prudent to discuss the factors affecting audit risk and the assessed level directly with the users. There are several reasons for this:

- a) One of the factors affecting the required level of audit risk is the extent to which the users rely on the entity's financial statements and audit report. If the users are placing extensive reliance on the financial statements, the auditor may wish to use a lower level of audit risk (i.e., obtain a higher level of overall assurance) than if the users are placing very little reliance on the financial statements. Discussing the level of audit risk with the users will provide the auditor with direct evidence with respect to this factor.
- b) Some of the users, such as government planners and managers as well as legislators, may be aware of special circumstances that could increase the auditor's professional exposure risk. These may include circumstances of which the auditor is not aware.

5.4.70 *Guidelines:* As for materiality, the assessment of audit risk is a subjective process requiring the use of professional judgment. While guidelines should not replace the use of professional judgment, the following may be useful:

Situation	Audit Risk	Overall Assurance
Entities perceived to be high risk (and therefore the auditor wants to achieve a high level of overall assurance and set a low level of audit risk)	3	97
All other entities	5	95

5.4.71 The Standard Audit Working Papers Kit contains a form that can be used to assess audit risk.

5.4.72 As is evident from the above guidelines, the lower the audit risk being taken, the more the assurance that is required. This is because audit risk and overall assurance are converses of each other. Reducing audit risk from 5% to 3% increases the desired level of overall assurance from 95% to 97%.

5.4.73 Increasing the overall assurance will increase the required amount of audit work. Going from 95% assurance to 97% assurance could, for example, add 20% to the total required amount of audit work.

Auditor's Responsibility to Detect Error and Fraud

5.4.74 Because the auditor designs audit procedures to detect errors in the financial statements that in total exceed the selected level of materiality, an audit most likely will not detect all immaterial errors. In fact, because the auditor is providing *reasonable* and not *absolute* assurance, there is a chance that an audit performed in accordance with GAAS will fail to detect some *material* errors. Some of these errors may be due to fraud.

The auditor is providing reasonable and not absolute assurance.

- 5.4.75** Fraud is the intentional act by one or more individuals to deceive others. For example, an employee may steal cash and cover up the theft by recording fictitious expenditures. Or the employee may not record an expenditure that would cause the ministry to exceed its allowable expenditures.
- 5.4.76** The most difficult type of fraud to detect is fraud committed by management. This is because management may be able to override internal controls.
- 5.4.77** Not all frauds will result in errors in the financial statements. For example, under the accounting principles contained in the New Accounting Model (NAM), consumable stocks are not recorded in the financial statements. Therefore, the theft of inventory would not affect financial statements prepared using NAM.
- 5.4.78** When planning an audit, auditors normally start by assuming good faith on the part of management, meaning that management officials are honest and have done their best to ensure that the financial statements do not contain any errors.
- 5.4.79** However, the assumption of management's good faith cannot be blind faith. As noted in paragraph 3.0.3 of DAGP's auditing standards, "*The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of regularity audits. The auditor also should be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of regularity audits.*"
- 5.4.80** While the auditor is not required to actively seek out evidence of lack of good faith by management, the auditor complies with the above standard by planning and performing the audit with an attitude of professional scepticism. This means that the auditor uses a questioning mind and keeps alert for evidence that brings into question the reliability of documents or management's representations. Should evidence come to light that indicates fraud may have occurred or the assumption of management's good faith is not appropriate, the auditor should design specific audit procedures to deal with the matter.
- 5.4.81** Analytical procedures are a good technique to identify areas where further investigations are required. These procedures are discussed in Section 7.8 below.
- 5.4.82** Procedures to investigate possible fraud normally include a detailed review of specific projects, disbursements, etc. in which the fraud could have occurred. Sampling would normally not be used to detect or investigate fraud, because it involves selecting a representative sample, as opposed to zeroing in on the specific areas where further investigation is required.
Please refer to Appendix "Additional Examples of Conditions and Events that may Indicate Risks of Material Misstatement" to ISSAI 1315.

The assumption of management's good faith cannot

5.5 Step 4 - Understand the Entity's Internal Control Structure

Definition and Concepts of Internal Control

- 5.5.1 INTOSAI defines the internal control structure as the plans and actions of an organisation, including management's attitude, methods, procedures, and other measures that provide reasonable assurance that the following general objectives are achieved:
- Assets are safeguarded against loss due to waste, abuse, mismanagement, errors, and fraud and other irregularities;
 - Laws, regulations, and management directives are complied with; and
 - Reliable financial and management data are developed, maintained and fairly disclosed in timely reports.
- 5.5.2 The internal control structure of an audit entity is therefore very important to the auditor.
- 5.5.3 Furthermore, an understanding of internal controls, and the weaknesses in internal controls, is often critical for the auditor to make recommendations for improvements. If the audit focuses only on individual transactions, the auditor can only conclude, when errors are observed, that these errors should be corrected. By examining the controls over these transactions, the auditor can identify the reasons that the errors occurred. Then the auditor can recommend that the weaknesses in the controls be corrected.
- 5.5.4 Hence, it is critical that the auditor examines controls not just transactions.

An understanding of internal controls, and the weakness in internal controls, is critical for the auditor to make recommendations

General Standards for an Internal Control Structure

- 5.5.5 INTOSAI describes five general standards that entity management and employees should follow:
- Reasonable assurance. Internal control structures are to provide reasonable assurance that the general objectives of the entity will be accomplished.
 - Supportive attitude. Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.
 - Integrity and competence. Managers and employees are to have personal and professional integrity and are to maintain a level of competence that allows them to understand the importance of developing, implementing and maintaining good internal controls, and to accomplish the general objectives noted in paragraph 7.4.1.
 - Control objectives. Specific control objectives are to be identified or developed for each activity of the organisation and are to be appropriate, comprehensive, reasonable, and integrated into the overall organisational objectives.

- e) Monitoring controls. Managers are to continually monitor their operations and take prompt, responsive action on all findings of irregular, uneconomical, inefficient, and ineffective operations.

Detailed Standards for an Internal Control Structure

- 5.5.6** In addition, INTOSAI describes six detailed standards that entity management and employees should follow:
- a) Documentation. The internal control structure and all transactions and significant events are to be clearly documented, and the documentation is to be readily available for examination.
 - b) Prompt and proper recording of transactions and events. Transactions and significant events are to be promptly recorded and properly classified.
 - c) Authorisation and execution of transactions and events. Transactions and significant events are authorised and executed only by persons acting within the scope of their authority.
 - d) Separation of duties. Key duties and responsibilities in authorising, processing, recording, and reviewing transactions and events should be separated among individuals.
 - e) Supervision. Competent supervision is to be provided to ensure that internal control objectives are achieved.
 - f) Access to and accountability for resources and records. Access to resources and records is to be limited to authorised individuals who are accountable for their custody or use. To ensure accountability, the resources are to be periodically compared with the recorded amounts to determine whether the two agree. The asset's vulnerability should determine the frequency of the comparison.
- 5.5.7** The extent to which these standards can be met depends to some degree on the nature of the entity. Small organisations are not always in a position to maintain comprehensive separation of duties. The auditor should take such matters into account when assessing the sufficiency of the internal control structure.

Responsibility for Maintaining Internal Controls

Entity management is responsible for a proper

- 5.5.8** Entity management is responsible for ensuring that a proper internal control structure is instituted, reviewed, and updated to keep it effective.
- 5.5.9** It is then the responsibility of everyone in the entity to ensure that the internal control structure functions as it should.
- 5.5.10** In addition, the Controller General of Accounts has some responsibility for maintaining an environment which promotes adequate internal control. Section 5(d) of the Controller General Ordinance states that one of the functions of the Controller General shall be “to lay down the principles governing the internal financial control for Government departments in consultation with the Ministry of Finance and the Provincial Finance departments as the case may be”.

The Elements of Control

- 5.5.11** There are five basic elements that make up a control structure:
- Control environment;
 - Risk assessment;
 - Control activities;
 - Information and communication; and
 - Monitoring.
- 5.5.12** *Control environment.* The control environment sets the tone for an organisation, influencing the control consciousness of the staff. It relates to:
- Management's philosophy and operating style, including the specific way in which staff are supervised and controlled;
 - The organisation structure;
 - Methods of assigning authority and responsibility;
 - Human resource policies and practices;
 - Management's and staff's integrity and ethical values;
 - Management's and staff's commitment to competence;
 - Management's reaction to change and outside influences; and
 - Existence of an internal audit unit.
- 5.5.13** *Risk assessment.* Risk assessment is the identification and analysis of relevant risks to the achievement of objectives. Management needs to identify these risks in order to know the areas in which the internal control structure needs to be particularly strong. Conversely, risk assessment may indicate areas where risks are low, and therefore where the entity does not need to design elaborate internal control structures.
- 5.5.14** *Control activities.* Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address the identified risks.
- 5.5.15** Control activities occur throughout the organisation, at all levels and in all functions. They include a range of activities such as:
- Proper authorisation of transactions and activities;
 - Physical control over assets and records;
 - Independent checks on performance; and
 - Adequate segregation of duties.
- 5.5.16** *Information and communication.* Pertinent information must be identified, captured and communicated in a form that enables people to carry out their responsibilities.
- 5.5.17** To have pertinent information for accounting purposes, the entity needs to have adequate documents and records. It also needs to have prompt and proper recording of transactions and activities. This, in turn, requires a good accounting system, and a good system of communication within the organisation and with customers, suppliers, and other government entities.

Risk assessment is the identification and analysis of risks to the achievement of objectives. In order to know the areas in which the

- 5.5.18** *Monitoring.* Monitoring by management involves the ongoing and periodic assessment of internal control performance to determine if controls are operating as intended, and are modified when needed. Summary information should be monitored and spot checks made on the quality and timeliness of the information on selected transactions.

The Role of Internal Audit

Internal audit is an internal control.

- 5.5.19** Internal audit is in itself an internal control. It acts as an independent check on performance. It can be very effective in helping management fulfil its monitoring role.
- 5.5.20** To be most effective, internal audit must not become part of the operational controls. The internal audit unit should not be performing checks on an ongoing basis. It should audit and review after the fact, or as a separate, independent and additional check, to ensure that the management and staff have been carrying out their duties properly.

Categories of Controls

- 5.5.21** Controls can take different forms and serve different purposes. Different ways of categorising controls are:
- a) Input vs. output;
 - b) Independent vs. interrelated;
 - c) Manual vs. electronic;
 - d) General vs. application;
 - e) Documented vs. undocumented;
 - f) Preventive vs. detective; and
 - g) Compensating.

Input vs. Output

- 5.5.22** Input controls are controls over the initial input of data. They include password controls to prevent unauthorised personnel from inputting transactions. Output controls are controls over the output from systems. They include comparing cheques (output of payment system) to supplier invoices and other supporting documentation, and reviewing printouts of cash disbursements to ensure that all pre-numbered cheques have been recorded.

Independent vs. Interrelated

- 5.5.23** A control may work on its own or may need to be part of a series of controls. For example, a reconciliation may be a powerful control in its own right, but an input control will really only be effective if the entity also has adequate controls over data processing and output.

Manual vs. Electronic

- 5.5.24 Manual controls, given the fact that they are operated by staff, can be affected by human errors of judgment, misinterpretation, carelessness, fatigue, and distractions.
- 5.5.25 In contrast, electronic controls are built into computer programmes and, assuming that the systems are properly designed, installed and tested, are inherently more reliable. Any problems with the software, however, might be difficult to detect and often expensive to correct.

General vs. Application

- 5.5.26 General controls are applicable to the accounting system as a whole, such as passwords restricting access to a computer network. Application controls relate specifically to a particular processing function to ensure transactions are authorised, complete and accurate.

Documented vs. Undocumented

- 5.5.27 Documented controls result in evidence that the control has been performed (e.g., signatures and initials). Undocumented controls are controls where there is no evidence that the control has been performed. These would include, for example, many electronic controls where there is no evidence that the appropriate person approved the transaction. The existence of these controls can often be established through observation, inquiry and testing/replication.
- 5.5.28 Another example is when management and staff of an entity follow sound control principles based on experience. Sound controls may be in place but not documented. This presents a control exposure since the control procedures may be lost when staff turnover occurs.

Preventive vs. Detective

- 5.5.29 Preventive controls prevent errors from occurring. Most data entry controls are preventive controls. In contrast, detective controls detect errors that have occurred. Most output controls and reconciliation controls are detective controls.
- 5.5.30 Preventive controls are usually less costly to use than detective controls. It is generally less costly to prevent an error than it is to detect and correct it after the fact. It is possible, however, to find systems that are so strict in preventing errors that a lot of valid data can be rejected because of minor errors or missing data elements. This can cause serious delays and expense in processing data.

Compensating Controls

- 5.5.31 These are controls that detect errors that occur at earlier control points.

5.5.32 As a general rule, a control over output can act as a compensating control for a weak input control. For example, a control to review the list of cash disbursements to ensure that there are no missing cheque numbers can compensate for a weak control over the input of the disbursements. Similarly, if a cheque is recorded for an incorrect amount, the error will show up when the organisation performs the bank reconciliation. (This assumes that the cheque has been cleared).

Limitations of Internal Control Structures

5.5.33 Internal control can help an entity to:

- a) achieve its objectives;
- b) comply with laws and regulations;
- c) ensure reliable financial reporting; and
- d) prevent loss of resources.

An internal control structure can only provide reasonable assurance.

5.5.34 No matter how well conceived and operated, an internal control structure can only provide reasonable – not absolute – assurance to management regarding the achievement of its objectives, etc. There are limitations inherent in all internal control structures. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes.

5.5.35 Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. In addition, the design of an internal control structure must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Multiple Sub-Entities and Locations

5.5.36 In the case of government-wide audits there will be multiple ministries, departments, etc. making up the reporting entity. Each of these may have multiple locations.

5.5.37 There is no requirement for the auditor to take the same approach with respect to each ministry and so on. The auditor may decide to place no reliance on the internal control structure at some Drawing and Disbursing Offices, but place a lot of reliance on some specific controls at the District Accounts Offices. In this case:

- a) For the DDOs, the auditor would only need an overview level understanding of controls and a general understanding of the systems to collect, record and process data and report on the results.
- b) For the District Accounts Offices, the auditor would need a more detailed understanding of the control environment and systems, to justify placing reliance on them.

5.5.38 In terms of level of effort, the auditor should already have a good understanding of the internal control structure through prior compliance with authority work. Where a given sub-entity is small compared to the materiality amount, a deep level of understanding is not required.

Understanding and Examining Internal Controls

5.5.39 The auditor is expected to review the internal controls as part of the audit.

The auditor is expected to review the internal control as part of the audit.

5.5.40 First, the auditor should review and document the systems and procedures in place to carry out the transactions and other activities of the operations. Normally, a description of the major systems and procedures should be maintained on the permanent audit file. In which case, the auditor should review the description of the system and identify whether there have been any changes to the system.

5.5.41 Next, the auditor should identify points in the accounting system, and in other systems being audited, where he/she would expect to find controls.

5.5.42 Then the auditor should identify and document the controls at these points and determine that the controls have been operating.

5.5.43 Finally, the auditor should assess the adequacy of the controls and conclude whether any controls are missing or ineffective. The auditor should make recommendations to management where, in the opinion of the auditor, the controls should be strengthened. These recommendations should be based on an appreciation of the risk of reduced performance, loss, damage or waste compared to the additional costs, if any, of implementing improved controls.

Assess the adequacy of the controls and conclude whether any controls are missing or ineffective.

5.5.44 A Control Environment Worksheet is provided in the Standard Audit Working Papers Kit.

Documenting Our Understanding of Controls

5.5.45 The auditor should document the internal controls as part of the audit. A clearly documented description of the controls enhances the auditor's ability to assess the controls. Also, the documentation aids supervision of the audit and improves communications between members of the team. The documentation should form part of the working papers and should be included on the permanent file.

The auditor should document the internal controls as

5.5.46 Methods of understanding the system and application of controls include:

- a) Narrative;
- b) Flowchart;
- c) Internal Control Questionnaire (ICQ); and
- d) Walk-through.

5.5.47 **Narrative.** This is a written description of an entity's internal controls. Narrative of an accounting system and related controls includes four characteristics:

- a) Information on the origin of every document and record in the system;

- b) Description of all processing that takes place;
- c) The disposition of every document and record in the system; and
- d) An indication of the controls relevant to the assessment of control risk - these typically include separation of duties, authorisation and approvals and internal verification.

5.5.48 *Flowchart.* This is a time-consuming exercise and is generally applied only when the effort can be justified, such as when there is some uncertainty about the processes or the complexity and importance of the procedures indicate a need for clear representation.

5.5.49 The flowchart is a diagrammatic representation of the entity's documents and their sequential flow in the organisation and can be a valuable component of the working paper file. It includes the same four characteristics identified above for narratives.

5.5.50 The advantages of a flowchart are that it:

- a) provides a concise overview of the entity's system;
- b) helps identify inadequacies by showing how the system operates;
- c) shows clearly the separation of duties allowing the auditor to judge whether they are adequate; and
- d) is easier to follow a diagram than to read a description.

The ICQ contains a series of questions about the

5.5.51 *Internal Control Questionnaire.* The ICQ is a common tool of the auditor. It contains a series of questions about the controls in each audit area. There is usually a pre-developed ICQ that may, or may not be tailored for the particular area under examination by the auditor. It is designed to require a "yes" or a "no" response, with a "no" response indicating potential internal control deficiencies.

5.5.52 The advantage of using the ICQ is it allows the auditor to thoroughly cover each audit area reasonably quickly at the beginning of the audit.

5.5.53 The disadvantages are:

- a) The individual parts of the entity's systems are examined without providing an overall view;
- b) A standard questionnaire may not apply to all audit entities; and
- c) There is a danger of taking a mechanical approach rather than thinking through the control needs of the particular operations under examination.

5.5.54 *Walk-Through (Cradle to Grave Test).* The walk-through is conducted to confirm that the system and controls are operating in accordance with the auditor's understanding. It is used to verify that identified controls have been put into operation.

5.5.55 To conduct a walk through test the auditor selects a few transactions (generally between 3 and 6), pertaining to each significant transaction cycle, and traces them through the cycle beginning with initiation of the transaction, through processing until it is ultimately summarised and included in a general ledger or management report.

5.5.56 The auditor should document the transactions selected for walk-through, the controls that were observed and describe any enquiries made of entity personnel.

5.6 Step 5 - Determine Components

Definition

5.6.1 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.

5.6.2 A component is a discrete item in the financial statements.

5.6.3 How to determine the components to be used

5.6.4 For a financial statement audit, 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.

5.6.5 “Line items” are each of the amounts reported in the financial statements, including amounts disclosed in the notes thereto.

5.6.6 Sometimes the financial statements include several different groupings of the same total amount. For example, expenditures may be grouped by:

- a) the ministries, departments, agencies, etc. making up the reporting entity;
- b) appropriation account;
- c) economic function (general public services, defence affairs and services, etc.); or
- d) object element (payroll expenditures, operating expenditures, civil works, etc.).

5.6.7 The auditor selects the grouping that makes it the easiest to plan, perform and evaluate the audit work. The auditor would then need to perform additional procedures to ensure that the amounts reported in the other groupings are also presented fairly.

5.6.8 To illustrate, assume that the financial statements group expenditures by both *ministry* and by *object element*. In this case, the auditor could either plan the audit of expenditures using each ministry as a component, or using each object element as a component. If the auditor chooses “object element”, the auditor would then plan the audit to obtain reasonable assurance that payroll expenditures are not materially misstated, that operating expenditures are not materially misstated, etc. The auditor would then develop additional audit procedures to ensure that the total expenditures reported for each ministry are also not materially misstated.

5.6.9 For financial certification audits, it is unlikely that the financial statements will contain details with respect to expenditures, etc. by district accounts officer or by drawing and disbursing officer. However, DAGP may wish to extend the audit to include these organisational units as components to be reviewed, based on DAGP’s assessment of their risk or significance.

- 5.6.10** For compliance audits, it might be decided that individual DAOs or DDOs should be subject to review. This is at DAGP's discretion and will be reflected in the individual audit plans.

Individually Significant Transactions and Events

- 5.6.11** Individual significant transactions and events include:
- a) Very large transactions and events; and
 - b) High risk transactions and events.
- 5.6.12** The auditor should audit 100% of these transactions and events.
- 5.6.13** Very large transactions and events are usually audited 100% because they are large enough that, should they be in error, the error could be significant. The auditor therefore does not want to risk failing to find an error in these transactions and events.
- 5.6.14** High risk transactions and events are transactions and events that, because of their nature, contain a high risk of being in error. They are often audited 100% because, while the error in each one of these transactions and events may not be significant, the high likely error rate in these transactions and events could result in a significant error in total.
- 5.6.15** Very large transactions are normally easy to find – the auditor should look for transactions and events exceeding a pre-determined amount.
- 5.6.16** High risk transactions can be more difficult to detect. The auditor should use his/her knowledge of the entity's business to identify these transactions and events.
- 5.6.17** These transactions and events are normally not treated as separate components. Rather, they are audited as part of the work performed on other components. However, there may be some cases where it is advantageous to consider them to be a separate component. This could occur when the inherent risk or control risk associated with these transactions are significantly different from the risks associated with the other transactions contained in the component.

Using Sub-Components

- 5.6.18** There may be cases where the inherent risk and control risk for part of a component are significantly different than for the rest of a component. In these cases, the auditor may decide to split the component into sub-components – the one(s) with the higher risks and the rest of the component. Higher-risk sub-components will receive a higher level of audit examination than lower risk ones.
- 5.6.19** Should the inherent risks or control risks for a particular DAO be significantly higher than for other DAOs, and if the amounts involved are substantial, the auditor should consider breaking out the single high risk office and planning its audit separately.

Related Components and Transaction Cycles

- 5.6.20 Some components are related to other components. For example, an understatement of expenditures may also result in an understatement of liabilities and/or an overstatement of cash. Therefore, the audit of each of these components will provide the auditor with some assurance as to the fairness of the related components. To avoid doing more work than necessary, the auditor should take the assurance achieved from auditing the related components into account.
- 5.6.21 One way to do this is to consider transaction cycles – the flow of the transactions. For example, the purchase of a medical supply will result in a stock item that will either be in expenses for the year or in the year-end stock balance. The purchase will also result in a cash disbursement or a payable at year end.
- 5.6.22 The internal control questionnaire and audit programmes contained in the Standard Audit Working Papers Kit and Audit Guides contain the “standard” components for the entities being covered, and use a transaction cycle approach for the tests of internal control. It must be stressed that the auditor needs to assess inherent risk and control risk for each component and specific financial audit or compliance with authority objective, as opposed to each transaction cycle and specific financial/compliance audit objective.

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

Specific Financial Audit Objectives

- 5.7.1 Having divided the audit into components, the next step is to define what we mean by “properly presents” in the audit certificate. To do so, the auditor needs to consider what he/she would consider to be an error.
- 5.7.2 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 asset, liability, revenue or expenditure is not complete;
 - the transactions have not been carried out in proper compliance with relevant laws, regulations and administrative rules;
 - the asset or liability is not properly valued or is misclassified, or the revenue or expenditure is not properly measured or is misclassified; or
 - the financial statement presentation is not proper.
- 5.7.3 The Standard Audit Working Papers Kit and Audit Guides make use of these specific financial audit objectives.
- 5.7.4 To illustrate, payroll expenditures may be materially misstated if:
- the costs are not valid. This could be due to, among other things, ghost workers on the payroll.
 - the costs are not complete. For example, employees have not been paid, or the payments have not been recorded.

- c) the costs are not properly measured. This could be due to paying employees more or less than they should be paid, or the amounts being recorded being more or less than the actual payments.
- d) the financial statement presentation is not proper. This could be due to the failure to disclose all of the information called for in the New Accounting Model.

Related Compliance with Authority Objectives

- 5.7.5** Reviewing compliance with laws and regulations is very important. Decision makers need to know if the laws and regulations are being followed, whether they are having the desired results and, if not, what revisions are necessary.
- 5.7.6** Section 3.4 of DAGP’s auditing standards states, “In conducting [financial] audits, a test should be made of compliance with applicable laws and regulations.”
- 5.7.7** To comply with this standard, the auditor need not test for compliance with all laws, regulations, rules, policies, etc. As noted in paragraph 3.4.3 of DAGP’s auditing standards, *“Because the laws and regulations that may apply to a specific audit are often numerous, the auditors need to exercise professional judgement in determining those laws and regulations that might have a significant impact on the audit objectives.”*
- 5.7.8** For financial audits, Section 3.4 of DAGP’s auditing standards requires the auditor to “design audit steps and procedures to detect errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of regularity audits. The auditor also should be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of regularity audits.”
- 5.7.9** In deciding which laws and regulations should be examined as part of a financial audit, the auditor should deal with those laws and regulations that might have a significant impact on the financial audit objectives.
- 5.7.10** In addition to compliance audit work performed as part of a financial audit, DAGP also conducts extensive compliance tests to identify deviations and validate controls at organisational units across the Government of Pakistan.
- 5.7.11** Departments, ministries, etc. are not permitted to spend, borrow or raise revenue without the approval of Parliament. Therefore, audits of compliance with authority should focus on compliance with authority to spend, borrow and raise revenue, as follows:

Spend

- 5.7.12** Determine that:
- a) the services were actually performed or the goods were actually received;

- b) the expenditure is consistent with the nature of the appropriation to which it was charged;
- c) the expenditure does not result in the total approved expenditure being exceeded; and
- d) the expenditure is in accordance with the applicable legislation and the rules and regulations issued by such legislation have been complied with.

Borrow

5.7.13 Determine that the amount and debt terms (period, interest rates, repayment schedule, etc.) are in accordance with the appropriate law.

Raise revenue

5.7.14 Determine that the cash received is:

- a) for an approved tax or other approved revenue source; and
- b) is received in accordance with the applicable legislation and the rules and regulations issued by such legislation have been complied with.

5.7.15 The compliance with the authorities tests noted above apply to organisational, functional or accounting units for different types of government body as follows:

5.7.16 *Federal and provincial governments.* All the authorities described in the preceding section would usually be considered part of the audit of federal and provincial governments.

5.7.17 *District governments.* District governments are not permitted to borrow. Therefore only authorities to spend and to raise revenues would normally be considered part of the audit of a district.

5.7.18 *State-owned enterprises.* These enterprises are usually created by separate acts. These acts and the supporting regulations usually specify the operations that the enterprise is permitted to carry out. Compliance with the spending, borrowing and revenue-raising authorities in these acts and regulations is therefore usually the principal focus of the compliance with authority work for these audits.

Potential Error Conditions

5.7.19 The last part to this step is to consider error conditions. The idea here is to consider ways in which an asset, liability, revenue or expenditure item might not be valid, might not be complete, etc. Put another way, the auditor's objective is to identify ways in which a monetary error can occur in the financial statements, or an applicable authority may not be complied with.

Error conditions are ways in which an asset, liability revenue or expenditure item may not

- 5.7.20** There are probably numerous reasons why a component might not be valid, might not be complete, etc. 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 auditor's objective 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 this reason, error conditions are sometimes referred to as "potentially big errors".
- 5.7.21** Note that conditions that constitute an error will be affected by the accounting policies being used. For example, if the accounting policies do not call for the recording of accounts payable, then the failure to record a payable would not constitute an error. However, there should be a system to track unsettled payables in the form of commitments against appropriations.
- 5.7.22** The process of determining which error conditions or compliance deviations should be audited will help to ensure that the audit plan is complete. The process will also help to ensure that the audit plan does not include unnecessary work. The process therefore helps to ensure that auditors spend their time dealing with matters of real importance, and do not waste their time on insignificant matters.
- 5.7.23** For example, consider the component "payroll expenditures".
- 5.7.24** For the *completeness of payroll expenditures*, the auditor considers how payroll expenditure figures might not be complete and may identify the following three error conditions:
- a) Services performed have not been paid for;
 - b) Payments made have not been recorded in the payroll register; and
 - c) The amounts in the payroll register have not been included in the financial statement amounts.
- 5.7.25** In addition, the auditor needs to consider whether there are any related compliance with authority objectives. In this case, because compliance objectives relate to controlling what has been spent, as opposed to ensuring that the spending is complete, there are no related compliance objectives.
- 5.7.26** Consider the *validity* and *measurement* objectives for payroll expenditure. The auditor may identify four additional error conditions, as follows:
- a) Services paid for were not performed (because, for example, there are ghost workers on the payroll);
 - b) Employees have been paid more or less than they should be paid;
 - c) Payroll expenditures are recorded in the Payroll Register at the wrong amount;
 - d) The payroll expenditures have been charged to an incorrect account or appropriation; and
 - e) The amounts in the payroll register have not been included in the financial statements at the correct amount.

- 5.7.27 In this case, the auditor may also identify the following *compliance with authority matters*:
- a) The work being performed was not properly approved;
 - b) Pay rates/employee levels were not properly approved in accordance with regulations; and
 - c) The payments were not properly approved.
 - d) The same approach can be applied to receipts. For example, for the completeness of income tax receipts, the auditor may identify three error conditions, as follows:
 - e) Income tax receipts are not deposited in the bank;
 - f) Income tax receipts are not recorded in the cash receipts register; and
 - g) The amounts in the cash receipts register are not included in the financial statement amounts.
- 5.7.28 In addition, the auditor needs to consider whether there are any related *compliance with authority* objectives. In this case, there probably is one – that the receipts were deposited within the time period required by government policy.
- 5.7.29 For the *validity* and *measurement* objectives for *income tax receipts*, the auditor may identify three other error conditions, as follows:
- a) The amount of the receipt does not match the amount required to be remitted as per the income tax return;
 - b) The income tax receipts are being charged to an incorrect account; and
 - c) The amounts in the cash receipts register are not included in the financial statements at the correct amount.
- 5.7.30 In addition, the auditor may also identify one *compliance with authority* matter – the government did not remit any overpayments by the taxpayer back to the taxpayer on a timely basis.

How Error Conditions and Compliance Irregularities are Used to Develop Audit Programmes

- 5.7.31 The error conditions/compliance deviations provide the auditor with guidance as to which audit procedures should be included in the audit programme. Using the errors/irregularities identified above, for regularity and measurement of payroll expenditures for example, the auditor can develop audit procedures to determine if:
- a) Services paid for were actually performed;
 - b) Employees were paid correct amounts;
 - c) Payments are being recorded in the payroll register at the correct amount
 - d) Payments are recorded in the correct account and appropriation at the correct amount;
 - e) Amounts in the payroll register are included in the financial statements at the correct amount;
 - f) The work performed was properly approved; and
 - g) Payments made were properly approved.
- 5.7.32 Similarly for the regularity and measurement of income tax receipts the auditor could develop procedures to determine if:
- a) The amount received matches the amount due;

- b) Receipts are posted to the correct account;
- c) Amounts in cash receipts register are included in the financial statements at the correct amount; and
- d) Government is remitting overpayments back to taxpayers on a timely basis.

5.8 Step 7 - Assess inherent risk and control risk

5.8.1 Inherent risk and control risk may differ by component and audit/compliance objective. As a result, the auditor may have a large number of different inherent and control risk valuations to deal with.

5.8.2 It is tempting to combine different risks by using a weighted approach. However, this approach is not generally recommended as it fails to meet the standards for generally accepted auditing standards.

Inherent Risk

5.8.3 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 one error or the sum of multiple smaller errors.

Inherent risk is the chance of material error occurring assuming there are not internal controls.

5.8.4 Inherent risk is evaluated at this stage to determine how much testing of internal controls and substantive testing (analytical procedures and substantive tests of details) the auditor needs to perform to achieve the desired level of assurance. In general, the greater the inherent risk, the greater the audit effort required.

5.8.5 Inherent risk is assessed assuming that there are no internal controls in place. As such, it needs to be assessed in a hypothetical environment.

5.8.6 Factors affecting inherent risk include:

5.8.7 *The nature of the component.* Components such as cash are more susceptible to manipulation or loss than, say, fixed assets.

5.8.8 *The extent to which the items making up the component are similar in size and composition.* If the population is composed of relatively homogeneous items, it would be easier for management (and the auditor) to detect anomalous transactions and amounts.

5.8.9 *The volume of activity.* If there are a lot of transactions being processed, the chances of an error occurring may be higher than if only a few transactions are being processed.

5.8.10 *Competence of the staff processing the transactions.* If staff are experienced and take their jobs seriously, there is probably a lower inherent risk than if they are inexperienced or careless.

- 5.8.11** *The number of locations.* Entities operating out of a single location with a centralised accounting system may have a lower inherent risk than those operating out of many locations, each with its own accounting system.
- 5.8.12** *The accounting policies being used.* Many components have a lower risk of error when the cash basis of accounting is being used than when the accrual basis of accounting is being used.
- 5.8.13** *Factors that could affect the risk of fraud.* An error could be an intentional one. The auditor should use a questioning mind and be alert for evidence that contradicts or brings into question the reliability of documents or management’s representations.
- 5.8.14** It can be seen from the above that evaluation of inherent risk is based primarily on the auditor’s knowledge of the entity and its environment. This knowledge would have been acquired primarily in Step 2 of the process – updating the understanding of the entity’s business.
- 5.8.15** The assessment of inherent risk will be subjective, and will require the use of professional judgment. It would therefore be appropriate to have the most experienced and knowledgeable individuals on the audit team make the assessment of inherent risk. These should be the individuals with the greatest knowledge of the entity being audited.
- 5.8.16** Inherent risk may differ by component and by specific financial audit objective. For example, the risk of cash being improperly valued is low, but the risk of cash not being complete may be quite high.
- 5.8.17** Inherent risk needs to be assessed throughout the audit. For example, if inherent risk is assessed as “low” at the general planning phase but numerous errors are found during the fieldwork phase, then the assessment of inherent risk may need to be revised.
- 5.8.18** While guidelines should not replace the use of professional judgment, the following may be useful when assessing inherent risk:

Level of Inherent Risk	Risk	Resulting Assurance
High inherent risk	60%	40%
Moderate inherent risk	50%	50%
Low inherent risk	40%	60%

- 5.8.19** Risk assessment is a matter for DAGP and will reflect ground realities within the entity being audited. It is recommended that a conservative approach be considered until DAGP gains experience with this methodology, to recognise the danger of using an incorrectly low risk factor. Assume the auditor sets inherent risk at a low 20%. At this level, the auditor could eliminate all or most substantive sampling, and little work would be required on the component. Given this low level of planned effort, if there are significant monetary errors or compliance irregularities they are likely not to be detected, and in the worst case, the auditor might issue an unqualified report when there were actually material errors present.

- 5.8.20** Accordingly, an inherent risk factor of not less than 40% is recommended unless there is convincing evidence such as prior compliance with authority audit work that detected a high level of compliance or few monetary errors.
- 5.8.21** The Standard Audit Working Papers Kit includes an Inherent Risk Assessment Form that can be used to assess inherent risk.

Control Risk

- 5.8.22** Control risk is the chance that the entity's internal controls will not prevent or detect material error and is directly related to the effectiveness of the internal control structure.
- 5.8.23** Control risk is evaluated at this stage as it limits the amount of assurance that the auditor can obtain from tests of internal control.
- 5.8.24** Much of the work required to assess control risk would have been performed as part of updating the understanding of the entity's internal control structure.
- 5.8.25** Control risk is also affected by the factors that could affect the risk of fraud – particularly management fraud. This is because management can often override the internal controls that have been put in place. As discussed above, the auditor needs to use a questioning mind and keep alert for evidence that contradicts or brings into question the reliability of documents or management's representations.
- 5.8.26** Control risk may differ by component and by specific audit objective and related compliance with authority objective. For example, entity management may have devised very good controls over the payment process to ensure the validity and measurement of expenditures, but may have paid less attention to the completeness of those expenditures.
- 5.8.27** In general, the control environment and the controls that collect, record, process and report often have a pervasive effect on many components and specific financial audit objectives and related compliance with authority objectives. The controls that enhance reliability are the ones that are most likely to differ by component and by specific audit objective.
- 5.8.28** Analytical procedures can be used as means of assessing the combination of inherent risk and control risk.
- 5.8.29** Control risk needs to be assessed throughout the audit. For example, if control risk is assessed as "low" at the general planning phase but numerous internal control deviations (improperly approved supplier invoices, for example) are found during the fieldwork phase, then the assessment of control risk may need to be revised.
- 5.8.30** While guidelines should not replace the use of professional judgment, the following may be useful when assessing control risk:

Control risk is the chance that the internal controls will or prevent or detect material error.

Level of Control Risk	Risk	Resulting Assurance
High (poor internal controls)	80%	Up to 20%
Moderate (moderate internal controls)	50%	Up to 50%
Low (strong internal controls)	20%	Up to 80%

5.8.31 The reason for presenting “Resulting Assurance” as an amount “up to” a percentage limit is that, unlike inherent assurance, control assurance must be earned. The auditor should not rely on the internal controls unless tests demonstrate that the controls are working.

5.8.32 To illustrate, the auditor may have concluded that the internal controls over the validity and measurement of payroll expenditures were moderate. The auditor may therefore have assessed control risk as “moderate” (50%). This means that, for this component and these specific financial audit objectives, the auditor can place moderate reliance (50%) on the internal control structure.

5.8.33 To place moderate reliance on the internal controls the auditor must do a fair amount of testing of internal controls. The auditor may decide that it is more efficient to place only limited reliance on the internal control structure and instead do detailed analytical procedures and use a large sample for substantive tests. In this case, even though the auditor may have been able to obtain a control assurance of 50%, the auditor may decide to do only enough tests of internal control to support a 20% level of assurance. The auditor would then set control risk at 80%.

5.8.34 It has been noted that control risk is assessed at this stage as it limits the amount of assurance the auditor can obtain from his/her tests of internal control. Assume that, in the above illustration, the auditor wants to place a lot of reliance on the internal control structure. Because control risk was assessed at 50%, it is not possible for the auditor to obtain more than a moderate level of assurance from the internal controls.

5.8.35 Put more simply, it is not possible to place a lot of reliance on a poor internal control structure.

5.8.36 To provide some practical guidance, consider the following questions:

Question 1:

5.8.37 Should the control environment in all DDOs be documented, or should only the controlling offices be taken into account?

Answer:

5.8.38 This answer refers back to a basic auditing concept – the auditor should document and test any controls on which reliance is to be placed. Therefore, any controls, in any DDOs, on which the auditor intends to rely should be documented.

Question 2:

5.8.39 If the controls in one department are not reliable, should it affect the auditors view of the overall control environment?

Answer:

5.8.40 If the controls in one department are not reliable, but in other departments they are, the auditor can assess control risk as “high” where they are not reliable, and “low” in the other departments. The auditor should not attempt to come up with an aggregate risk assessment.

Question 3:

5.8.41 What would be the relative weightings of authorisation and accounting controls? That is to say, how would the auditor’s assessment be affected if the authorisation controls are working and the accounting controls fail more often than not?

Answer:

5.8.42 As for the response to Question 2, the auditor should not attempt to derive an aggregate risk assessment. In this case, the auditor may decide to rely on the authorisation controls, but cannot rely on the accounting controls.

5.8.43 Since the auditor would need to take a substantive approach with respect to transactions flowing through the system because of the poor accounting controls, relying on the authorisation controls would not likely reduce the amount of the required substantive testing. Therefore, the most cost effective approach would likely be to assess control risk for the particular transaction cycle as high and audit accordingly.

Question 4:

5.8.44 What aggregation and consolidation mechanism should be used to develop an overall assessment of the control environment prevailing in the Federal Government?

Answer:

5.8.45 Because the Federal Government is made up of many sub-entities, each of which has its own risk profile, it is not appropriate to try to derive an aggregate risk assessment. Separate control risk assessments are made for each financial audit and compliance with authority audit objective for each component, within each sub-entity.

Question 5:

5.8.46 Suppose in all but two of the sub-offices of a ministry, controls can be relied on, but they cannot be relied upon for the remaining two sub-offices. Suppose also that the control environment in the DDOs is poor. How should the auditor proceed?

Answer:

5.8.47 The auditor could assess control risk as “low” in all but the two sub-offices and plan to rely on the related controls, while not relying on controls in the “high” risk sub-offices. Since the control environment in the DDOs is poor, the auditor may be forced to a substantive approach with respect to the transactions flowing through the system. Relying on the controls in the sub-offices may therefore not reduce the amount of required substantive testing. If that is the case, the most cost effective approach would probably be to assess control risk for the particular transaction cycle as high.

Question 6:

5.8.48 If the auditor does not aggregate the risk assessments of individual sub-entities, components and objectives, won't the auditor end up with hundreds of different assessments of control risk? And won't it take an auditor considerable time to come up with all those different assessments?

Answer:

5.8.49 Theoretically, it is possible that the auditor will end up with hundreds of different assessments of control risk. However, in practice this is not generally the case and the auditor often winds up taking approximately the same approach for many different components, specific financial audit objectives and related compliance with authority objectives. There are several reasons for this:

5.8.50 The control environment is generally a strong determinant of the effectiveness of internal controls, and often applies quite widely across components in each sub-entity. As a result, if it is possible to place a lot of reliance on the internal controls for one component, it is normally possible to place a lot of reliance on internal controls for many of the other components in the same sub-entity.

5.8.51 Also, as noted previously, components may be inter-related. For example, an understatement of cost of sales may also result in an overstatement of the year-end stock balance and/or an understatement of the year-end accounts payable balance and/or an overstatement of cash. One particular audit procedure, such as testing the validity and measurement of cost of sales, may also provide assurance as to the validity and valuation of the year-end stock and accounts payable balances. It therefore often makes sense to use approximately the same sources of assurance for these related components.

5.8.52 Regarding the amount of time required to perform multiple assessments, it is true that the level of effort will be greatest when first assessing each control risk. Once the various controls have been assessed, the auditor would only need to consider the impact of changes in the nature of the entity, the results of the previous year's audit, and so on, as opposed to repeating the entire exercise from scratch.

5.8.53 Recognising the challenge of establishing initial risk assessments across large audit entities, it is suggested that DAGP consider a phased approach to risk assessments, and accepts that audits for the initial years will not cover all aspects of risk assessment because of resource and time constraints. This is not intended to provide a justification for weak execution of audit procedures, but recognises that it may take a number of audit cycles for rigorous audit procedures to be applied across all aspects of each audit. It is suggested that DAGP strategic audit plans for the first few years of implementing these new audit procedures should accommodate this phased approach.

5.8.54 The Standard Audit Working Papers Kit contains a Control Risk Assessment Form that can be used to assess control risk.

5.9 Step 8 - Determine mix of tests of internal controls, analytical procedures and substantive tests of details

Introduction

5.9.1 Financial audit procedures are usually broken down between tests of internal control and substantive tests supplemented with compliance with authority tests. DAGP also conducts audit activities which focus exclusively on compliance with authority testing.

5.9.2 Tests of internal control are used to gain assurance that specific controls within the entity's internal control structure are operating effectively, and are therefore helping to reduce the chance of material error existing in the accounting information.

5.9.3 Substantive tests are procedures used to gain direct assurance as to the completeness and accuracy of the data produced by the accounting systems. They are often broken down between analytical procedures and substantive tests of details.

5.9.4 Audit procedures that provide both assurance with respect to internal controls and substantive assurance are often referred to as "dual purpose" tests.

5.9.5 Compliance with authority procedures are used to determine whether entity staff have fulfilled the administrative requirements of all applicable rules, regulations and legislation.

Financial audit procedures usually include tests of internal control and substantive tests

Tests of Internal Control

5.9.6 Tests of internal control include:

- a) Inquiries of appropriate entity personnel;
- b) Observation of policies and procedures in use;
- c) Walk-through procedures; and
- d) Selecting a sample of transactions and verifying that the appropriate control procedures were followed.

- 5.9.7** The first three procedures are the same as were used to update the understanding of the internal control structure. The work done at that stage will have already provided some assurance with respect to the internal control structure.
- 5.9.8** With respect to sampling, if the auditor wishes to place high reliance on a specific internal control, it is normally necessary to test the control throughout the entire year. If, on the other hand, the auditor only wishes to place moderate reliance on the control, it may be sufficient to select a sample of transactions to an interim date (say, the first 8 months of the year), and then to use inquiries, observations and walk-through procedures to ensure that there have been no changes made to the internal control structure between the interim date and the year-end date.
- 5.9.9** If the auditor only wishes to obtain limited reliance on a particular internal control, then sampling is often not required at all –inquiries, observations and walk-through procedures may provide all of the required assurance.
- 5.9.10** GAAS do not permit the auditor to obtain all of his/her assurance through tests of internal control – some substantive testing must always be performed. This is because the ability of the internal control structure to prevent or detect material error is subject to practical limitations, such as:
- a) Members of management may be in a position to override specific internal controls.
 - b) Collusion can circumvent internal controls that depend on good segregation of duties to be effective.
 - c) Inexperienced entity officials may not perform their control procedures properly. There is always a possibility of human error.
 - d) Internal controls are often designed to address transactions arising from the normal course of the entity’s activities. They may not cover transactions of an unusual nature, or arising from new activities.
 - e) Management may not be prepared to devote the resources that would be required to prevent or detect all errors. Rather, management normally requires that the internal controls be cost-effective. This means that the benefits of having the controls must exceed their costs.

Analytical Procedures

- 5.9.11** Analytical procedures are techniques used by the auditor to:
- a) Form expectations as to what the recorded amounts should be by studying the relationships among elements of financial and non-financial information;
 - b) Compare those expectations with the recorded amounts; and,
 - c) Draw conclusions about entity operations, inherent risk and control risk, and the completeness and accuracy of the recorded amount.
- 5.9.12** Analytical procedures are an efficient and effective way to obtain audit assurance. As a result, they should be performed on every audit.
- 5.9.13** Analytical procedures may be used in all phases of the audit to achieve various objectives, for example:

- 5.9.14** Planning phase:
- a) to obtain knowledge of the entity's business operations;
 - b) to identify unusual items and explore areas of potential high inherent risk; and
 - c) to obtain some degree of audit assurance.

5.9.15 Fieldwork phase: to obtain some degree of audit assurance.

- 5.9.16** Evaluation phase:
- a) to assess the internal consistency and overall reasonableness of the financial statements using the auditor's knowledge of the entity; and
 - b) to obtain some degree of audit assurance.

5.9.17 The auditor can derive various levels of assurance from analytical procedures depending on how rigorously the analytical procedures are designed and performed.

5.9.18 There are several different types of analytical procedures, as follows:

General reviews for reasonableness.

- 5.9.19** These analytical procedures involve a high level comparison of current information with previous periods, budgets or statistics from the entity. No pre-determined threshold amount is specified for identifying significant fluctuations. The process is sometimes referred to as "eyeballing" the financial statements – looking for accounts that appear to be unusual in amount, in volume of activity, etc. The objective of this type of analysis is generally to decide where to focus audit attention.

"Eyeballing" the financial statements.

Comparative analysis.

- 5.9.20** This involves comparing the current year's reported amounts (or ratios) with those of the prior years. Comparative analysis assumes that the prior year's amount is a sufficiently accurate estimate of the current year's amount and, therefore, can be used to identify any significant fluctuations from the current year's recorded amount. A pre-determined threshold amount is specified for identifying significant fluctuations.

Comparing current year's amounts with prior years.

Predictive analysis.

- 5.9.21** Predictive analysis compares the current year's reported amounts (or ratios) with a prediction of what the current year's amount (or ratio) should be, based upon the trend of the prior years' amounts (or ratios). The prior years' data used in making the prediction is adjusted for all known changes in the factors affecting the data. This usually results in a more precise estimate than comparative analysis. A pre-determined threshold amount is specified for identifying significant fluctuations.

Comparing current year's amounts with a prediction

Statistical analysis.

Uses more rigorous methods to provide more accurate

5.9.22 This category of analytical procedures involves analysing the known behaviour of variables and developing an equation (model) that explains the relationship between these variables. Although this category is similar to "predictive analysis", the distinguishing characteristics of statistical analysis is that it uses more rigorous methods, such as regression analysis, to provide more accurate predictions and objectively measures the confidence level and the achieved level of precision.

Overall verification procedures.

Building up an estimate of an account balance from known data.

5.9.23 This category of analytical procedures involves building up an estimate of an account balance from known and verified data. For example, the auditor could verify the number of rental units by type of unit, the average rent by type of unit, and the vacancy rate. The auditor could then compare the product to the revenue received from the rents. Overall verification procedures usually result in an accurate estimate of the account. A pre-determined threshold amount is specified for identifying significant fluctuations for the auditor to investigate.

5.9.24 Care is required with this type of analysis. The auditor must not assume that the data are more accurate than the financial information. For example, the actual vacancy rate may be lower than the recorded vacancy rate, with the difference being due to fraud. Thus the analytical data might substantiate the financial data, while income being received is less than income due. The auditor should therefore test whether sources of information are independent or might be subject to the same potential errors.

5.9.25 Appendix B discusses each of these types of analytical procedures in detail. The discussion includes a description of how the auditor normally determines the pre-determined threshold amount.

5.9.26 The following table provides guidance as to the amount of assurance that each category of analytical procedure can provide. While guidelines should not replace the use of professional judgment, the following is typical:

Type of Analytical Procedure	Risk	Assurance
Overall reviews for reasonableness	100%	0%
Comparative analysis	70% or more	Up to 30%
Predictive analysis	50% or more	Up to 50%
Statistical analysis	30% or more	Up to 70%
Overall verification procedures	10% or more	Up to 90%

- 5.9.27 The Standard Audit Working Papers Kit contains an Analytical Procedures Assessment Form that can be used to assess the amount of assurance that the auditor can derive from the different categories of analytical procedures.
- 5.9.28 Appendix B also discusses the fact that computer-assisted auditing techniques (CAATs) are a very useful tool for performing analytical procedures. With the use of a CAAT, the auditor can perform numerous analyses instantaneously. If performed manually, the equivalent work could consume extensive audit effort.
- 5.9.29 CAATs are discussed in more detail in Appendix C.

Substantive Tests of Details

- 5.9.30 Substantive tests of details include such procedures as physically inspecting an asset, checking transactions recorded in the books and records to supporting documentation, and confirming amounts with third parties.
- 5.9.31 The auditor usually tests a sample of transactions as opposed to verifying 100% of them.
- 5.9.32 Appendix B contains a detailed description of sampling.
- 5.9.33 Substantive tests of details can involve more than sampling. There are often specific transactions and events that the auditor wants to examine. These could be:
 - a) Very large transactions and events; or
 - b) High risk transactions and events.
- 5.9.34 These transactions and events are often referred to as “individually significant transactions and events”. They are often audited 100% because they are large enough that, should they be in error, the error could be significant. The auditor therefore does not want to risk failing to find an error in these transactions or events.
- 5.9.35 Auditors often audit 100% of the individually significant transactions and events, and audit a sample of the remaining transactions.

Substantive Tests of details include such procedures as physically inspecting an asset, checking transactions to supporting documentation

Compliance with Authority Tests

- 5.9.36 The first step for the auditor is to work with entity management to identify the rules and regulations that apply to the entity. Of these, the auditor will determine which authorities are most significant and will design tests to check compliance. The auditor will also determine what sampling approach is appropriate. Sampling is discussed at length in Appendix B.
- 5.9.37 The auditor will then plan to extract the samples as determined, and apply the compliance tests.

Identify the rules and regulations that apply to

The Audit Risk Model

The audit risk model is a way to tie together all the sources of

5.9.38 The audit risk model is a useful way to tie together all of the various sources of audit assurance.

5.9.39 The basic theory behind the audit risk model is that, for errors adding up to more than materiality to remain in the accounts at the end of the audit (audit risk - AR), all of the following must have happened:

- a) The errors must have occurred in first place (inherent risk - IR);
- b) The internal controls must have failed to prevent or detect the errors (control risk - CR); and
- c) The auditor's substantive procedures (analytical procedures and substantive tests of details) must have failed to detect the errors (detection risk - DR).

5.9.40 Basic probability theory states that, if two events are mutually exclusive (the occurrence of one is not affected by the occurrence or non-occurrence of the other), then the probability of both events occurring is the probability of the first event occurring times the probability of the second event occurring.

5.9.41 All of the events in paragraph, as defined, are mutually exclusive, and all must occur before errors adding up to more than materiality remain in the accounts at the end of the audit. We therefore have the following formula:

$$\begin{aligned} \text{AR} &= \text{IR} \times \text{CR} \times \text{DR}; \text{ where:} \\ \text{AR} &= \text{Audit risk;} \\ \text{IR} &= \text{Inherent risk;} \\ \text{CR} &= \text{Control risk (achieved); and} \\ \text{DR} &= \text{Detection risk.} \end{aligned}$$

5.9.42 The reason for qualifying the control risk as being "achieved" is because the auditor needs to validate his/her control assurance. What goes in the risk model is the converse of the achieved assurance.

5.9.43 The audit risk model is often expanded upon to split detection risk (DR) into two parts. This is done for two reasons:

1. Analytical procedures are often effective and efficient at obtaining audit assurance. As a result, they should normally be performed on every audit. The assurance to be achieved from these procedures needs to be reflected in the risk model;
2. The auditor often performs more than one substantive test of detail to obtain the required assurance with respect to each specific financial audit objective and related compliance with authority objective. To link the risk model to the confidence level to be used for one key substantive test of details, these other substantive tests of details need to be considered separately.

5.9.44 It is done as follows:

$$\begin{aligned} \text{AR} &= \text{IR} \times \text{CR} \times \text{DR} \\ &= \text{IR} \times \text{CR} \times \text{OSPR} \times \text{STDR}; \text{ where:} \end{aligned}$$

$$\text{AR} = \text{Audit risk};$$

IR = Inherent risk;
 CR = Control risk (achieved);
 OSPR=Other substantive procedures risk, being the risk that the auditor's analytical procedures, and all substantive tests of details expect one key substantive test of details, will fail to detect material error; and
 STDR =Substantive test of details risk, being the risk that one key substantive test of details will fail to detect material error.

5.9.45 The reason for splitting out one key substantive test of details in this manner is that the formula can be rearranged as follows:

$$\text{STDR} = \frac{\text{AR}}{\text{IR} \times \text{CR} \times \text{OSPR}}$$

5.9.46 The resulting STDR is the converse of the confidence level that the auditor will use for his/her substantive sample. For example, if STDR is determined to be 15%, the auditor will use an 85% confidence level for his/her sampling procedures.

Considering the Assurance Achievable from Each Audit Step

5.9.47 Auditors are not required to develop the detailed audit programmes during the Planning Phase. However, the auditor should give some consideration to the types of procedures, and the assurance that can be derived from each procedure, in order to make a reasonable determination of the optimum combination of sources of audit assurance.

5.9.48 The amount of assurance that can be derived from each procedure depends on the nature of the test and the evidence that will be collected. The auditor should have a sound understanding of:

- a) The nature of evidence;
- b) What constitutes appropriate quality and quantity of evidence; and
- c) The most appropriate methods of collecting evidence.

Considering Staffing, Budgeting and Timing of the Audit

5.9.49 The staffing, budgeting and timing of the audit are all matters to be dealt with in detail at the detailed planning stage. They are discussed in detail in Chapter 8.

5.9.50 However, the auditor should give these matters some consideration during the general planning phase. There is no point coming up with an optimum combination of tests of internal control, analytical procedures and substantive tests of details unless adequate time or resources are available.

5.9.51 *Staffing.* Unless an audit is appropriately staffed, the benefits of good audit planning can be lost. Persons involved in the general planning phase need to make sure that there are staff members available who have the audit skills required to perform the work efficiently and effectively.

- 5.9.52 For example, the auditor may determine that the most efficient audit approach would be to place high reliance on internal controls and to use regression analysis. However, unless the audit can be staffed with people capable of doing a detailed evaluation of an internal control structure and using a regression analysis software package, this approach is not practicable.
- 5.9.53 *Budgeting the work.* DAGP has finite resources, so it is important to estimate the time required to perform the audit under each combination of tests.
- 5.9.54 Each financial audit will require a minimum amount of resources. DAGP needs to ensure that the required resources are allocated. Since the resources required for compliance with authority work can be more flexible than those required for financial certification, The Director may have some scope for reallocating resources in response to certification audit demands.
- 5.9.55 *Timing of the work.* Most government entities have the same year-end date (30 June). To keep audit staff busy throughout the year, and complete the audit of the financial statements on a timely basis after the year-end date, it is often appropriate to perform some of the work in advance of the year-end date. This should be taken into account when scheduling audit activities.
- 5.9.56 *Supporting software.* Audit management software can be used to assist in the staffing, budgeting and timing of the audit work.

Re-assessing the general planning decisions for individual audits

- 5.9.57 Before completing the general planning phase, the auditor should consider whether decisions made in later steps in the phase indicate that changes are needed to decisions made earlier in the phase. For example, the assessment of inherent risk and control risk may result in the auditor re-estimating the amount required for the expected aggregate error. Similarly, staffing and timing issues may affect the auditor's ability to use the optimum mix of tests of internal control, analytical procedures and substantive tests of details.
- 5.9.58 In addition, audits cannot be planned in isolation. Each audit directorate needs to consider how best to utilise all of its staff members on all of its audits in the most efficient and effective manner. Planning decisions should also be re-assessed in later stages of the audit.

5.10 Reliance on Other Auditors

- 5.10.1 A key factor to consider in the general planning phase is the extent to which the auditor can rely on the work of internal auditors.

- 5.10.2** Reliance on internal auditors can affect the work required to update the understanding of the internal control structure. It will also likely affect the assessment of control risk.
- 5.10.3** In addition, the ability to rely on internal auditors will likely affect the optimum mix of tests of internal control, analytical procedures and substantive tests of details.

Internal Auditors

5.10.4 Internal auditors have an independent appraisal function within their organisations. As such, they are part of the entity’s internal control structure.

5.10.5 In general, the relationship between DAGP and the internal audit community should be one of cooperation and professional reliance. Coordination of work can ensure adequate audit coverage, while at the same time minimising duplicate efforts.

The relationship between DAGP and internal audit should be one of cooperation.

5.10.6 The coordination and cooperation between DAGP and each internal audit organisation can be enhanced by:

- a) DAGP and the internal audit unit coordinating their audit effort, which in turn requires each:
 - i) To have knowledge of the planned audit coverage of the other; and
 - ii) To the extent possible, to amend its plans to better coordinate the effort.
- b) Having access to each other’s audit programmes and internal control questionnaires;
- d) DAGP having access to the working papers of the internal audit organisation;
- e) Having an exchange of audit reports and management letters;
- f) Having a common understanding of audit techniques, methods, and terminology; and
- g) DAGP relying, to the extent possible, on the audit work of the internal auditors, and thus reducing the amount of additional testing required by the DAGP auditors.

5.10.7 Coordination of effort requires that DAGP and the internal audit staff meet well before the commencement of specific audits to jointly plan their work for the following year. During these meetings, DAGP could, for example:

- a) Discuss areas where it would like to rely on the work of internal audit;
- b) Provide the internal auditors with its basic planning parameters – materiality, audit risk, sources of audit assurance, etc.;
- c) Provide the internal auditors with an audit programme, summary of unadjusted differences and other forms and checklists for the internal auditors to complete; and
- d) Discuss the timing of the work and any required deadline dates.

Consult with internal audit to determine how much audit work internal audit has

- 5.10.8** One of the roles of internal audit is to provide management with an assessment of the adequacy and effectiveness of the internal control structure and the extent to which it can be relied upon. Auditors from DAGP should consult with the head of the internal audit organisation to determine how much audit work internal audit has performed on the internal controls. Wherever possible, the DAGP auditors should rely on the work of internal audit.
- 5.10.9** Just like any other control, the unit’s work needs to be tested before it can be relied upon. DAGP auditors should consider examining the systems and procedures that the internal audit unit has in place to ensure that its work is performed to the required standards. These systems and procedures would include the unit’s quality assurance procedures, hiring policies and training programme. The DAGP auditors may also wish to re-perform some of the work performed by internal audit.
- 5.10.10** Sometimes the external auditors use internal auditors to perform some of the external audit work. In cases such as this, the internal auditors are effectively acting as members of the external audit team. Their work should be supervised and their files reviewed just like the work of any other member of the team.

5.11 Documenting strategic planning decisions

The Need to Document Planning Decisions

- 5.11.1** The auditor’s documentation, in the form of audit files, is collectively referred to as the “working papers”.
- 5.11.2** Paragraph 3.5.5 of DAGP’s auditing standards states, “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.”
- 5.11.3** Documentation of the planning decisions is discussed in detail in Chapter 8. At the end of the detailed planning stage, all steps in the planning process should be complete and adequately documented.
- 5.11.4** It should be noted that the documentation of the audit planning phase should not wait until the detailed planning steps are complete. The work done in each step of the audit planning phase should be fully documented as soon as the work has been completed.
- 5.11.5** At the end of the audit planning phase there should be documentation in the planning file and in the permanent file of all of the decisions made during the general planning phase. In addition, the relevant sections in the audit planning memorandum should be completed. The individuals completing the detailed planning phase can then make use of all of this material.

Auditors should document evidence in working papers, including the basis and extent of the

5.12 Application to Government-wide Audits

The auditor uses one overall materiality amount for the audit, and does not

Sample Selection

- 5.12.1** As noted earlier, the auditor uses one overall materiality amount for the audit, and does not need to allocate it to each grant, component, location, etc. In addition, this one overall materiality amount is used when determining minimum sample sizes for the audit of each component, and each specific financial audit objective and related compliance with authority objective. (Note: this is not to limit the discretion of DAGP to perform more rigorous sampling as it sees fit, especially for compliance with authority audit work).
- 5.12.2** For government-wide audits, the materiality amount will be established by a central DAGP team that is responsible for the overall planning, performance, evaluation, reporting and follow up of the audit. For the audit of the financial statements of an individual government agency, the materiality amount will usually be set by the audit director or a more senior staff person.
- 5.12.3** Each ministry, department etc. performs accounting functions at different locations – the Account General Pakistan Revenues, principal accounting officers in the ministry or department, DAOs, DDOs, etc.
- 5.12.4** Using one overall materiality amount ensures that every grant that is greater than the materiality amount, and every location with assets, liabilities, revenues or expenditures greater than the materiality amount will be virtually certain to have at least one transaction selected for audit. Similarly, each grant and each location with assets, liabilities, revenues or expenditures greater than one half of the materiality amount will also be likely to have at least one transaction selected for audit. It is possible that sampling techniques will not select items from all DDOs, DAOs etc. (DAGP has full discretion to extend sample selection to include items from every DDO and DAO if it is considered necessary).
- 5.12.5** In addition, for the audit of the Federal Government, a province or a district, the auditor is again using a single materiality amount for each audit entity, and that amount is based on the assets, liabilities, revenues or expenditures of that entity as a whole, not each of the sub-entities, such as ministry or department, within the audit entity. Therefore it is possible that sampling techniques will not select audit items from some of the smaller sub-entities. This is logical, since sub-entities that are small relative to materiality are not significant from a financial audit perspective.

5.12.6 However, with direction from DAGP, auditors have the freedom to extend the scope of their audit to extend audit coverage to as many sub-entities as deemed appropriate, and the coverage within each sub-entity, even 100% sampling, is also discretionary. Auditors often accomplish this by developing a list of minimum procedures to be applied at specified sub-entities that is applied over and above the samples determined by sampling techniques. Procedures that can help identify additional areas where coverage would be useful include:

- a) Updating knowledge of the business by looking for new legislation, reviewing minutes etc.,
- b) Reviewing the basic control environment;
- c) Performing analytical procedures on each line item in the financial statements (including statement of appropriations); and,
- d) Exploring for significant events and transactions after the year-end cut-off date.

5.12.7 The auditor could also select additional transactions at random and perform various tests on those items. Bear in mind that the most useful test, given the small size of some sub-entities relative to materiality, is to look for unrecorded transactions rather than errors in recorded transactions. In particular, the auditor would look for unrecorded expenditures that could be hiding over-expended appropriations.

5.12.8 The choice of which grants, locations, ministries or other sub-entities on which to perform these discretionary procedures is based primarily on the auditor's professional judgement and knowledge of the entity. The auditor should consider the following:

- a) The grants, locations, ministries, etc. suspected of significant inherent and control risk;
- b) Sub-entity headquarters where records are kept and where management likely exerts the most influence over transactions; and
- c) All individually significant events, transactions or sub-entities.

5.12.9 In addition to extending the coverage of planned financial audit procedures, the auditor may also decide to conduct additional audit work to review compliance with authority, internal controls, performance and so on.

Coordination

5.12.10 It is not feasible for each audit directorate to plan its portion of the audit of the Federal Government, province or district in isolation. The materiality amount and planned precision value need to be set and the audit work on each component (e.g. line item in the financial statements) should be coordinated across ministries, departments, agencies, etc.

Audit work on each component should be coordinated.

5.12.11 A single grant may be spread across a number of departments, and one DAO may manage more than one grant. It is essential that each grant is subject to an appropriate level of investigation. DAGP has created a central team responsible for audit planning, performance, evaluation, reporting and follow up of each government wide audit. For the annual audit of the financial statements of the Federation, the central team is responsible for:

- a) Setting basic planning parameters (materiality, audit risk, planned precision, components to audit, etc.);
- b) Setting inherent risk, control risk, other substantive procedures risk and substantive test of details risk for each component and audit objective, compliance objective, error and irregularity;
- c) Determining optimum mix of tests of internal control, analytical procedures, and substantive tests of detail for each component and audit objective, compliance objective, error and irregularity;
- d) Drafting audit programmes, forms and checklists to be used by audit teams;
- e) Performing overall error evaluation; and
- f) Reporting the results of the audit.

6 ACTIVITY AND RESOURCE PLANNING FOR INDIVIDUAL AUDITS

6.1 Introduction

6.1.1 This phase primarily involves using the decisions made during the audit planning phase to update the audit programmes that will be used in the fieldwork phase. It is also concerned with updating budgets, staffing requirements, the timing of the audit work, and the information to be obtained from the entity.

6.2 Formulate/update Audit Programmes

6.2.1 The audit programmes provide the auditor with a list of all the procedures that he/she is to perform.

6.2.2 As discussed in Section 3.5 of DAGP's auditing standards, the audit findings, conclusions and recommendations must be based on evidence. The audit programme must contain all of the procedures necessary for the auditor to obtain sufficient, relevant, timely, reliable and objective evidence to support his/her audit findings.

The audit programme must contain procedures necessary to obtain sufficient, relevant, timely, reliable and

6.2.3 The Standard Audit Working Papers Kit and the Audit Programme Guides for specialised audit areas provide a good starting point for the audit programmes to be used on any entity. The kit and guides contain the following components:

- a) Internal control questionnaires (ICQs) and tests of internal control;
- b) Analytical procedures; and
- c) Substantive tests of details.

6.2.4 The kit and guides also contain various planning documents, checklists, forms and supervision instruments.

6.2.5 This material cannot be used blindly, even on those audits where the auditor has extensive material. All entities are different, and each entity can change over time. Therefore, there is always a need to use professional judgment. For example:

- a) If limited reliance is being placed on the internal control structure, then some of the procedures in the Internal Control Questionnaires can often be deleted, or the work required for specific procedures can be reduced.
- b) If a lot of reliance is being placed on the internal control structure, then some of the substantive tests of details may not be necessary, or the extent of the work required in some of the procedures could be reduced.

6.2.6 When developing an audit programme, or tailoring one that is already in existence, it is important to ensure that the programme will provide sufficient, relevant, timely, reliable and objective evidence for each specific audit objective, related compliance with authority objective, and error condition.

- 6.2.7** As a starting point to assist in this process, the audit programme guides contained in the Standard Audit Working Papers Kit and the Audit Guidelines contain a column that indicates for which objective the procedure is designed to provide assurance. Once the auditor has completed tailoring the programme for the specific entity, the auditor should then ensure that each specific objective contains an adequate, but not excessive number of procedures to test it.
- 6.2.8** *Nature.* Some procedures, by their nature, will provide more assurance than other procedures. They may be more relevant, more reliable, more objective, etc. To assess the amount of assurance that the auditor can derive from a particular audit procedure, the auditor needs to have a sound understanding of:
- a) The nature of evidence;
 - b) What constitutes an appropriate quantity and quality of evidence; and
 - c) The most appropriate methods of collecting evidence.
- 6.2.9** *Extent.* The extent of testing relates to how much work the auditor performs – the size of the sample, the number of observations he/she makes, the threshold amount selected for following up significant fluctuations from an analytical procedure, etc. The audit risk model and the guidance provided in Annexes B and D may be useful for this purpose.
- 6.2.10** *Timing.* Timing relates to the period covered by the test. Generally, the longer the period of time being covered by the test, the more assurance the auditor can derive from it. For example, a test of internal control that covers transactions for the entire year is better than a test of internal control that covers only a few months. This is why, if high reliance is placed on internal controls, the auditor normally samples transactions from the entire year. Similarly, a cut-off test that covers the transactions for a month after the year end would be a better test than one that only covers the transactions for a few days after the year end.
- 6.2.11** The requirement to consider the nature, extent and timing of each procedure applies to entity audit teams who are completing audit programmes developed by a central team. For the audit of the financial statements of the Federation, for example, entity teams will be provided with audit programmes prepared by a central team. However, these audit programmes cannot be used blindly. It is the responsibility of each entity team to review the programmes to ensure that:
- a) They contain all of the necessary audit procedures and that the required assurance will be achieved; and
 - b) They do not include unnecessary audit procedures or involve more work than is required.
- 6.2.12** However, audit programmes for each specific financial audit objective and compliance with authority objective are not developed in isolation, for several reasons:
- a) Many internal controls, such as those that are part of the control environment, will be common to many components, specific financial audit objectives, related compliance with authority objectives and error

conditions. The tests of internal control performed on these controls can be used to provide assurance for all of these components, specific financial audit objectives, etc.

- b) Some components are related to other components. For example, an understatement of expenditures may also result in an understatement of liabilities and/or an overstatement of cash. Therefore, the audit of each of these components will provide the auditor with some assurance as to the completeness and accuracy of the related components. To avoid doing more work than necessary, the auditor needs to take the assurance achieved from auditing the related components into account. Professional judgment is required.

6.3 Updating staffing requirements and allocating resources

- 6.3.1 The audit must be appropriately staffed to achieve its objectives.
- 6.3.2 Audit planners should ensure that the staff members assigned to the audit have the audit skills required to perform the work efficiently and effectively.
- 6.3.3 Changes to the nature, extent and timing of the audit work may affect the levels of staff required to perform the work, and the assignment of specific staff members to the audit. Staffing requirements need to be updated at this time.
- 6.3.4 For example, if the auditor wishes to reduce the size of substantive samples and increase reliance on internal controls and analytical procedures, and also intends to introduce CAATs, then the staff members assigned to the audit should have the required training to carry out the tests of internal control, the analytical procedures, and the CAATs.
- 6.3.5 For the audit of the financial statements of the Federation and other audits where a central team makes the initial planning decisions, the central team will often be making its planning decisions on the assumption that each entity team will be able to provide the staff members with the required technical and supervisory skills to perform the audit as planned. It is the responsibility of each entity team to review the proposed audit plan and to discuss any potential staffing problems with the central team before commencing the work.

Ensure that staff members assigned to the audit have audit skills.

Factors to Consider

- 6.3.6 When assigning specific staff to audits consider the following:
 - a) The required skill mix for each specific audit. Ensure that each audit team is composed of staff members with the technical and supervisory skills that are required to complete the audit.
 - b) The needs of all the audits in the directorate. Better auditors should be assigned to the more difficult and risky assignments.
 - c) The audit deadline. Should the deadline date for an audit be moved forward, the auditors may have less time after the year end to complete

their audit. This may necessitate adding extra staff to the audit to complete it in a shorter period of time.

- d) Audit continuity. Having at least some of the audit staff members return to perform work on the entity the next year will help to ensure that the audit team has the required knowledge of the entity.
- e) Rotation. Changing audit staff every few years can add new ideas to the planning and performance of the audit. It can also help to ensure that the auditors remain independent of the entity being audited.
- f) Learning and advancement. While it is beneficial for some staff to return to an entity, it's also advantageous to give them more challenging work each year. At the same time, they could provide advice and assistance to the more junior auditors who are performing the work that they performed in the previous year.

6.3.7 Audit management software will assist in making these staffing decisions.

Allocating resources

6.3.8 The specific audits planned for the period may have to be changed if certain audit skills or experience within the Audit Directorate (or supplied from elsewhere within DAGP) are overextended. The Audit Director should ensure that not only can the proposed set of audits be conducted within available resources but also that there are specific resources with required skills available to conduct the audits. For example, if there is only one person capable of conducting audits of IT systems under development, the Director should ensure the total audit workload of this type across several audits does not exceed the time available.

6.3.9 This can be managed by drawing up a matrix assigning audit resources against audit tasks to enable the manager to balance workload with available resources.

6.4 Updating budget requirements

6.4.1 Any changes made to the nature, extent and timing of the audit procedures will most likely affect the budgets for the work. The auditor should update the budgets at this time.

6.4.2 The audit budget should include a projection of:

- a) costs of travel, accommodation and subsistence while visiting audit sites;
- b) cost of any purchases;
- c) level of effort of audit team members.

6.4.3 The biggest aspect of budgeting is the budgeting of time – estimating the amount of time required to:

- a) Plan the audit;
- b) Perform the audit of each specific component, and in total;
- c) Evaluate the audit results;
- d) Report the results of the audit;
- e) Follow up the results of previous audits (if being done at this time); and
- f) Manage the audit, including the supervision of lower level staff and a review of their work.

- 6.4.4** Good budgeting is very important for audits where an opinion is being expressed. In these cases, the auditor needs to complete all the activities that have been deemed necessary to form an opinion, and so needs to ensure adequate resources (people, time, and money) are available. Where no opinion is being expressed, the auditor has discretion over the scope of work performed and can adjust the audit plan to best use the resources that are available.
- 6.4.5** For the audit of the financial statements of the Federation and other audits where a central team makes the initial planning decisions, the central team will also be providing the entity teams with a budget to perform the work. It is the responsibility of each entity team to review the budget that it has been given and to discuss any problems with the central team before commencing the work.

Factors to Consider

- 6.4.6** The following factors should be considered when setting the budgets:
- a) size of the entity;
 - b) complexity of the entity and its transactions;
 - c) audit risk;
 - d) inherent risk;
 - e) quality of the internal control structure; and
 - f) experience of the staff performing the audit.
- 6.4.7** Each of these is discussed below.
- 6.4.8** *Size of the entity.* The size of the entity may only have a limited effect on the required budget. This is because, as the entity being audited gets bigger, the materiality amount may increase proportionately. The sample size required to audit the expenditures in a small entity may be just as large as the sample size required to audit the expenditures in a large entity.
- 6.4.9** *The complexity of the entity and its transactions.* This will likely have a considerable impact on the budget. Some entities are inherently complex, and the substance of their transactions may be difficult to determine. Entities such as these could require a much larger budget than entities that are straightforward.
- 6.4.10** *Audit risk.* The lower the audit risk being taken, the more assurance is required. Reducing audit risk from 5% to 3%, for example, could add 20% to the total required audit work.
- 6.4.11** *Inherent risk.* The higher the assessed inherent risk, the more assurance the auditor needs in total from his/her tests of internal control, analytical procedures and substantive tests of details. Also, the auditor may need to use a higher expected aggregate error when determining planned precision, further increasing the required amount of work.

- 6.4.12** *The quality of the internal control structure.* It is often more efficient to place a lot of reliance on the internal control structure and reduce the substantive tests of details. Should this not be possible because the internal controls are poor (control risk is high), the auditor may need to increase the budget. Also, the auditor may need to use a higher expected aggregate error when determining planned precision, further increasing the required amount of work.
- 6.4.13** *The experience of the staff assigned to the audit.* More experienced staff should be able to complete the work in a fewer number of hours.

Reviewing and Approving the Budget

- 6.4.14** The budget for each audit should be reviewed by the Director General responsible for the audit, and approved by the Deputy Auditor General responsible for the audit.
- 6.4.15** Each audit directorate should review the budgets set for each individual audit within the directorate to ensure that they look reasonable in relation to each other. Senior DAGP officials could carry out the same review across all directorates.
- 6.4.16** Team members should record the time that they spend auditing each component. Explanations for any deviations from the budget should be obtained, and the auditor should conclude whether or not the factor causing the increase or decrease in time is expected to recur in the next year. This information can be used as a starting point for the following year's budget.

Team members record the time that they spend

6.5 Updating timing considerations

- 6.5.1** All government entities have a 30 June year end. If DAGP were to wait until after the financial statements of all of these entities were completed before commencing work, the audit reports would not be timely and DAGP may not be able to meet required deadline dates.
- 6.5.2** To improve the timeliness of the audit reports, and to achieve other benefits, DAGP should commence work on the audits before the year end (i.e., at an interim date).
- 6.5.3** This approach will be essential for the audit of the financial statements of the Federation and the provinces since the New Accounting Model calls for the Auditor-General to issue a report on the financial statements on or before 30 October.
- 6.5.4** For the audit of the financial statements of the Federation and other centrally-planned audits, the central team will request each entity team to report to it by a certain deadline date. It is the responsibility of each entity team to discuss, with the central team, any potential problems that it may have meeting the deadline date before commencing the work.

The Use of Interim Audits

- 6.5.5 An “interim date” is a date in advance of the year-end date. An “interim audit” is an audit performed at an interim date.
- 6.5.6 To illustrate, the auditors could decide to perform an audit of the transactions for the first six months of the year (1 July to 31 December) in the following February and March. They could then return to the entity in May to do the next three months (1 January to 31 March). They could then return again after 30 June to complete their audit.
- 6.5.7 The work performed at an interim date could include:
- Auditing a sample of revenue and expenditure transactions up to the interim date. A sample of the transactions for the rest of the year could then be audited at a later interim date, or after the year-end.
 - Reviewing and testing the entity’s internal control structure. Enquiries, observations and walk-through procedures could then be performed at the year-end date to ensure that the internal controls had not deteriorated.
 - Note: When high reliance is being placed on the internal controls, the auditor normally needs to also sample the transaction between the interim date and the year-end date.
 - Discussing accounting policies, the form and content of the financial statements, contentious authority matters, etc. with entity officials. This could avoid having to deal with these matters at the end of the audit.

6.6 Factors to consider when determining the optimum timing

- 6.6.1 The key benefit of using interim dates is to improve the timeliness of the audit reports.
- 6.6.2 Another benefit of using an interim audit is that it can provide the auditor with an earlier indication that the planning decisions may need changing. For example, the auditor may have intended to place a lot of reliance on the internal controls, but may find at an interim date that the controls are not reliable. The auditor would then be able to amend the audit plan well before the year-end date.
- 6.6.3 A further benefit of performing an interim audit is that it may solve staffing problems. The required staff may not be available to do all of the audit work after the year-end date. Also, there may be a need to do some of the work before the year-end to keep all of the staff fully occupied.
- 6.6.4 The major drawback of doing some work at an interim date is that it may add to the cost of the audit. If, for example, the bank reconciliations were verified before the year end, the auditor would normally need to review the transactions that took place between the date of the in term work and the year end.

It is entity management's job to ensure that the financial statements, and the supporting books and records

Updating information required from the entity

- 6.7.1 It is entity management’s job to ensure that the financial statements, and the supporting books and records, are complete and accurate. To do so, management should be preparing its own analyses of the account balances, reconciling accounts, preparing lists of specific assets and liabilities making up various account balances, checking the year-end cut-off, doing searches for unrecorded transactions, etc.
- 6.7.2 The auditor could make use of the above work to reduce the audit effort. To do so, the auditor should prepare a list of all of entity management’s analyses, reconciliations, schedules, lists, etc. that would be useful for the audit, and submit the list, with a request for copies, to entity management well in advance of the commencement of the audit.
- 6.7.3 This process will not only help to improve the efficiency of the audit, but will also be a good test of the extent to which entity management has fulfilled its own responsibilities.
- 6.7.4 The Standard Audit Working Papers Kit includes a form that outlines the typical forms, schedules, reconciliations, analyses, documents, etc. that are often requested from entity officials.

6.8 Re-assessing the general and detailed planning decisions for individual audits

The Need for Re-assessments

- 6.8.1 Decisions made in the detailed planning phase could result in changes being needed to decisions made during the general planning phase. For example, staffing and timing issues may affect the auditor’s ability to use the optimum mix of tests of internal control, analytical procedures and substantive tests of details.
- 6.8.2 In addition, audits cannot be planned in isolation. Each audit directorate needs to consider how best to utilise its entire staff on all of its audits in the most efficient and effective manner. This could result in some individual audits not being done in the most efficient and effective manner.
- 6.8.3 As we will see in later chapters, the general and detailed planning decisions should also be re-assessed in later stages of the audit.

6.9 Documenting the detailed planning decisions

The Need for Documentation

- 6.9.1 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.”

Document audit evidence in working paper including the planning.

- 6.9.2** The general and detailed planning decisions are documented primarily through:
- An updated permanent file;
 - An updated planning file;
 - An updated audit planning memorandum; and
 - Updated audit programmes.
- 6.9.3** Updated permanent file
- 6.9.4** The permanent file contains information that can be useful to the auditor for several assignments. A sample index for a permanent file is contained in the Standard Audit Working Papers Kit.
- 6.9.5** As is illustrated in the Working Papers Kit, the information that is often found in the permanent file includes:
- The role of the entity, its vision and mission statements, and its most recent corporate plan;
 - Copies of relevant government legislation, regulations, guidelines and other rules affecting operations;
 - Organisation charts;
 - Chart of accounts;
 - Summary of accounting principles used by the organisation;
 - Copies of long-term contracts/leases;
 - Copies of loan agreements, schedules of amortisation for debts and special assets;
 - Extracts of minutes;
 - Special remuneration conditions for senior officers; and
 - Reports to management and management's response.
- 6.9.6** Policies and procedures manuals may be in the permanent file if they are brief or, alternatively, a copy should be kept on the auditor's premises.

6.10 Updated planning file

The planning file contains support planning decisions.

- 6.10.1** The planning file contains support for all of the planning decisions that have been made. The usual content of these files is illustrated in the Standard Audit Working Papers Kit.
- 6.10.2** As is illustrated in these guidance materials, the information that is often found in the planning file includes:
- Support for the work performed and the decisions made at each step of the general and detailed planning processes. This would include the work performed to update the planning decisions made in previous years
 - An updated audit planning memorandum. See below.
 - Updated audit programmes. See below.
 - Updated budgets, staffing requirements, timing considerations, information required from the entity, etc. resulting from the detailed planning process.

Updated audit planning memorandum

6.10.3 This document is usually included in the planning file. It summarises the key planning decisions that have been made, with emphasis on the changes that have been made to the previous year's plan.

6.10.4 The usual content of an audit planning memorandum is illustrated in the Standard Audit Working Papers Kit.

Updated audit programmes

6.10.5 Audit programmes contain the specific audit procedures that the auditor needs to complete during the fieldwork phase.

6.10.6 Standard audit programmes are included in the Standard Audit Working Papers Kit. Audit programmes for the 13 specialised areas are included in the Audit Guides for those areas.

6.11 Approval of the general and detailed planning decisions

6.11.1 All planning decisions should be approved before the fieldwork commences. This is to ensure that:

- a) Appropriate and sufficient evidence is obtained to support the opinion;
- b) All of DAGP's auditing standards are complied with; and
- c) Only necessary work is performed.

6.11.2 Since the work performed will form the basis for the conclusions reached and the form and content of the reports being issued, it is important that the general and detailed planning decisions be reviewed and approved by senior DAGP officials. It is suggested that the planning decisions be reviewed by the responsible Director General and approved by the responsible Deputy Auditor General.

7 CONDUCTING THE AUDIT

7.1 Introduction

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

- a) Permanent file;
- b) Planning file;
- c) Audit planning memorandum;
- d) Audit programmes;
- e) Staffing requirements, and the staff to be assigned to each component of the audit;
- f) Budget requirements;
- g) Timing considerations; and
- h) List of information to be obtained from entity officials.

7.1.2 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.

The updated audit programmes will guide the detailed

7.2 Compliance Testing

7.2.1 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.

Evaluate the effectiveness of internal controls.

7.2.2 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).

7.2.3 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 determine whether

- 7.2.4 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).
- 7.2.5 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.

7.3 Substantive Testing

Substantive testing is required to determine how much assurance can be placed on financial assertions.

- 7.3.1 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.

Substantive Analysis

- 7.3.2 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:

- a) 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);
- b) Other audit procedures relating to the same audit objectives;
- c) 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);
- d) 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.

Tests of Details

- 7.3.3 Tests of details are the application of one or more of the following audit techniques to individual transactions that make up an account balance:
- a) Recomputation;
 - b) Confirmation;
 - c) Inspection; and
 - d) Cut-off tests.

Most assurance is

- 7.3.4 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.
- 7.3.5 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.
- 7.3.6** Paragraph A1 of the ISSAI 1505 (External Confirmation) and paragraph A48 of ISSAI 1330 (The Auditor's Responses to Assessed Risks) state that confirmations can be used to obtain evidence about the presence or absence of certain conditions (e.g. "side agreements" not included in formal arrangements). In addition to assertions related to the audit of financial statements, public sector auditors may find confirmations useful in obtaining evidence related to additional audit objectives stipulated by their audit mandate or arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. For example, external confirmations can be used to obtain evidence about:
- a) The presence or absence in agreements or arrangements with third parties of legislated or other terms and conditions such as guarantees of performance or funding;
 - b) The commitment of expenditures that have not yet been authorized by the legislature;
 - c) The continued eligibility of individuals in receipt of pensions, income assistance, annuities or other ongoing payments; or
 - d) The presence of "side deals" with suppliers for the return of goods for credit in order to use funding that would have otherwise lapsed in a subsequent fiscal period.
- 7.3.7** Use of templates given in Appendix-G of FAM in conjunction with the relevant audit programs given in the Workin Paper Kit wherever applicable is mandatory for both compliance and financial audits
- 7.3.8 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.

7.3.9 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.

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

7.3.11 This is done by:

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

7.3.12 Key items are normally selected when:

- a) 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,
- b) 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
- c) The population consists largely of non-routine transactions and therefore the account is unlikely to consist of similar items that could be sampled.

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

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

7.3.14 Representative sampling is likely to be most effective when:

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

Substantive Sampling

7.3.15 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.

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

- a) Decide what is to be tested;

- b) Define the sample and select the sample;
- c) Audit the sample items; and
- d) Evaluate and interpret the results.

7.3.17 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.

7.3.18 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.

7.3.19 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.

7.3.20 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.

7.3.21 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).

7.3.22 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 the cause of the observed errors is common.

7.3.23 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.

7.3.24 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 compliance work is performed as part of a financial certification audit, the auditor should

7.3.25 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.

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

7.3.27 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.

7.3.28 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.

7.4 Evidence

The auditor requires evidence to support all information

7.4.1 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.

Attributes of Evidence

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

- a) Sufficient;
- b) Relevant;
- c) Reliable; and
- d) Objective.

7.4.3 **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:

- a) The auditor's knowledge of the entity and its environment;
- b) The materiality/significance of the matter in hand;
- c) 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;
- d) Whether the audit is providing assurance or just identifying particular weaknesses in need of correction;
- e) The degree of risk that insufficient evidence will lead to a misleading statement or conclusion or produce an inappropriate recommendation;
- f) The quality and persuasiveness of the evidence; and
- g) The degree of acceptance of the evidence by management.

Evidence should be sufficient to lead a reasonable

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

7.4.5 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.

7.4.6 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.

Collect relevant evidence to conclude

7.4.7 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.

7.4.8 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.

7.4.9 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.

7.4.10 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:

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

Ensure that evidence obtained is reliable.

- 7.4.11** 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.
- 7.4.12** 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.
- 7.4.13** 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.
- 7.4.14** 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.
- 7.4.15** **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.
- 7.4.16** 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.

Evidence should be objective and free from bias.

Types of Evidence

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

7.4.18 Evidence can be classified according to the following:

- a) Documentary;
- b) Observational;
- c) Physical;
- d) Oral; or,
- e) Analytical.

7.4.19 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 outgoing 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.

The main source of audit evidence is ..

7.4.20 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.

Observing people and events or by examining

7.4.21 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.

7.4.22 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.

7.4.23 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.

Interviews provide important leads.

7.4.24 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:

- a) Various levels of management;
- b) Personnel directly involved in operations;
- c) Suppliers and contractors;
- d) Recipients of government services;
- e) Members of the general public;
- f) Other ministries/departments/agencies; and
- g) Experts and consultants.

7.4.25 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.

7.4.26 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:

- a) This increases the reliability of the information, particularly where the sources are independent;
- b) The source of the information is less likely to be traceable to one particular individual;
- c) A stronger statement can be made, such as “the majority of those interviewed commented that ...”, or “x% of managers responded ...”; and
- d) The auditor cannot be accused of placing too much emphasis on a source that could be biased.

7.4.27 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 for a particular location or visit, preferably 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 the auditor wants further documentation of these findings, then minutes of this meeting can be sent for confirmation.

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

Analysis of data can provide important

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

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

7.4.30 Analysis can be time-consuming but can provide results that are valuable. Wherever possible, the auditor should try to arrive at a quick approximation rather than conduct detailed analyses at the start. 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.

Procedures for Gathering Audit Evidence

7.4.31 Broad Approach. At the start of an audit, usually during the planning stage, the auditor is taking 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.

7.4.32 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.

7.4.33 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 and/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.

7.4.34 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.

7.4.35 Experience will guide the auditor, for example, 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:

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

7.5 Matters to deal with during fieldwork

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

7.5.2 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.

*Obtain
relevant,
reliable,
sufficient
and*

Unanticipated Matters

7.5.3 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 had not been known about 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.

- 7.5.4** 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 to be placed 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.
- 7.5.5** To detect matters such as these, the auditor should not conduct the audit blind to evidence beyond the audit programme. The auditor needs to remain on the lookout for these unanticipated matters, and to consider their implications for the audit.
- 7.5.6** 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.
- 7.5.7** Should an unanticipated matter be relatively minor, such as one that requires the addition of 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.
- 7.5.8** 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.

The Substance of the Transaction

- 7.5.9** 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.
- 7.5.10** 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.

7.5.11 If the auditor suspects that the substance of a transaction is different from its form, the auditor should consider what the correct 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.

Inadequately Supported Transactions

7.5.12 Inadequately supported transactions are often the result of missing documents. They may also indicate the entity's accounting system does not call for the documentation that the auditor would consider appropriate.

7.5.13 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.

7.5.14 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.

7.5.15 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.

7.5.16 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.

Conflicting Audit Evidence

7.5.17 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:

- a) The auditor's analytical procedures indicate that material error exists in a particular component, while the auditor's substantive tests of details indicate that there are no errors in the component.

- b) One entity official provides the auditor with information or an explanation that is inconsistent with the information provided by another entity official.
- c) 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.

7.5.18 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.

7.5.19 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.

It is not appropriate for the auditor to disregard some of the evidence received

7.5.20 One way to do this is to seek input from entity officials. For example, entity officials may be able to provide the auditor with additional information that helps to explain the fluctuation identified by analytical procedures.

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

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

7.5.22 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.

7.5.23 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:

- a) deals directly with the matter at hand;
- b) was sufficient and appropriate, and done correctly; and
- c) explains why the auditor's original estimation of the error was not correct.

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

7.6 Cause and Effect Analysis

7.6.1 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:

- a) Inexperienced individual carrying out the transaction;

- b) Insufficient training of that individual;
 - c) Lack of proper systems and procedures;
 - d) Insufficient management involvement / scrutiny; or
 - e) Unclear accountability.
- 7.6.2** It is usually a matter of judgment as to which factor, or combination of factors, is generally regarded as the underlying cause(s).
- 7.6.3** These underlying causes need to be addressed to obtain long-term improvement of the operations. The auditors' recommendations for improvement should address these items.
- 7.6.4** 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.
- 7.6.5** Cause and effect analysis is often 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.
- 7.6.6** 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.
- 7.6.7** 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.
- 7.6.8** Cause-and-effect analysis requires the auditor to:
- a) 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.
 - b) 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.

7.7 Developing Conclusions and Recommendations

- 7.7.1 In theory, the auditor compares an actual finding with an expected finding (the accounting standard or audit criterion) and identifies any deviations.
- 7.7.2 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.
- 7.7.3 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.
- 7.7.4 Conclusions should focus on significant issues. These are generally concerned with:
- a) Inefficient or ineffective operations, or examples of not achieving intended results; and,
 - b) Failures to measure and report on the efficiency of operations and the effectiveness of the programmes.
- 7.7.5 Performance audits are also concerned with:
- a) Failures to acquire resources economically and to safeguard assets;
 - b) Lack of accountability;
 - c) Inadequate controls and excessive risks to the entity; and
 - d) Inefficiencies, errors, waste, and misuse.
- 7.7.6 Issues relating to these concerns should have been identified during the planning stage of the audit.
- 7.7.7 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 quite unrelated, the management have 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.

Conclusions should focus on significant issues.

Significant Findings and Conclusions

The audit report provides a few key messages.

- 7.7.8 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 the key areas and may not have the time or inclination to get into details that do not appear substantive. 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.
- 7.7.9 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.
- 7.7.10 In developing findings, the auditor needs to:
- a) 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;
 - b) Assess the significance of the weakness, in both terms of frequency and impact;
 - c) Develop one or more examples or cases, for inclusion in the report, to clearly illustrate the nature of the deficiency;
 - d) Clearly communicate the actual or potential impact of the identified deficiencies; and
 - e) 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.
- 7.7.11 These steps are necessary to determine reporting strategy and to ensure fairness and balance of the report.
- 7.7.12 **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.
- 7.7.13 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.
- 7.7.14 When developing recommendations, the auditor should consider:
- a) 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);
 - b) The feasibility and cost of adopting a recommendation (i.e., the benefits of a recommendation should outweigh the cost of implementing it);
 - c) Alternative courses for remedial action; and

- d) Effects, both positive and negative, that may arise if the recommendations are adopted.

7.8 Keeping Entity Officials Informed

- 7.8.1 To successfully complete the fieldwork, the auditor should:
 - a) Have effective communication skills, both oral and written; and
 - b) Establish and maintain good working relationships with entity officials.
- 7.8.2 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.
- 7.8.3 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.
- 7.8.4 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.
- 7.8.5 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.
- 7.8.6 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.

Entity officials must have confidence in the auditors.

7.9 Documenting the Work Performed

- 7.9.1 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.”
- 7.9.2 The content and arrangement of the working papers reflect the auditor's proficiency, experience and knowledge.
- 7.9.3 Adequate documentation is important for several reasons. It will:
 - a) serve as evidence of the auditor's compliance with DAGP’s Auditing Standards;
 - b) help to ensure that delegated work has been satisfactorily performed;

Document evidence in working

- c) increase the efficiency and effectiveness of the audit;
- d) help the auditor's professional development;
- e) serve as a source of information for preparing reports;
- f) provide information to answer enquiries from entity officials, the Legislature and its committees, or from any other party;
- g) assist in the planning of the audit for the following year; and
- h) help auditors in the following year to perform their work.

Documentation Standards

- 7.9.4** 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.
- 7.9.5** 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.
- 7.9.6** To achieve this objective, the fieldwork, evaluation and reporting files should include:
- a) evidence that all of the planned audit work was performed;
 - b) an indication as to who performed the audit procedures and when they were performed;
 - c) evidence that the work performed by lower level staff was supervised and reviewed;
 - d) copies of communication with experts and other third parties;
 - e) copies of letters or notes concerning audit matters communicated to or discussed with the entity; and
 - f) copies of the auditor's reports.
- 7.9.7** To illustrate, assume that:
- a) the auditor selected a sample of 20 supplier invoices and performed numerous procedures on them;
 - b) 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;
 - c) in one case there was no receiving report; and
 - d) the auditor was unable to find other evidence to support the validity of the expenditure.
- 7.9.8** In this illustration, as a minimum the audit working papers would need to include:
- a) a description of the sampling procedure used – the population from which the sample was selected, the parameters used to determine the sample size, etc.;
 - b) 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;
 - c) 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;

- d) description of the efforts made by the auditor to locate the missing receiving report, and to otherwise support the validity of the transaction; and
- e) 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.

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

7.9.10 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:

- a) 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
- b) 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.

Standards for Working Paper Files

7.9.11 Every working paper should clearly show:

- a) the name of the audit entity and audit area;
- b) the period covered by the audit;
- c) the date the work was performed;
- d) initials of the preparer;
- e) the source from which information or explanations were obtained;
- f) cross-references to schedules, notes and other documents that support the working papers;
- g) cross-references of all amounts and other information in the audit report to the working papers supporting the amounts and information;
- h) evidence that the audit procedures were performed;
- i) an explanation of any "tick marks" that appear on the working paper; and
- j) the date and initials of the reviewer.

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

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

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

Working papers should be

7.10 Custody and maintenance of working paper files

- 7.10.1 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.
- 7.10.2 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.
- 7.10.3 Audit files should be kept for the length of time specified by DAGP's file retention policy.

Working paper files are confidential and not for general

7.11 Quality assurance during fieldwork

- 7.11.1 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."
- 7.11.2 This section discusses the role of supervision and review. It also discusses the need for effective time reporting.
- Supervision**
- 7.11.3 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."
- 7.11.4 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.
- 7.11.5 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.
- 7.11.6 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;

Work should be properly supervised during the audit.

Supervision is essential to ensure the quality of the audit work.

- c) The audit programmes are completed as planned, unless changes are required;
- d) 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;
- e) Only essential work is performed;
- f) Sufficient evidence will have been obtained when the work is completed;
- g) Audit findings and conclusions are being adequately supported by evidence in the working papers;
- h) The audit is performed within the time budget and by the deadline dates set; and
- i) 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.

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

7.11.8 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.

Review of Working Paper Files

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

7.11.10 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:

- a) all evaluations and conclusions are soundly based and are supported by competent, reliable, relevant and reasonable audit evidence;
- b) all errors, deficiencies and unusual matters have been properly identified, documented and evaluated; and
- c) 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.

7.11.11 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.

7.11.12 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.

Time Reporting and Monitoring

- 7.11.13** 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.
- 7.11.14** 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 Papers Kit includes a daily time schedule that is applicable to most audits.
- 7.11.15** 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.
- 7.11.16** 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.
- 7.11.17** Audit management software can be used for this purpose.
- 7.11.18** 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:
- a) Set the budget for the following year; and
 - b) Refine the optimum combination of tests of internal control, analytical procedures and substantive tests of details.
- 7.11.19** To illustrate, assume that the auditor is over budget 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.

8 EVALUATING AUDIT RESULTS

8.1 Evaluating Financial Audit Results

- 8.1.1** By the end of the fieldwork stage the auditors will have completed their audit programmes and documented the results of their work. Part of this work will have involved the identification of potential monetary errors, compliance with authority violations, internal control deviations, etc. These errors and deviations need to be dealt with during the evaluation phase.
- 8.1.2** Error evaluation is done in stages. First the auditor reaches a conclusion on the results of each test. Next, the auditor reaches a conclusion on each component. Finally, the auditor reaches a conclusion on the financial statements as a whole.
- 8.1.3** As described earlier in this Manual, the optimum mix of tests of internal control, analytical procedures and substantive tests of details for one specific financial audit or compliance objective for one component may be totally different than for a different objective or component. Appendix B provides a non-technical discussion on the theory behind the overall error evaluation process – how the auditor can combine different sources of assurance to reach an overall conclusion on the financial statements.

The fieldwork stage will have identified monetary errors, compliance violations, and internal

Use of CAATS

- 8.1.4** Evaluation of fieldwork results hinges on the application of a number of error-based calculations, as described in the following section.
- 8.1.5** Computer-assisted auditing techniques (CAATs) are useful in determining the most likely error and the upper error limit for individual substantive tests of details, or the most likely deviation rate and the maximum possible deviation rate for individual tests of internal control. This is because the easiest way to perform and document these calculations is to use the error evaluation function of a CAATs product.
- 8.1.6** Advantages of CAATs over manual evaluation of errors are:
- (a) Calculations are much quicker using computer power;
 - (b) Manual calculations are complex and prone to error – computers produce much more accurate and reliable results;
- 8.1.7** Auditors are therefore strongly encouraged to use CAATs. DAGP is establishing a capability to provide access to auditors across the department.
- 8.1.8** There may be circumstances in which manual calculations are judged to be appropriate. For this reason, the Standard Audit Working Papers Kit contains standard forms that can be used.

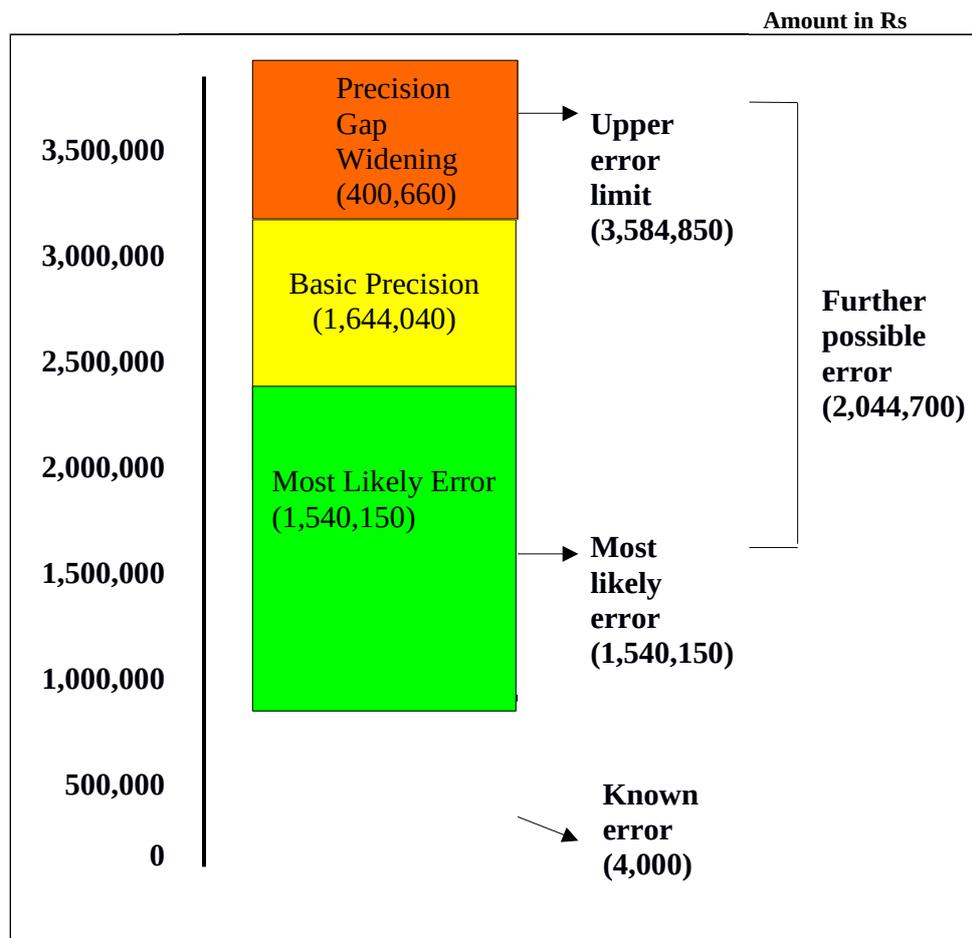
Computer-assisted auditing techniques (CAATS) are

8.2 Known Errors, Most Likely Errors, Further Possible Errors and Maximum Possible Errors

Errors are evaluated by projecting the findings from a representative sample to

- 8.2.1 Error evaluations are performed by projecting the findings from a representative sample to the population as a whole. The rest of this Chapter illustrates the process based on sampling from a population of supplier invoices.
- 8.2.2 Some key terms used in this chapter are Known Error (KE), Most Likely Error (MLE), Further Possible Error (FPE), Maximum Possible Error (MPE) and Upper Error Limit (UEL). They are illustrated in the figure below for reference when reviewing later sections of this Chapter.

Figure 8.1: Known Error, Most Likely Error, Further Possible Error and Upper Error Limit – Overstatement Errors



Known Error

The known error is the sum of errors actually found during the audit.

- 8.2.3 The known error is the sum of the errors that the auditor actually finds during the audit.

- 8.2.4 If for example, the auditor tests a sample of 181 supplier invoices out of a population of 30,000 and finds 5 overstatement errors totalling Rs. 4,000 then the known error is Rs. 4,000.

Most Likely Error (MLE)

- 8.2.5 The most likely error (MLE) represents the auditor's best estimate of the error in the population.

The most likely error (MLE) is auditor's best estimate of the error in the

- 8.2.6 In the example, the auditor has only selected a sample of 181 supplier invoices out of a population of 30,000. There are likely to be more overstatement errors than just the Rs. 4,000 found in the sample. The auditor needs to estimate the most likely error in the population based on the results of the sample.

- 8.2.7 Using the approach illustrated in Appendix B, the auditor determines the MLE in the population to be Rs. 1,540,150.

Upper Error Limit (UEL)

- 8.2.8 The auditor has only taken a sample of 181 supplier invoices out of 30,000 supplier invoices. Therefore, it is very likely that the actual error in the population will not be exactly Rs. 1,540,150. The actual error could be larger or smaller than Rs. 1,540,150.

- 8.2.9 The upper error limit (UEL) represents the maximum possible error that could exist in the population at a given confidence level.

The upper error limit (UEL) is the maximum possible error that could exist in

- 8.2.10 The reason for the phrase "at a given confidence level" is because the upper error limit will be different depending on the confidence level the auditor wishes to achieve. With a MLE of Rs. 1,540,150, the auditor would be very confident that the actual error in the population is less than Rs. 10,000,000, but would have less confidence that the actual error in the population is less than Rs. 2,000,000.

- 8.2.11 As discussed in detail in Appendix B, the auditor normally does two error evaluations – one for overstatement errors and one for understatement errors. The auditor then combines the results of the two evaluations.

- 8.2.12 Using the techniques illustrated in Appendix B, the auditor is able to conclude that:

- (1) the population is not overstated by more than Rs. 3,584,850; and
- (2) the population is not understated by more than Rs. 103,890.

Further Possible Error

The further possible error is the difference between the UEL and the MLE.

- 8.2.13 The further possible error is the difference between the UEL and the MLE. It has two components – basic precision and precision gap widening.

- 8.2.14** In our example, the further possible error for overstatements is Rs. 2,044,700, being the difference between the UEL of Rs. 3,584,850 and the MLE of Rs. 1,540,150.

Basic Precision

Basic precision is the possible error that could exist in the population.

- 8.2.15** Basic precision is the possible error that could exist in the population even if no errors are found in the sample. It therefore represents the upper error limit when the most likely error is nil.
- 8.2.16** Assume the audit fieldwork uncovers no understatement errors. Therefore, the most likely understatement error is Rs. nil. However, it is difficult to believe that there isn't a single understatement error in any of the 30,000 supplier invoices.
- 8.2.17** In fact, with a desired 95% confidence level, the auditor determines basic precision to be Rs. 1,644,040. The auditor can therefore conclude with 95% confidence that the understatement errors in the population sum to a maximum of Rs. 1,644,040.
- 8.2.18** When the basic precision value, Rs. 1,644,040, is netted against the MLE for overstatements of Rs. 1,540,150, the auditor gets the UEL for understatements of Rs. 103,890.
- 8.2.19** Note that basic precision is the same amount for both overstatement errors and for understatement errors. The same Rs. 1,644,040 is also used for the evaluation of overstatement errors.

Precision Gap Widening

Precision gap widening is the traditional further possible error that results from finding

- 8.2.20** Basic precision does not represent the total amount of the further possible error. The reason is that, for each additional Rs. 1 in the MLE, the UEL increases by more than Rs. 1. Precision gap widening is the additional further possible error that results from finding errors in the population.
- 8.2.21** In the above illustration, the precision gap widening for overstatement errors is Rs. 400,660. (There is no precision gap widening for understatement errors as no understatement errors were found in the sample.)
- 8.2.22** The sum of the Rs. 400,660 precision gap widening amount and the Rs. 1,644,040 basic precision amount is Rs. 2,044,700 – the further possible overstatement error.
- 8.2.23** Compliance with authority violations and internal control deviations
- 8.2.24** The above illustration has been based on a monetary error. The same terminology and process are used for compliance with authority violations and internal control deviations.

8.2.25 For example, assume the auditor tests 184 supplier invoices out of a population of 30,000 and finds 5 invoices that have not been approved. The auditor could then calculate the most likely amount of the unapproved expenditures, and the maximum possible amount of the unapproved expenditures. The only difference in the process is that, since we are dealing with approvals, all errors will be 100% errors i.e. the full amount of the invoice. An invoice cannot be 50% approved.

8.3 Determining the cause of errors, violations and deviations

8.3.1 In the illustration discussed above, the auditor is projecting the results of the sample onto the entire population. The auditor is assuming that the sample is representative of the population, and that the monetary errors, compliance with authority violations and internal control deviations found are therefore representative of the errors and deviations that exist in the population as a whole.

8.3.2 This is normally the appropriate assumption to make. The auditor selects the sample from the population in a way that is designed to produce a representative sample. Therefore, the auditor can conclude that the sample results are representative of the population. If the auditor concluded that the results were not representative of the population, the auditor would be effectively concluding that the sample itself was not representative of the population. The auditor would then need to select another sample and repeat all the audit procedures.

8.3.3 As a result, it is normally not acceptable to conclude that a monetary error, a compliance with authority violation or an internal control deviation found in a sample is an “isolated incident” and therefore does not need to be projected over the population.

8.3.4 However, there may be rare cases where a particular monetary error, compliance with authority violation or internal control deviation is clearly not representative of the entire population. These would include cases where the cause of the error, violation or deviation was so unique that it is safe to assume that there could not be too many other similar items in the entire population.

8.3.5 One case where this can happen is where the auditor selects one sample of transactions from a population made up of numerous ministries and finds an error that clearly could only relate to one ministry. In this case, the auditor could divide the ministries into two populations – those to which the error could potentially relate and those to which the error could not possibly relate. The auditor would then divide the sample on the same basis and perform two separate error evaluations.

8.3.6 Therefore, the auditor needs to consider the cause of each monetary error, compliance with authority violation and internal control deviation found in his/her sample to determine if there is any reason why the sample results should not be projected over the entire population.

The auditor is projecting the results of the sample onto the entire population and monetary errors compliance violations and internal control

8.3.7 There are several other reasons for the auditor to determine the cause of each monetary error, compliance with authority violation and internal control deviation uncovered:

- a) In the case of a test of internal control, the auditor may need to reduce reliance on a specific control and replace that reliance with additional assurance from substantive tests of details. Unless the auditor can determine the cause of the internal control deviation, the auditor may not be able to determine the substantive tests to perform. The auditor could wind up performing substantive tests that do not deal directly with the same error conditions, and do not provide the required amount of compensating assurance.
- b) Also in the case of a test of internal control, the auditor needs to determine the cause of the deviation to develop an appropriate recommendation to help prevent the deviation from occurring in the future.
- c) In the case of a substantive test, as illustrated below, errors that affect a closing balance carried forward in one year may affect the opening balance brought forward in the following year. The auditor needs to determine the cause of the error to determine which errors could affect opening balances for the following year.
- d) Further to (c), the same type of monetary error, compliance with authority violation or internal control deviation may recur in the following year. Investigating the cause of the error, violation or deviation found in the first year might help the auditor to arrive at a more accurate estimate of the most likely amount in the following year. It should also help the auditor to better plan the following year's audit.
- e) Also in the case of a substantive test, the auditor needs to determine the cause of the monetary error or the compliance with authority violation to identify the particular internal control(s) that may need to be re-evaluated. And, as above, the auditor needs to determine the cause of the error to develop an appropriate recommendation to help prevent the error from occurring in the future.

8.4 Concluding on the Results of Each Test

8.4.1 This process is somewhat different depending on whether the auditor is performing a test of internal control, an analytical procedure or a substantive test of details. Each is discussed in turn below. This section starts, though, with a discussion on determining known monetary errors, compliance with authority violations and internal control deviations.

Determining Known Monetary Errors, Compliance with Authority Violations and Internal Control Deviations

8.4.2 Determining known monetary errors, compliance with authority violations and internal control deviations is normally quite straightforward. At the planning stage, the auditor updates the financial audit objectives and related compliance with authority objectives and error conditions. He or she then designs audit procedures to obtain the required amount of assurance for each error condition.

- 8.4.3** Sometimes, though, the determination of a monetary error, a compliance with authority violation or an internal control deviation is not all that straightforward. For example, the auditor may be confronted with:
- a) Some doubt as to the substance of the transaction.
 - b) Some doubt as to whether a particular transaction is adequately supported.
 - c) Conflicting audit evidence affecting the transaction being audited or the test being performed. For example, one entity official may provide the auditor with information that is inconsistent with information provided by another entity official.
 - d) Some doubt as to whether the entity's explanation for a significant fluctuation identified in an analytical procedure adequately explains the fluctuation.
 - e) Vaguely worded legislation or other authorities that make it difficult to determine precisely what is required.
 - f) Errors that are subsequently detected by entity officials.
- 8.4.4** As an example of (f), consider an overpayment to a supplier. Entity officials may have identified the error and requested a reimbursement from the supplier. In this case, there may or may not be a monetary error in the accounts, depending on the whether:
- a) overpayment had been reimbursed by year-end; or
 - b) The accounting policies being followed would not consider this to be a monetary error even if the overpayment had not been reimbursed.
- 8.4.5** Similarly, while the internal controls over the original payment may have failed to prevent the overpayment from occurring, the entity may have had other controls that ultimately detected the overpayment. If that was the case, the auditor may conclude that there is no weakness in the overall internal control structure. On the other hand, if the overpayment has been brought to light by the supplier notifying the entity of the overpayment, then the auditor would conclude that there is a weakness in the internal control structure.
- 8.4.6** Such matters should be resolved by discussing all potential errors and deviations with entity officials. In fact, given the impact that a monetary error in one small transaction can have on the most likely error and the upper error limit, it is prudent to discuss all errors and deviations with entity officials no matter how clear cut they are from the auditor's perspective.

Concluding on the Results of Each Test of Internal Control

- 8.4.7** The auditor should reach a conclusion on a test of an internal control sample by determining the number of internal control deviations (violations of specific internal controls) in the sample, and the maximum possible deviation rate, and then comparing the maximum possible deviation rate to the tolerable deviation rate.
- 8.4.8** Should the maximum possible deviation rate be less than or equal to the tolerable deviation rate, the auditor can place the desired level of reliance on the control.

8.4.9 Should the maximum possible deviation rate exceed the tolerable deviation rate, the auditor reduces reliance on the internal control, and obtains additional assurance through other procedures. The auditor may also have other options, as discussed below.

8.4.10 Suppose the auditor selects a sample of 42 supplier invoices and finds 2 internal control deviations – 2 supplier invoices that are not properly approved. The auditor can use a CAATs to arrive at a maximum possible deviation rate of 12.18%. Since the tolerable deviation rate was 9%, this is an unacceptable result. The process for doing this is described in Appendix B.

Analytical Procedures

8.4.11 The auditor should investigate significant fluctuations identified by analytical procedures and evaluates the results. Appendix E provides details of the process.

8.4.12 If the investigation is completed successfully, the auditor will have obtained the desired amount of assurance from the analytical procedure.

8.4.13 If the investigation is not completed successfully, the auditor will normally not have obtained the desired amount of assurance from the analytical procedure, and will need to obtain additional assurance through other procedures. The auditor may have other options as discussed below.

Substantive Tests of Details

8.4.14 As described above, the auditor should determine the known error, the most likely error and the upper error limit, and then compares the upper error limit to the materiality amount to determine if there is the required amount of assurance.

8.4.15 Should the upper error limit be less than or equal to the materiality amount, the auditor can obtain the desired amount of assurance from the procedure.

8.4.16 Should the upper error limit exceed the materiality amount, the auditor's results are not acceptable. In this case, the auditor has several options, all of which are discussed below.

8.4.17 It should also be noted that, as discussed in Appendix B, the auditor can follow the same procedures to determine a most likely error and an upper error limit whether using statistical or non-statistical sampling. GAAS in many countries requires the auditor to determine an upper error limit regardless of the sources of audit assurance.

Combine the results of each individual test to reach a conclusion

8.5 Concluding on the results of each component

Consider the results of tests and use professional judgement to estimate the most likely error

- 8.5.1** Having concluded on the results of each individual test of internal control, analytical procedure and substantive test of details, the auditor must combine these results to reach a conclusion on the component being audited.
- 8.5.2** If the auditor is faced with numerous monetary errors, compliance with authority violations and/or internal control deviations, the auditor may first wish to reach a conclusion on each specific financial audit objective and compliance with authority objective within each component, as opposed to reaching a conclusion on the whole component.
- 8.5.3** Note that the same terminology and process is used for compliance with authority violations, internal control deviations and monetary errors.

Determining the Most Likely Error and Upper Error Limit

- 8.5.4** The auditor should consider the results of all tests of internal control, analytical procedures and substantive tests of details and use professional judgment to estimate the most likely error and the maximum possible error in the component.
- 8.5.5** If the results of all of the auditor's procedures are consistent with each other, this may not be difficult. For example, assume the auditor has:
- a) concluded that the applicable internal controls are functioning well enough to prevent and detect material error;
 - b) not found any significant fluctuations through analytical procedures; and
 - c) has an upper error limit from substantive tests of details that is less than the materiality amount.
- 8.5.6** In this case, the auditor may conclude that the most likely error and the upper error limit determined from his substantive tests of details are the best estimates of the most likely error and the upper error limit in the component as a whole.
- 8.5.7** Sometimes, though, the auditor is faced with conflicting audit evidence. Suppose the auditor's analytical procedures indicate that material error exists in a particular component, while the auditor's substantive tests of details indicate that there are no errors in the component.
- 8.5.8** In this case, it is not appropriate for the auditor to ignore the results of his/her analytical procedures and to conclude that the most likely error in the component is Rs. nil. 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.
- 8.5.9** One way to resolve conflicting audit evidence is to seek input from entity officials. Entity officials may be able to provide the auditor with additional information that helps to explain the fluctuation identified by the analytical procedures.

- 8.5.10** As a second example, consider the reverse situation – the auditor’s analytical procedures indicate that material error does not exist in a particular component, while the auditor’s substantive tests of details indicate that material error does exist in the component.
- 8.5.11** Again, it is not appropriate for the auditor to ignore the results of analytical procedures. The auditor may, in fact, have a substantive sample that is not representative of the population.
- 8.5.12** To resolve the conflicting audit evidence the auditor could ask entity officials to perform a detailed investigation of the specific errors identified by the auditor, or of the entire component to determine the actual error in the component.
- 8.5.13** The auditor should not take any assurance from the affected audit procedures until such time as the conflicting audit evidence is satisfactorily resolved. To do so would be to ignore evidence that indicates that the results of at least one of the procedures is not correct, or that there are causes of the errors that are yet to be identified.

Reaching the Conclusion

- 8.5.14** The comparison that the auditor performs at the end of this stage of the evaluation process is essentially the same as the comparison that the auditor makes when evaluating the results of an individual substantive test of details. If the upper error limit is less than or equal to the materiality amount, the results are acceptable. If the upper error limit exceeds the materiality amount, the results are unacceptable.
- 8.5.15** If the most likely error in the component is larger than the expected aggregate error that was allowed for when planning the audit then, as a general rule, the upper error limit will exceed the materiality amount.
- 8.5.16** The auditor can follow the same procedures to determine a most likely error and an upper error limit when using statistical or non-statistical sampling.

Case Study

- 8.5.17** The process followed by the auditor in evaluating the audit results of a financial attest audit can be explained by the use of an example.
- 8.5.18** Consider a small independent power production plant (with separate financial statements) within the overall operation of WAPDA.
- 8.5.19** Revenue is obtained from the sale of electricity. The expenditures on diesel fuel, equipment and other production expenses are recorded separately from other expenditures such as administration. The storage of diesel fuel is the main component of year-end inventory.

8.5.20 Auditors have identified overstatements of the production expenditure amount and the accounts payable amount, but have found the year-end inventory amount to be correct. Assume no other monetary errors are found in the cost of sales amount, and that there is no conflicting audit evidence that needs to be resolved.

8.5.21 Following the approach described above, the auditor would conclude that the most likely error and the upper error limit determined from the substantive test of details are the best estimates of the most likely error and the upper error limit in the cost of sales.

8.5.22 The auditor would have the results shown below.

Figure 8.2: Error evaluation for Production Expenditure

	Overstatements	Understatements
Most likely error (MLE)	1,540,150	nil
Basic precision (BP)	1,644,040	1,644,040
Precision gap widening (PGW)	400,660	nil
Total of MLE, BP and PGW	3,584,850	1,644,040
(Less): "Opposing" MLE	(nil)	(1,540,150)
Net UEL in component	3,584,850	103,890

Amount in Rs

8.5.23 As materiality is Rs. 3,000,000, this is an unacceptable result for this component, which must be taken into consideration when concluding on the financial statements as a whole.

8.6 Concluding on the financial statements as a whole

Combine results to reach a conclusion on the financial statement

8.6.1 Once the auditor has drawn conclusions from the results on each individual component, he or she must now combine the results to reach a conclusion on the financial statements as a whole.

8.6.2 As with reaching a conclusion on each component, conflicting audit evidence may arise. For example, the auditor may have concluded that the most likely errors in several expenditure components were negligible but that the most likely error in another expenditure component was close to materiality. If all of the expenditure components are subject to the same basic internal control structure, the auditor should investigate why the most likely error in the one component is so significantly different than the most likely errors in the other components.

8.6.3 Determining the Most Likely Error and Upper Error Limit

8.6.4 The basic rules are as follows:

- a) For most likely errors – Net all overstatements and understatements;
- b) For basic precisions – Use the largest basic precision for each of overstatements and understatements; and
- c) For precision gap widenings – Add all precision gap widenings for each of overstatements and understatements.

8.6.5 The above process results in a very conservative overall error evaluation. This is because the largest basic precision for each of overstatements and understatements is being used, and because the sum of the precision gap widenings will almost always be much higher than if the entire financial statements were treated as one population and one overall sample had been taken.

8.6.6 To illustrate, assume the auditor has obtained the results shown below.

Figure 10.3: Error Evaluation for Financial Statements – Results for Revenue and Expenditure Components

Amount in Rs.

Audit Area	MLE	BP	PGW	UEL
Revenue				
Overstatements	180,000	920,000	90,000	1,190,000
Understatements	20,000	920,000	10,000	950,000
Production Expenditures				
Overstatements	1,540,150	1,644,040	400,660	3,584,850
Understatements	Nil	1,644,040	nil	1,644,040
Other expenditures				
Overstatements	Nil	1,280,000	nil	1,280,000
Understatements	700,000	1,280,000	220,000	2,200,000

8.6.7 When performing the evaluation on the financial statements as a whole, the auditor needs to ensure that a common base is used when adding overstatements and understatements. The common base normally used in a Government context is a percentage of total expenditures. When using these bases, overstatements of revenues and understatements of expenditures would be added together as they would both overstate net income and residual equity.

8.6.8 Following the basic rules in paragraph, we would obtain the results in Figure 10.4 for the Statement of Revenue and Expenditure:

Figure 10.4: Error Evaluation for Financial Statements – Overall Results for Statement of Revenue and Expenditure

Amount in Rs.

Audit Area	Understatements in Net Income	Overstatements in Net Income
Most likely error (MLE):		
Revenue	20,000	180,000
Production Purchases	1,540,150	Nil
Other expenditures	Nil	<u>700,000</u>
Total MLE	<u>1,560,150</u>	<u>880,000</u>
Basic precision (BP) (largest)	<u>1,644,040</u>	<u>1,644,040</u>
Precision gap widening (PGW):		
Revenue	10,000	90,000
Production purchases	400,660	Nil
All other expenditures	<u>Nil</u>	220,000
Total PGW	<u>410,660</u>	<u>310,000</u>
Total of MLE, BP and PGW	3,614,850	2,834,040
(Less): “Opposing” MLE	(880,000)	(1,560,150)
Net UEL in net income	<u>2,734,850</u>	<u>1,273,890</u>

- 8.6.9** As materiality is Rs. 3,000,000 we would appear to have acceptable results. However, this is not the case. We still need to deal with the unacceptable results for production expenditures.
- 8.6.10** This is why the auditor needs to reach a conclusion on each component before doing an evaluation of the financial statements of a whole. Potentially material errors in one component may be “hidden” by offsetting errors in other components.
- 8.6.11** The same schedule as above would also be prepared for errors in the asset and liability accounts to come up with an overall error evaluation for the balance sheet and for the financial statements as a whole.

Evaluating the Overall Financial Statement Presentation and the Reasonableness of the Overall Results

- 8.6.12** At the end of the evaluation phase, the auditor needs to step away from the mathematical calculations, the theory and the detail, and establish whether:
- a) The overall financial statement presentation – both the amounts and the disclosures – properly presents, in all material respects, the government’s financial position, the results of its operations, its cash flows and its expenditures 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.
- 8.6.13** Where the auditor believes that they do not, he/she would need to estimate what changes are required to the recorded amounts and/or to the financial statement disclosures to deal with his/her concerns.

Assessing the Achieved Level of Assurance

- 8.6.14** At the end of evaluation phase, the auditor also needs to determine whether the audit supports the desired level of overall audit assurance.
- 8.6.15** If, for example, control risk is assessed as “low” at the general planning phase but numerous internal control deviations or monetary errors are found during the fieldwork phase, then the assessment of control risk may need to be revised.
- 8.6.16** Similarly, the auditor may need to reconsider the assessment of inherent risk. If, for example, inherent risk is assessed as “low” but numerous monetary errors are found during the fieldwork phase, then the assessment of inherent risk may also need to be revised.
- 8.6.17** The Standard Audit Working Papers Kit contains an “Achieved Level of Assurance Form” that can be used to assist the auditor in this process.

8.7 Dealing with unacceptable results

- 8.7.1** Where the evaluation of audit work provides unacceptable or ambiguous results, the auditor must determine a course of action. Actions to be taken in different circumstances are described below.
- 8.7.2** Most likely error less than materiality; upper error limit greater than materiality
- 8.7.3** In this case, the auditor has four potential options:
- Increase the materiality amount;
 - Increase the sample size;
 - Request entity officials to record a correcting entry; or
 - Request entity officials to perform a detailed investigation and then re-audit.
- 8.7.4** Each is discussed in turn.
- 8.7.5** *Increase the materiality amount.* In our case study, materiality was set at Rs. 3,000,000. However, determination of materiality is not an exact science, but instead depends on the auditor's professional judgment. As such, setting materiality at Rs. 3,000,000 does not necessarily mean that an upper limit of Rs. 2,999,000 (or somewhat less) is always acceptable, or that an upper error limit of Rs. 3,001,000 (or somewhat more) is always unacceptable.
- 8.7.6** The margin of variance around the materiality amount is a matter of judgment. As a rule of thumb increasing the materiality amount by 25% would normally be considered acceptable, and increasing the amount by as much as 50% may be acceptable in some cases.
- 8.7.7** In our case study, our upper error limit for overstatement errors in cost of sales was Rs. 3,584,850 – only 19.5% more than the Rs. 3,000,000 materiality amount. In this case, the auditor may decide that the Rs. 3,584,850 really is not material, and that the results are acceptable.
- 8.7.8** *Increase the sample size.* Assuming that the original sample is representative of the population, it is unlikely that increasing the sample size will change the auditor's estimate of the most likely error. However, increasing the sample size will normally decrease both basic precision and precision gap widening.
- 8.7.9** Increasing the sample size can result in the auditor performing a lot more work and still having unacceptable results. Therefore, the auditor should only use this option when:
- The most likely error is significantly less than the materiality amount; and
 - The upper error limit is only slightly higher than the materiality amount.
- 8.7.10** In the example, the most likely error is more than 50% of the materiality amount. Therefore, it is unlikely that this approach would work.
- 8.7.11** At the same time, the upper error limit is 33.7% higher than the materiality amount. Therefore it is unlikely that increasing the sample size would work. This leads to a third option.

- 8.7.12** *Request entity officials to record a correcting entry.* The most likely error and the upper error limit can be decreased by the amount of any corrections made by entity officials. Should the adjustment be large enough, it may result in the upper error limit dropping below the materiality amount. Care must be taken when choosing this option. If the correction is made across the whole population and not just for the case within the sample (where the type of error can be recognised and corrected everywhere) then this is acceptable. Otherwise, even where the sample has been corrected there is no assurance that the same problem does not persist elsewhere. As a minimum, the auditor should take another sample and repeat the test.
- 8.7.13** In our example, if entity officials were to make a correcting entry to decrease the production costs by Rs. 1,540,150 – the amount of the most likely error – the upper error limit would be reduced to Rs. 2,044,700. This is much less than the Rs. 3,000,000 materiality amount.
- 8.7.14** Entity officials will rarely make an adjustment based on a most likely error. They will usually only be prepared to adjust for known errors. In our example, this would only reduce the upper error limit from Rs. 3,584,850 to Rs 3,580,850 – a negligible change. In this event, the next option is appropriate.
- 8.7.15** *Request entity officials to perform a detailed investigation, and then re-audit.* As noted above, entity officials will usually only be prepared to adjust for known errors. Therefore the auditor needs to get entity officials to perform a detailed investigation of the transactions in the population in order to arrive at a more accurate estimate of the error in the component. The auditor should then re-audit the component and request entity officials to record a correcting entry for the known error.
- 8.7.16** In our example, entity officials might perform a detailed investigation and conclude that cost of sales were overstated by Rs. 1,400,000, and make a correcting entry for that amount. The auditor would then audit the work done by the officials and reach his/her own conclusions as to the most likely error and upper error limit remaining in the component.
- 8.7.17** Most Likely Error Greater Than Materiality
- 8.7.18** Where MLE exceeds materiality, increasing the materiality amount and increasing the sample size would normally not result in acceptable results. Only two of the options listed above are available to the auditor. They are:
- a) Request entity officials to record a correcting entry; and
 - b) Request entity officials to perform a detailed investigation and then re-audit.
- 8.7.19** If neither of these options is possible, the auditor should qualify the audit opinion.

Unacceptable Results for Tests of Internal Control

- 8.7.20** Assume the auditor selects a sample of 44 supplier invoices and finds 2 internal control deviations – 2 supplier invoices have not been properly approved. This gives a most likely deviation rate of 4.55% (2 divided by 44). The auditor then uses CAATs to arrive at an upper error limit frequency (maximum possible deviation rate of 12.11%. If the upper error limit (tolerable deviation rate) selected is 9%, this is an unacceptable result.
- 8.7.21** In this case, the auditor normally needs to reduce reliance on the internal control structure. There are three other potential options the auditor can consider:
- Increase the upper error limit;
 - Increase the sample size; or
 - Request entity officials to perform the “missing” controls, adjust the books for all identified errors, and audit the work performed.
- 8.7.22** Each is discussed below.
- 8.7.23** *Increase the upper error limit.* This is equivalent to increasing the materiality amount in the case of monetary errors, and the preceding discussion relating to increasing the materiality amount also applies here to increasing the tolerable deviation rate.
- 8.7.24** *Increase the sample size.* Assuming the original sample was representative of the population, it is unlikely that increasing the sample size would change the auditor’s estimate of the most likely deviation rate, but could decrease the maximum possible deviation rate.
- 8.7.25** Increasing the sample size could result in the auditor performing a lot more work and still having unacceptable results. Therefore, the auditor should normally only make use of this option when:
- The most likely deviation rate is significantly less than the upper error limit; and
 - The maximum possible deviation rate is only slightly higher than the upper error limit.
- 8.7.26** In our example, the most likely deviation rate is more than 50% of the tolerable deviation rate, and maximum possible deviation rate is 34.6% higher than the upper error limit. Therefore, increasing the sample size would most likely not lead to acceptable results.
- 8.7.27** Request entity officials to perform the “missing” controls, adjust the books for all identified errors, and audit the work performed.
- 8.7.28** The deviation rate can be decreased by the amount of any corrections made by entity officials. Should the adjustment be large enough, it may result in the deviation dropping below the tolerable deviation rate.

8.7.29 Entity officials will usually only be prepared to adjust for known errors. Therefore the auditor should re-audit the component and request entity officials to record a correcting entry for the known error. Nevertheless, correction of internal controls does not alter the fact that the transactions throughout the population as a whole are likely to have been subject to inadequate controls prior to the correction resulting in both identified and unidentified errors.

Unacceptable Results for Analytical Procedures

8.7.30 The auditor should perform and evaluate analytical procedures to:

- a) Determine the threshold amount (the amount above which a difference is considered to be significant);
- b) Identify significant fluctuations;
- c) Investigate the significant fluctuations found; and
- d) Conclude as to whether entity officials have adequately explained all significant fluctuations.

8.7.31 Appendix B provides details of the process.

8.7.32 The threshold amount in (a) is normally set at a percentage of planned precision. Fluctuations are normally considered to be adequately explained when the unexplained portion is less than one-half the threshold amount.

8.7.33 If the amount cannot be adequately explained, or the auditor cannot obtain audit evidence to substantiate the explanation, the auditor must reduce his/her reliance on the analytical procedure. There are, though, two other options, as follows:

- a) Increase the threshold amount; and/or
- b) Request entity officials to perform further follow up, adjust the books for all identified errors, and audit the work performed.

8.7.34 Each is discussed in turn.

8.7.35 *Increase the threshold amount.* This could be done by increasing the materiality amount (and hence planned precision) or by increasing the percentage of planned precision used to determine a significant fluctuation. This could result in some unexplained differences becoming immaterial fluctuations, or inadequate explanations now being sufficient.

8.7.36 This option is equivalent to increasing the materiality amount. The arguments for increasing the materiality amount can also be used to increase the threshold amount.

8.7.37 Request entity officials to perform further follow up, adjust the books for all identified errors, and audit the work performed. In the case of analytical procedures, this option will rarely work. This is because entity officials should already have attempted to explain all significant fluctuations, and attempted to substantiate their explanations.

8.8 Dealing with acceptable results

- 8.8.1** Given the impact that a monetary error in one small transaction can have on the most likely error and the upper error limit, it is prudent to discuss all errors and deviations with entity officials no matter how clear cut they are from the auditor's perspective.
- 8.8.2** The auditor has another reason for discussing all errors with entity officials – getting entity officials to investigate and correct for all monetary errors found by the auditor. This should not only include investigating and correcting the known errors, but also investigating the accuracy of the auditor's most likely error, and making a correction for the determined amount.
- 8.8.3** This investigation should be done even when the results are acceptable. There are two reasons for this:
- a) Entity officials should be interested in having their accounts as accurate as possible. Investigating and correcting for all errors will help to achieve this.
 - b) Errors that affect a closing balance in one year may affect the related opening balance for the following year. When combined with errors found in the subsequent year, the result may be a material error in the following year's financial statements.
- 8.8.4** To illustrate point (b) assume:
- 8.8.5** A Rs. 1,540,150 overstatement error in costs is caused by recording some of the following year's expenditures in the current year. This will result in an understatement of the purchases in the following year.
- 8.8.6** When doing the following year's audit, the auditor identifies other understatement errors in costs, and estimates the most likely error of these other errors to be Rs. 1,100,000.
- 8.8.7** In this case, if the Rs. 1,540,150 is not adjusted for in the first year, the most likely understatement error in the second year will be Rs. 2,640,150 (Rs. 1,540,150 plus Rs. 1,100,000). This will likely result in an upper error limit significantly larger than the Rs. 3,000,000 materiality amount.
- 8.8.8** On the other hand, if the Rs. 1,540,150 had been adjusted for in the first year, the most likely understatement error in the second year would be Rs. 1,100,000, which would probably result in an upper error limit less than the materiality amount.

8.9 Documenting the evaluation process

- 8.9.1** The Standard Audit Working Papers Kit includes a Summary of Unadjusted Differences. This is a series of forms that can be used to:
- a) Document individual monetary errors and compliance with authority violations;
 - b) Calculate errors in each component and in the financial statements as a whole; and

- c) Determine the amount of such compliance with authority violations as:
 - i) Errors in the amount reported for authority available;
 - ii) Errors in the amount reported for excess or saving;
 - iii) Vote over-expended but not so reported; and
 - iv) Spending for purposes not authorised.

8.9.2 The Summary of Unadjusted Differences does not include a component to show the determination of the most likely error and the upper error limit for individual substantive tests of details, or the most likely deviation rate and the maximum possible deviation rate for individual tests of internal control. This is because the easiest way to document these calculations is to print out the error evaluation forms produced by CAATs.

8.9.3 However, to prepare for circumstances where manual calculations are required, the Standard Audit Working Papers Kit contains standard forms that can be used for this purpose.

8.10 Evaluating Regularity Audit Results

8.10.1 The auditor does not need an accurate prediction of the extent of irregularities, but wants to know:

- a) whether the occurrence of irregularities is low enough to be ignored, is sufficiently serious to be brought to the attention of management and Parliament or is so serious that immediate corrective actions are required;
- b) what factors have contributed to the irregularities, particularly internal control weaknesses that have to be corrected; and
- c) the impact of the irregularities (these may be (i) minimal where the rules that have been broken are of a preventive nature but no consequences occurred; (ii) serious wastage and misappropriation of funds; and in the most serious case, (iii) loss of Parliamentary control).

8.10.2 Thus the auditor needs to be able to judge how the irregularities occurred and what impact they have had on propriety and the financial and operational performance of the entity.

8.10.3 A series of minor infractions in themselves are not worthy of reporting. However, if a pattern can be detected, individual minor findings may indicate a more serious problem at a higher level. For example many minor miscalculations in payroll may not amount to very much money. The fact that there are errors in the way payroll is calculated can indicate a lack of proper supervision of the payroll section, thus putting the controls over payroll in a situation of high risk. In that situation, the audit finding is not miscalculations of pay but inadequate internal controls over the management of the payroll section.

- 8.10.4** The audit of individual transactions is not an end in itself. The auditor must identify the underlying causes of the irregularities identified. Determining the causes is not always easy. Often a combination of weaknesses contributes to the breakdown of proper procedures. A high turnover of staff combined with a lack of documented procedures could result in inadequate controls although the lack of one or the other in itself might not be problem. The experience and the judgment of the auditor is critical in getting to the underlying causes of the observed irregularities. Hence, it can be seen that just observing and documenting the irregularities is not the end of the audit process.
- 8.10.5** Sometimes the audit programme has to be adjusted during or at the end of the audit to follow up on control weaknesses not anticipated at the start of the audit. Further audit work to identify the causes and impact of the irregularities discovered is far more important than increasing the sample size to determine the extent of the weaknesses. In fact, it is management's responsibility to determine the extent of the problem. The auditor's responsibility is to draw management's attention to the need to improve the internal controls.
- 8.10.6** To identify the impact of the problem, the auditor may decide to take a larger sample to identify the seriousness of the problem. This decision is up to the judgment of the auditor. Senior management within the DAGP may request further work in order that the Auditor-General is able to comment on the extent of the problem discovered. In some cases, other audit teams involved in auditing other parts of the government may be asked to conduct the same type of audit to determine how widespread is the practice of irregularities discovered within one department or entity.

8.11 Quality assurance during the evaluation phase

Professional judgement is required during the evaluation

- 8.11.1** Considerable professional judgment is required during the evaluation phase. Every step, from the identification of what is a monetary error, a compliance with authority violation, or an internal control deviation, through to the evaluation of the financial statements as a whole and the resolution of unacceptable results, requires this judgment. If the judgment is not appropriate, the auditor could issue an incorrect opinion on the financial statements.
- 8.11.2** Therefore, it is critical that there is a detailed review and approval of:
- All monetary errors, compliance with authority violations and internal control deviations found, and the assessment of their causes;
 - The calculation of the most likely error and the upper error limit for each test;
 - The calculation of the most likely error and the upper error limit for each component;
 - The calculation of the most likely error and the upper error limit for the financial statements as a whole;
 - The assessment of the overall financial statement presentation and the reasonableness of the overall results;
 - The assessment of the achieved level of assurance;

- g) The documentation supporting the discussion of the results of the error evaluation with entity officials;
- h) The follow-up work performed by entity officials; and
- i) How unacceptable results were dealt with.

8.11.3 Given the importance of this phase, the Director or Director General responsible for the audit should perform this review and approval.

9 THE REPORTING PROCESS

9.1 Introduction

- 9.1.1 There are different reports that may result from a completed audit.
- 9.1.2 Reports for Certification purposes are generally brief and follow a standard format for the type of opinion to be delivered.
- 9.1.3 Reports on management controls (identifying control weaknesses), compliance with laws, regulations and administrative procedures, and on the performance of the organisation require more developed writing and reporting skills.
- 9.1.4 Irrespective of the type of audit report, the main measure of the performance of the DAGP is the quality and usefulness of the reports produced by the Office. The reports bring together the professional knowledge and professional judgment of the auditors. Therefore, audit reports have to be well written and substantiated, and developed in accordance with a formal process, as described in this Chapter.
- 9.1.5 Prior to reporting, during the evaluation phase of the audit, the auditor should have sought the agreement of entity officials with respect to:
- The extent and cause of each monetary error; and
 - The extent and cause of each compliance with authority violation and internal control deviation.
- 9.1.6 The auditor will also have reached a conclusion on the results of each test, on each component, and on the financial statements as a whole, and dealt with any unacceptable results.
- 9.1.7 In the reporting phase, the auditor performs some final quality assurance procedures, concludes on the type of audit opinion to issue, and then drafts and issues the opinion. The auditor may also issue audit reports and management reports.
- 9.1.8 DAGP's Auditing Standards use the term "opinion" to refer to the auditor's conclusions as to whether:
- the financial statements properly present, in all material respects, the government's financial position, the results of its operations, its cash flows and its expenditures and receipts by appropriation; and
 - 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.
- 9.1.9 The word "report" refers to DAGP's other products.

Audit reports have to be well written and substantiated.

9.1.10 DAGP's reporting standards are contained in paragraph 4.0.7 of DAGP's Auditing Standards. They are:

- a) At the end of each audit the auditor shall prepare a written opinion or report, as appropriate, setting out the findings in an appropriate form; its content should be easy to understand and free from vagueness or ambiguity, include only information which is supported by competent, reliable, and relevant audit evidence, and be independent, objective, fair and constructive.
- b) It is for the Department of the AGP to decide finally on the action to be taken in relation to fraudulent practices or serious irregularities discovered by the auditors.

9.1.11 An audit report (a report that is made public or that is presented to the appropriate public accounts committee or other external party) will be signed by the Auditor-General, the Deputy Auditor General (Senior) or the responsible Deputy Auditor General.

9.1.12 Management reports (reports addressed to entity officials) will be signed by the responsible Director General.

9.2 Focus on the Reporting Process

Writing the report, cross referencing and finalising the working paper files, is time

9.2.1 The reporting stage of the audit often takes longer than estimated. The process of writing the report, cross referencing to the working paper files and finalising the working paper files, is time consuming. The auditor has to allow time for managers to review the draft report. There should also be an extensive review process within the DAGP to ensure:

- a) a high quality report, with clear, unambiguous messages; and
- b) the existence of sufficient evidence to support the wording contained within the report.

9.2.2 A way of reducing the time taken to complete the audit report is to start writing the report as early as possible during the audit. The effort of putting down the points to be reported also helps to focus the analysis and identify whether sufficient evidence has been collected or whether more evidence is required.

9.2.3 Preparation for a mid-point review meeting, or for other review meetings, can help to focus the message that will eventually be contained in the report.

9.2.4 At the end of the reporting process, it is important that the audit is finalised with completed working papers. At the end of the audit, an Audit Completion Checklist should be completed.

9.3 Clearing Observations, Conclusions and Recommendations

Before the auditor can publish findings or an opinion, audit observations, conclusions and recommendations must

- 9.3.1** Before the auditor can publish a report on findings or an opinion on financial statements, the audit observations, conclusions and recommendations must be cleared with entity management.
- 9.3.2** This is accomplished by briefing entity management on audit findings and documenting their responses, which can also provide additional audit evidence. This process can be based on formal written statements or verbal briefings.
- 9.3.3** The auditor should make best efforts to obtain a sound understanding of the operations and to obtain sufficient evidence to support findings. Nevertheless, at the initial stages of clearing observations, not all observations may be complete or accurate. Where findings are refuted, or modified by the manager's response further evidence may be sought to substantiate the manager's assertions.
- 9.3.4** It is normal to clear the observations up the management chain, briefing lower level managers and confirming the auditor's understanding before briefing more senior managers. When visiting an entity's local office, it is usual to brief the senior manager before leaving the site.
- 9.3.5** The auditor should take detailed minutes of these briefing meetings. The auditor may send a copy of these notes to the manager for confirmation.
- 9.3.6** When there is a significant difference between what the auditor would expect to see and the findings, the auditor should discuss this with management to determine the reasons and then decide whether the expectations are still appropriate in the particular circumstances. The auditor should conclude whether management has fallen short or whether the expectations were unreasonable in the context.
- 9.3.7** In developing recommendations, the auditor can explore options with management through this process before including them in the draft report. The auditor should ensure it is clear that the conclusions and recommendations are preliminary at this time.
- 9.3.8** The effectiveness of the communication of the contents of an audit report is influenced by:
- a) Facts;
 - b) Opinions; and
 - c) Wording.
- 9.3.9** In clearing the report, the auditor should first, ensure there is agreement on the facts. The auditor should recognise that in addition to the facts, there are opinions. For example, a fact may be that there is no control in place. Whether there should be a control in place is an opinion, even if it is a generally accepted accounting practice. Much of the conflict between the entity management and the auditor is over wording. The auditor should be careful when making generalised statements or using adjectives that could be considered to exaggerate a finding.

9.4 Obtaining Management Responses

- 9.4.1 When clearing audit queries, or getting management responses to the draft report, the auditor needs a timely response.
- 9.4.2 To encourage this, the auditor should establish a date for discussing the material or indicate by what date the auditor would like to receive the response. A reasonable time should be allowed management to respond.
- 9.4.3 When management of the entity fails to provide a response as requested, the auditor should consult with senior DAGP management and draft a letter for the signature of the AG, informing the management of the entity that if a response is not provided by a given date, usually two weeks from the date of the letter, the DAGP assumes that the management of the entity have no disagreements with the contents of the report and that the DAGP will proceed to publish the report.
- 9.4.4 There are often multiple briefings to entity management, clearing each area with the respective manager(s) and then briefing the senior manager on the total audit. If there are no briefings to lower managers or if all involved managers are going to meet together, it is advisable to make sure that managers are aware of the findings in their area before other managers hear about them. Even a briefing by phone is preferable to no briefing at all. This is consistent with a “no surprises” style of audit.

There are often multiple briefings to entity management.

9.5 Management representation letter

- 9.5.1 Entity officials in each ministry, department, agency, etc. are responsible for the completeness and accuracy of the financial statements or, in the case of the financial statements of the Federation, the provinces and the districts, their portion of the financial statements. In addition, entity officials have often provided the auditors with numerous pieces of information – both verbally and in writing – during the course of the audit.
- 9.5.2 The auditor prepares the management representation letter to have entity officials acknowledge, in writing, their responsibility for the completeness and accuracy of the financial statements (or their portion thereof), and for the representations they made during the audit.
- 9.5.3 Section 7(b) of the Controller General Ordinance requires the Controller General of Accounts to “prepare and submit to the Auditor-General for each financial year a Consolidated and General Financial Statement incorporating the summary of the accounts of the Federation, all provinces and district authorities”.
- 9.5.4 Section 5(d) of the Controller General Ordinance states that one of the functions of the Controller General shall be “to lay down the principles governing the internal financial control for Government departments in consultation with the Ministry of Finance and the Provincial Finance departments as the case may be”.

Entity officials in each ministry, department, agency, etc. are responsible for the completeness

- 9.5.5** Since the Controller General of Accounts is responsible for the preparation and submission of the financial statements for the Federation, all provinces and district authorities, and for laying down the principles governing the internal control structures, the auditors should normally obtain a representation from the Office of the Controller General on the financial statements of the Federation, each province and each district. The auditors should also normally obtain a representation from the Office of the Controller General on other relevant financial statements. This representation is in addition to obtaining a representation from officials in the specific entity that they are auditing.
- 9.5.6** For audits that are coordinated by a central team, the central team could obtain the representation letter from the Office of the Controller General on behalf of all the other audit teams.

Standard Content

- 9.5.7** A sample management representation letter is included in the Standard Audit Working Papers Kit. In this letter entity officials are asked to acknowledge their responsibility for the proper presentation of the entity's financial position, results of operations, etc., and confirm, to the best of their knowledge and belief, that:
- a) all relevant information has been made available to the auditors;
 - b) they are not aware of any irregularities involving management or employees, or any violations of statutes or regulations whose effect should be recorded or disclosed in the financial statements;
 - c) specifically listed asset, liability, revenue and expenditure items are valid, complete, properly valued, etc.;
 - d) all required disclosures have been made;
 - e) there are no significant subsequent events that require recording or disclosure in the financial statements; and
 - f) there are no other matters of significance that require recording or disclosure in the financial statements.
- 9.5.8** The letter should normally be addressed to the person within DAGP who will be signing the audit opinion (the Auditor-General, the Deputy Auditor General (Senior) or the responsible Deputy Auditor General).
- 9.5.9** The letter should normally be signed by the:
- a) Head of the Organisation;
 - b) Principal Accounting Officer;
 - c) Financial Advisor; and
 - d) Finance and Accounts Officer.
- 9.5.10** For exempt entities, officials performing the equivalent functions would sign the representation letter.
- 9.5.11** It is possible that more than one letter will be required on each audit. First, as discussed above, for the audits of the financial statements for the Federation, the provinces and the districts, the auditors should normally seek a representation from the Office of the Controller General in addition to officials in the specific entity that they are auditing.

Entity officials are asked to acknowledge their responsibility for the proper presentation of the entity's financial

- 9.5.12** Furthermore, separate representations may also be required from entity officials at several different locations within the entity.
- 9.5.13** The auditor needs to ensure that, if multiple representations are being used, all significant matters are covered off in the representations, and that at least one senior official is taking responsibility for each representation.

Preparation and Clearance of the Letter

- 9.5.14** The auditor should review the letter of representation contained in the Standard Audit Working Papers Kit to ensure that it is appropriate for the entity. The auditor should make whatever changes are considered necessary, including adding any representations that he/she believes should be added.
- 9.5.15** The auditor should then discuss the draft letter with entity officials. This should be done well in advance of the deadline date for the letter to ensure that there will be no difficulties obtaining the required representations.
- 9.5.16** When the response is received from the officials, the auditor should ensure that any alterations made by the officials are acceptable to the auditor.
- 9.5.17** The Standard Audit Working Papers Kit includes a checklist that the auditor can use to assist in the preparation and clearance of the representation letter.

9.6 Audit completion checklist

- 9.6.1** The primary purpose of the checklist is to give assurance to the person signing the audit opinion (the Auditor-General, the Deputy Auditor General (Senior) or the responsible Deputy Auditor General) that:
- a) the Director and the Director General have reviewed the working paper files;
 - b) the audit work is complete;
 - c) sufficient appropriate audit evidence has been obtained to support the auditor's opinion;
 - d) all matters that should be reported are included in the opinion;
 - e) Either:
 - i) An unqualified opinion can be issued; or
 - ii) The auditor's opinion contains all of the required reservations; and
 - f) The auditor's opinion can be signed and released.
- 9.6.2** A secondary purpose of the audit completion checklist is to act as final review document (supervision instrument) that the Director and the Director General can use to assure themselves that all of the critical planning, fieldwork, evaluation and reporting procedures have been completed satisfactorily.

Standard Content

- 9.6.3** A sample audit completion checklist is included in the Standard Audit Working Papers Kit.
- 9.6.4** The checklist contains a series of questions concerning the entire audit process – planning, fieldwork, evaluation and reporting as well as the certification referred to above.
- 9.6.5** The checklist should be completed after all of the audit procedures have been performed. The Director and the Director General responsible for the conduct of the audit should complete it and sign it. The responsible Deputy Audit or General should then approve it.

Memorandum Supporting Signature

- 9.6.6** The audit completion checklist provides the person signing the audit opinion with the assurances about the completeness of the audit process noted above. However, the checklist does not provide any details concerning the contents of the financial statements or the audit process itself.
- 9.6.7** The memorandum supporting signature provides the person signing the audit opinion with this additional information.

Standard Content

- 9.6.8** The Standard Audit Working Papers Kit contains a table of contents for a typical memorandum supporting signature.
- 9.6.9** As indicated from the table of contents, the memorandum normally contains a discussion of:
- a) Any reservations being expressed in the auditor’s opinion;
 - b) Contentious matters on which DAGP decided not to express a reservation;
 - c) Significant changes made to the form and content of the financial statements;
 - d) Significant changes made to the accounting policies used to prepare the financial statements, and their impact on the financial statement amounts and disclosures;
 - e) Explanations for the more significant fluctuations in each asset, liability, revenue and expenditure account;
 - f) Significant changes to the basic planning parameters (materiality, audit risk, etc.);
 - g) Significant changes to the audit approach (for example, significantly increasing or decreasing reliance on the internal control structure for a particular component);
 - h) Any difficulties encountered during the conduct of the audit, and how they were resolved; and
 - i) A summary of the amounts contained on the Summary of Unadjusted Differences.

9.7 Producing the Audit Report

- 9.7.1 The auditor should prepare a draft opinion and audit report which will be issued to entity management after they have been briefed.
- 9.7.2 If there are any especially controversial matters, or matters with broad policy implications, it may be appropriate to brief the AG prior to issuing the draft report.
- 9.7.3 There will likely be a greater reaction to the draft report than was raised during the briefing. Much of the concern may be in response to specific wording and a desire for a different balance in the presentation of the findings. If the clearing process was well conducted, there should not be much debate regarding the facts unless the managers involved had not been forthcoming or had not taken the process seriously.
- 9.7.4 Sometimes, entity management may have taken corrective actions by the time the observations are reported. In this case the auditor has two options. Either the comments of management may be acknowledged and included in the report (with or without verifying the accuracy of the statements) or after verifying that the corrective action has been taken, the observation may be dropped.
- 9.7.5 The auditor also has to prepare a report or audit note for the Annual Report. This is usually much briefer than the full report to management. Alternatively, the auditor may prepare a brief audit report and use a management letter to convey the supporting details.
- 9.7.6 Details of the various opinions and reports that may be published by DAGP are provided in the next Chapter.

9.8 Review of reports by others

- 9.8.1 Once DAGP publishes an opinion and audit report, it becomes available for review by certain other parties.

Public Accounts Committees

- 9.8.2 A PAC may conduct a hearing on the matters contained in a particular audit report, which could lead to the PAC issuing its own report and recommendations on the subject. These recommendations might reinforce the recommendations contained in the audit report itself.
- 9.8.3 In preparation for a meeting of the PAC to discuss a particular report, the auditor should prepare a “Briefing Book”, or briefing file. The briefing book is described in the next Chapter, and should contain:
- a) A copy of the report (cross referenced back to the key pieces of supporting evidence;
 - b) The key evidence (including extracts of important documents with source of the documents, etc.) which should be copied from the working papers; and
 - c) Anticipated questions with pre-determined answers.

- 9.8.4** During the course of the audit, the auditor may have discovered fraudulent practices or serious irregularities that should be brought to the attention of these organisations.
- 9.8.5** The auditor may be required to provide these organisations with considerable detail regarding the irregularities and the audit work already performed, to permit the organisation to conduct an efficient and effective investigation.

Other External Parties

- 9.8.6** The contents of specific audit reports may be reported by the media, reviewed directly by the general public, etc.
- 9.8.7** These readers of the report will often have very little knowledge of the matter other than what is contained in the report itself. This makes it important that the matters dealt with in the report be very clearly described so that the readers can appreciate the significance of the matters raised, and the importance of the auditor's recommendations.
- 9.8.8** If the auditor wishes to attract the attention of the media and the general public, it is also important that the audit report be clear and concise. The use of press releases, videos, and media briefing sessions could also be beneficial.

10 THE AUDIT REPORT

10.1 Introduction

10.1.1 DAGP produces three main types of report:

- a) Financial certification report expressing an audit opinion (on the government as a whole, on an audit entity or on a major project);
- b) Individual reports on audit work focused on investigations, compliance or performance (although often these may be included as part of the certification report); and
- c) Annual Report.

10.1.2 The Auditor General's Annual Report is a key document. Every audit team has to ensure that its input for the Annual Report is produced in a timely manner; is clear and concise; and is free of any errors.

10.1.3 Much of the impact of the audits and the reputation of DAGP rests on the quality of the Annual Report and, to a lesser degree, the individual audit reports produced. Thus, the report is not only an integral part of the audit but the key to audit success.

The impact of audits rests on the quality of the Annual Report and individual audit report.

10.1.4 In an attest audit, the major concern is the reliability and fairness of the presentation of the financial facts in the financial statements. Only inappropriate accounting methods, material risks and significant misrepresentations are normally commented on. Audit observations of minor inaccuracies and errors should not be included in an audit report. A large volume of small inaccuracies or errors should be summarised as an error percentage.

10.1.5 In compliance auditing, the report should focus much more on the controls in place and the reliance that can be placed on them than on individual findings. The audit report should not list all the minor non-compliance or errors observed.

10.1.6 In the case of performance audits, a much higher proportion of the audit work gets included within the report. Further, in performance audit reports, much more explanation of the business of the entity and description of the areas examined is usually included than in the other types of audit. The auditor's expectation, or performance criteria, is often included to place the observations and conclusions in context.

10.1.7 Whatever the audit type, the same considerations apply:

- a) Audit reports should be easy for entity management to read (brief, clear and in the case of performance audits, pertinent);
- b) The Annual Report will be read by Parliamentarians, the media and the public and so should be written with a minimal technical terminology and not assume an understanding of the detailed business of the entity;
- c) The contents of the report should focus only on material and significant matters;
- d) Any assurances, conclusions and recommendations should be useful; and

Audit reports should be easy for the entity management to read.

The report

- e) All statements should be fully supported by reliable and sufficient evidence.

10.1.8 Audit reports take a very different form according to whether they are presenting an opinion on a set of financial statements; or the results of reviewing compliance and performance. These are discussed in the following sections.

10.2 The Certification Report and Types of Opinion

*The
Certification
Report follows*

10.2.1 The Certification Report is the product of the financial attestation audit work. It follows very specific standards, modified as necessary to reflect different qualifications that the auditor may wish to express.

Unqualified auditor's opinion on financial statements

10.2.2 The auditor's report on a set of financial statements is referred to as the "auditor's opinion", even though the report is often entitled "Auditor's Report". This differentiates the report from other audit reports, such as reports dealing with compliance with authority and performance matters. These other reports are discussed in a subsequent section.

10.2.3 Paragraph 4.0.9 of DAGP's Auditing Standards states, "An audit opinion is normally in a standard format, relating to the financial statements as a whole, thus avoiding the need to state at length what lies behind it but conveying by its nature a general understanding among readers as to its meaning. The nature of these words will be influenced by the legal framework for the audit, but the content of the opinion shall indicate unambiguously whether it is unqualified or qualified and, if the latter, whether it is qualified in certain respects or is adverse (paragraph 4.0.14) or a disclaimer (paragraph 4.0.15) of opinion."

10.2.4 This Auditing Standard contains several important messages. First, the auditor expresses one opinion on all of the financial statements, as opposed to having a separate opinion on each financial statement. Second, and probably more important, it is critical that the readers receive an unambiguous message.

10.2.5 For the readers to receive an unambiguous message from what is normally a very short report, it is important that:

- a) The auditor adopt a standard wording for an unqualified opinion, and only deviate from that standard wording when a reservation of opinion is being expressed; and
- b) Any reservations of opinion be very clearly expressed.

10.2.6 When expressing a reservation of opinion the auditor should not issue an opinion that deviates only somewhat from the standard wording, as the message could be ambiguous. There is a danger that casual readers will read it as an unqualified opinion. Even readers who are familiar with the standard content of an audit opinion might not be able to determine whether or not the deviation is intended to be a reservation of opinion.

When to Give an Unqualified Opinion

- 10.2.7** As discussed in Paragraph 4.0.10 of DAGP's Auditing Standards, "an unqualified opinion is given when the auditor is satisfied in all material respects that:
- a) the financial statements have been prepared using acceptable accounting bases and policies which have been consistently applied;
 - b) the statements comply with statutory requirements and relevant regulations;
 - c) the view presented by the financial statements is consistent with the auditor's knowledge of the audited entity; and
 - d) there is adequate disclosure of all material matters relevant to the financial statements."

Standard Wording

- 10.2.8** An example of a standard unqualified auditor's opinion is contained in the Standard Audit Working Papers Kit.
- 10.2.9** To fully comply with paragraph 4.0.8 of DAGP's Auditing Standards, the unqualified opinion should contain:
- a) A title;
 - b) An addressee;
 - c) A signature and a date; and
 - d) Three standard paragraphs – an introductory paragraph, a scope paragraph and an opinion paragraph - which contain material that satisfies the other disclosure requirements of paragraph 4.0.8 of DAGP's Auditing Standards. Each of these paragraphs is discussed below.
- 10.2.10** *The introductory paragraph.* The introductory paragraph identifies the financial statements covered by the auditor's opinion and distinguishes the responsibilities of management and the responsibilities of the auditor.
- 10.2.11** *The scope paragraph.* In this paragraph the auditor informs the reader that the audit was planned and performed in accordance with professional standards, and that the auditor has made judgments in applying these standards. It also provides the reader with some explanation of the nature and extent of an audit and the degree of assurance it provides.
- 10.2.12** *The opinion paragraph.* In this paragraph the auditor expresses his/her opinion as to the whether:
- a) the financial statements properly present, in all material respects, the government's financial position, the results of its operations, its cash flows and its expenditures 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.
- 10.2.13** The opinion paragraph may also state whether, in the auditor's opinion, certain statutes and regulations have been complied with. (The statutes and regulations should be spelled out in the opinion).

10.2.14 Sometimes the auditor wants to insert a reference in the opinion to an unusual or important matter that is properly disclosed in the financial statements. Since the auditor does not intend to express a reservation of opinion on the financial statements, this reference should be included in a fourth paragraph, after the opinion paragraph.

10.2.15 The auditor should not use this additional paragraph to rectify a lack of appropriate disclosure in the financial statements. It is also not an alternative to, or a substitute for, expressing a reservation of opinion.

10.2.16 Even when a matter is placed after the opinion paragraph, there is still a danger that some readers may think that a reservation of opinion is intended. As a result, this paragraph should only be used in very rare cases.

10.2.17 A better way to provide additional information or recommendations is to use a separate report, such as an audit report. The fourth paragraph of the auditor's opinion could then contain a reference to the audit report. Audit reports are discussed later.

Reservations in the Auditor's Opinion

10.2.18 There are four general types of reservation that the auditor may express –
Matters that Do Not Affect the Auditor's Opinion

1) Emphasis of matter

Matters that Do Affect the Auditor's Opinion

2) Qualified opinion,

3) Disclaimer of opinion, or

4) Adverse opinion

Examples of emphasis of matter, qualified, adverse and disclaimers of opinion are included in the Standard Audit Working Papers Kit.

10.2.19 In accordance with paragraph 4.0.12 of DAGP's Auditing Standards, reservations are issued when any of the following circumstances occur, and when the auditor believes that the effect is or may be material:

- a) a scope limitation;
- b) a departure from the government's accounting principles; or
- c) uncertainty affecting the financial statements.

10.2.20 Each is discussed below.

10.2.21 *Scope limitation.* A scope limitation has occurred when the auditor has not been able to apply all the tests and procedures considered necessary in the circumstances and, as a result does not have sufficient appropriate audit evidence to form an opinion as to whether the financial statements give a true and fair view, in all material respects, in accordance with the government's accounting principles.

10.2.22 Scope limitations may arise in a number of situations, including:

- a) circumstances beyond the control of the entity or the auditor, such as the destruction of accounting records in a fire;

There are four general types of reservation that the auditor may express.

- b) a limitation imposed by the entity, such as refusing to allow the auditor to perform certain audit procedures; and
- c) a limitation created by the entity, such as or a failure to maintain adequate accounting records or internal control structures.

10.2.23 When the auditor has a scope limitation, the reporting objective is to inform the reader that the auditor:

- a) has been unable to perform specific tests and procedures and obtain certain audit evidence; and, as a result,
- b) is unable to determine whether or not there has been a departure from the government's accounting principles that materially affects the financial statements.

10.2.24 *Departure from government's accounting principles.* A departure from the government's accounting principles occurs when there is:

- a) An inappropriate accounting treatment, such as the failure to record certain assets or liabilities that are required to be disclosed by the government's stated accounting policies;
- b) An inappropriate valuation of an item in the financial statements, such as recording fixed assets at an appraised value;
- c) A failure to disclose all of the information required, such as not segregating expenditures into all the categories that are called for by the government's accounting principles.

10.2.25 In any of these circumstances, the auditor's reporting objective is to inform the reader about the departure from the accounting principles.

10.2.26 *Uncertainty.* An uncertainty normally involves a significant contingency or other event that is primarily dependent on future developments or future decisions by parties other than entity officials.

10.2.27 For example, the government may have guaranteed loans to third parties who are now experiencing financial difficulties. In these circumstances, the auditor (and entity officials) might not have sufficient information to determine what amount, if any, the government may ultimately be required to pay.

10.2.28 When the auditor has an uncertainty, the reporting objective is to inform the reader that he/she has been unable to determine what adjustments, if any, might be needed to the financial statements.

Emphasis of Matter

10.2.29 *Emphasis of Matter paragraph* – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

10.2.30 An auditor may not be able to express an unqualified opinion when any of the following circumstances exist and, in the auditor's judgment, their effect is or may be material to the financial statements:

- a) There has been limitation on the scope of the audit:

- b) The auditor considers that the statements are incomplete or misleading or there is an unjustified departure from acceptable accounting standards; or
- c) There is uncertainty affecting the financial statements.

10.2.31 If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

10.2.32 When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- a) Include it immediately after the Opinion paragraph in the auditor's report;
- b) Use the heading "Emphasis of Matter," or other appropriate heading;
- c) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
- d) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

10.2.33 The Standard Audit Working Papers Kit contains two examples of emphasis of matter paragraph – a significant uncertainty and going concern assumption.

Qualified Opinion

10.2.34 A qualified opinion is issued where the auditor is faced with a scope limitation, a departure from the government's accounting principles, or an uncertainty, but the matter at hand:

- a) is not critical to an understanding of the financial statements; and
- b) can be explained clearly and concisely.

10.2.35 To explain a matter clearly and concisely, it helps if the auditor can quantify the financial effect. Of course, in the case of a scope limitation, this would not be possible.

10.2.36 The use of a paragraph (called the reservation paragraph) between the scope paragraph and the opinion paragraph is the usual way of alerting the reader to the fact that there is a qualified opinion. To be most effective the paragraph needs to explain the matter as clearly and concisely as possible. It is not sufficient to provide only a general indication of a problem so that the reader is merely warned that further questions should be asked.

10.2.37 To be clear and concise, the auditor should:

- a) state the financial effect of the matter. If it cannot be quantified, the auditor should so state.
- b) In the case of an audit involving more than one Ministry, identify the specific Ministry (or Ministries) in which the monetary errors or

compliance with authority violations occurred. This is particularly important if the reservation in the auditor's opinion was the result of significant errors in only one or two Ministries.

10.2.38 Note: where material monetary errors or compliance with authority violations have occurred, the auditors should request Ministry officials to investigate the matter and make necessary adjustments to the financial statements. If Ministry officials refuse, the auditors could request the Controller General of Accounts to make the necessary adjustment. This is consistent with Sections 5(a) and 5 (i) of the Controller General Ordinance. Once the necessary adjustments have been made, the financial statements can be considered accurate, and the Auditor-General can issue an unqualified opinion.

10.2.39 In addition to adding the reservation paragraph, other changes are made to the standard wording of the auditor's opinion, as follows:

10.2.40 The opinion paragraph is amended to insert:

- a) In the case of a scope limitation or a departure from the government's accounting principles, an "except for", "except that" or "except as", followed by a brief summary of the matter and a reference to the reservation paragraph; or
- b) In the case of an uncertainty, a "subject to", followed by a brief summary of the matter and a reference to the reservation paragraph.

10.2.41 In the case of a scope limitation or an uncertainty, the scope paragraph would also contain an "except as" clause. This is done by inserting "Except as explained in the following paragraph, ..." at the start of the scope paragraph.

10.2.42 The Standard Audit Working Papers Kit contains three examples of qualified opinions – a scope limitation, a departure from the government's accounting principles, and an uncertainty.

Adverse Opinion

10.2.43 An adverse opinion is issued when there is a departure from the government's accounting principles that is:

- a) so pervasive and fundamental that the auditor is unable to describe clearly how the financial statements are affected; or
- b) so significant that it overshadows a clear description of how the financial statements are affected.

10.2.44 In these circumstances, a qualified opinion would not be adequate. The wording of an adverse opinion makes it clear that:

- a) the financial statements do not properly present, in all material respects, the government's financial position, the results of its operations, its cash flows and its expenditures and receipts by appropriation; or,
- b) the sums expended have not been applied, in all material respects, for the purposes authorised by parliament and have not been booked to the relevant grants and appropriations.

10.2.45 As with a qualified opinion, a reservation paragraph should be inserted between the scope paragraph and the opinion paragraph. The reservation paragraph should clearly and concisely describe all the matters of disagreement, and the financial effect should be quantified where relevant and practicable.

10.2.46 The opinion paragraph would be amended to state something to the effect that, “In my opinion, because [brief description of matter] described in the preceding paragraph:

- a) these financial statements do not properly present, in all material respects, the government’s financial position, the results of its operations, its cash flows and its expenditures and receipts by appropriation; or,
- b) the sums expended have not been applied, in all material respects, for the purposes authorised by parliament and have not been booked to the relevant grants and appropriations....”

10.2.47 The Standard Audit Working Papers Kit contains an example of an adverse opinion.

Disclaimer of Opinion

10.2.48 Where the auditor is unable to arrive at an opinion regarding the financial statements taken as a whole due to a scope limitation or uncertainty that is so fundamental, pervasive or significant that a qualified opinion would not be adequate, a disclaimer is given. The wording of the disclaimer makes it clear that an opinion cannot be given.

10.2.49 As with a qualified and an adverse opinion, a reservation paragraph should be inserted between the scope paragraph and the opinion paragraph. The reservation paragraph should clearly and concisely describe the reason for the disclaimer.

10.2.50 In this case the opinion paragraph would be amended to state something to the effect that, “In view of the possible material effects on the financial statements of the matter described in the preceding paragraph, I am unable to express an opinion whether ...

- a) these financial statements properly present, in all material respects, the government’s financial position, the results of its operations, its cash flows and its expenditures and receipts by appropriation; or,
- b) the sums expended have been applied, in all material respects, for the purposes authorised by parliament and have been booked to the relevant grants and appropriations.

10.2.51 The scope paragraph should be amended by inserting “Except as explained in the following paragraph” at the start.

10.2.52 The Standard Audit Working Papers Kit contains an example of a disclaimer of opinion.

10.3 Audit reports other than opinions on financial statements

Nature and Content of Reports

- 10.3.1** This section covers two general types of reports – audit reports and management reports.
- 10.3.2** Audit reports are reports that are made public and/or that are presented to the appropriate public accounts committee (PAC) or other external party. These reports would deal with matters of such significance that they require the attention of Members of the National Assembly, a Provincial Assembly, or a District Assembly.
- 10.3.3** Audit reports may also deal with matters that require the attention of the police, the National Accountability Bureau and/or other similar organisations. Matters to be reported to these organisations include fraudulent practices or serious irregularities.
- 10.3.4** Management reports are reports addressed to entity officials. They contain matters of a lesser significance.
- 10.3.5** Both audit reports and management reports may deal with:
- a) Reservations being expressed in the auditor’s opinion;
 - b) Contentious matters on which DAGP decided not to express a reservation;
 - c) Comments on the form and content of the financial statements;
 - d) Comments on the accounting policies used to prepare the financial statements;
 - e) Compliance with authority violations;
 - f) Internal control weaknesses; and
 - g) Performance (value-for-money) matters.
- 10.3.6** With respect to item (a), because the standard audit opinion is usually very short, the auditor normally does not have an opportunity to provide a detailed discussion on the reservations that he/she has expressed. Such a discussion could be included in a separate report.
- 10.3.7** With respect to items (b), (c) and (d), the inclusion of additional matters in the auditor’s report could result in some readers thinking that a reservation of opinion is intended. As a result, it is preferable for the auditor to use a separate audit report to make comments about the financial statements and his/her audit thereof.
- 10.3.8** Items (e), (f) and (g) would be matters that were identified during the conduct of the audit.
- 10.3.9** The decision to include a particular matter in the audit report or in a management report may change during the audit and even during the reporting phase itself. The auditor needs to keep in perspective the message and the most important conclusions expected to result from the audit.

10.3.10 For example, the auditor may have initially concluded that a particular matter was significant enough to be brought to the attention of the appropriate PAC. However, during the clearance process entity officials may have agreed to deal promptly with the matter. In this case, the auditor may decide to report the matter in his/her management report.

10.3.11 On the other hand, the auditor may have initially included a matter in a management report because entity officials had agreed to deal with the matter promptly. If the matter was still outstanding the following year, the auditor may decide to include it in his/her audit report for that year.

10.4 Reporting style and format

The audit will not be successful and useful unless the report is well

10.4.1 A good audit report needs to present a clear message. However well the audit has been conducted and however strong the findings, the audit will not be successful and useful to Parliament, a Public Accounts Committee (PAC), the public, and the management of the entity unless the report is well written.

10.4.2 Whatever the audit type, the same basic reporting principles apply:

10.4.3 The report should be easy for entity officials, PAC members, etc. to read. This means that it should:

- a) be brief, interesting and clear;
- b) be written in a style that maintains the reader's interest; and
- c) avoid, as far as possible, details that distract from the message that is to be conveyed.

10.4.4 If extensive definitions, detailed calculations, and other distracting details are required, they could be inserted as a footnote or as an appendix.

10.4.5 Particularly in the case of audit reports (reports intended for Parliamentarians and the general public), the report should be written with the minimum amount of technical terms. The report should not assume that the reader is familiar with these terms, or with the entity's business.

10.4.6 The report should clearly explain the significance of each matter being raised. For example, reporting that certain bank accounts have not been reconciled for several months may not be meaningful on its own. Reporting that there may be unauthorised or unrecorded payments, missing receipts, stolen funds and so would ensure the point is understood.

10.4.7 Matters should be grouped by the nature of the issue at hand, or by recommendation. This helps the readers to better appreciate the overall extent of a particular matter.

10.4.8 Conclusions and recommendations should be presented. These help the reader to obtain an overall understanding of the auditor's position, and to understand the actions that are expected to be taken as a result of the matter.

10.4.9 One possible exception to these principles is reports to the police, the National Accountability Bureau and/or other similar organisations where the auditor is recommending that the organisation perform an additional investigation. In this case, the auditor may be required to provide a great deal of detail with respect to the matter at hand, and the audit work already performed, to permit the organisation to conduct an efficient and effective investigation.

10.4.10 A useful structure for each matter dealt with in the report is:

- a) Background material – a description of the area audited, etc.;
- b) A description of the work that was performed;
- c) A description of what entity officials should have been doing, and why;
- d) A description of what was found, and the cause;
- e) What can be concluded;
- f) The auditor's recommendation to deal with the matter; and
- g) The entity's response (if shown in a separate section).

10.4.11 Each of these is discussed below.

10.4.12 The Standard Audit Working Papers Kit includes an example of an observation that follows this format.

10.4.13 Where the report is more than, say, 10 or 15 pages there should also be an Executive Summary at the front of the report. It is common to include a list of the major recommendations at the end of the Executive Summary.

10.4.14 *Background material.* The amount of background material required will depend on the intended reader of the report. For reports to be made public, more material is often required than if the report is only to be sent to entity officials who are responsible for the applicable component.

10.4.15 Whoever is the intended reader, background material should be kept as brief as possible.

10.4.16 *Description of work performed.* As for the background material, the amount of detail required will depend on the intended reader of the report. In general, though, it should also be kept as brief as possible.

10.4.17 *Description of what entity officials should have been doing, and why.* It is important for the auditor to ensure that readers of the report appreciate the implications of the compliance with authority violation, the internal control deviations, etc. Simply stating that several supplier invoices were not properly approved may not get the readers' attention if the significance of this issue is not explained. The auditor needs to state why the violation or deviation is significant. In the case of proper approval of supplier invoices – to prevent payment being made for fictitious goods, services not performed, for excessive amounts or for corrupt purposes and so on.

- 10.4.18** *Description of what was found and the cause.* In this section the auditor should describe what his/her findings were. To help the reader appreciate the matter at hand, the findings should be worded in a way that clearly shows the difference between what entity officials should have been doing, and what they were (or were not) doing.
- 10.4.19** The description should also include the cause of the matter, if it is known. This would make it easier for the reader to understand the nature of the problem, and the reasoning behind the recommendation.
- 10.4.20** As noted in paragraph, matters should be grouped by the nature of the issue at hand, or by recommendation. Where there is a large volume of small inaccuracies or errors, they should be grouped.
- 10.4.21** It is normally not necessary to list all of the specific internal control weaknesses or compliance with authority matters. For example, the auditor could simply note that, in a sample of 200 supplier invoices, 8 lacked proper approval. There is usually no need to list the 8 invoices in the report.
- 10.4.22** *The auditor's conclusion.* The conclusion section summarises the matter being discussed, and puts the findings in context.
- 10.4.23** The tone of the conclusion should be consistent with the significance of the matter being raised. If, for example, the matter has been presented as a relatively minor internal control violation, the conclusion should not imply that material frauds could occur if the matter is not fixed immediately.
- 10.4.24** *The auditor's recommendation.* The recommendation should describe specific actions that the entity should take to deal with the matter raised in the observation and/or to prevent similar matters from recurring in the future. Unless the auditor can identify a specific and useful recommendation, the auditor should question the value of reporting the matter in the first place.
- 10.4.25** Assume the auditor detected that several suppliers had been overpaid. A simple recommendation that the auditor could make in this case is that the entity should recover the amounts of the overpayments from the suppliers. This recommendation, though, will not necessarily help to prevent a repeat of the error or fraud that led to the overpayments. It would be more useful to the entity for the auditor to identify the internal control weakness that led to the overpayments, followed up with a recommendation to prevent similar error or fraud from occurring in the future.
- 10.4.26** To further improve the effectiveness of the recommendation, the recommendation should:
- a) be as specific as possible. This helps the reader to know exactly what is expected to be done, and helps the auditor to assess at a later date whether the recommendation was implemented. Recommendations such as "The internal controls should be improved" are too general and do not describe for the reader what needs to be done;

- b) be addressed to a specific person or group of individuals. This helps to fix accountability for the implementation of the recommendation, which in turn should improve the chances that it will be implemented. Recommendations such as the “The government should ...” do not fix accountability; and
- c) contain a date by which the auditor would like the recommendation to be implemented. This will help to prevent unreasonable delays in implementing the recommendation.

10.4.27 *Entity response.* Entity officials will often want auditors to include, in the report, a description of the context in which the matter occurred, and corrective actions taken by the time the matters are reported. Entity officials may also wish to indicate whether they agree with the recommendation, or, if not, why they disagree.

10.4.28 There are two ways in which the entity’s position can be reflected in the report. The auditor could amend the wording of the observation, or the auditor could permit the entity to insert an “entity response” directly into the report. If the latter option is taken, the response would normally be inserted at the end of the material on the specific observation.

10.5 Compliance and Performance Reports

10.5.1 A report on a compliance audit or a performance audit should draw attention to the key issues and concerns raised by the audit. The reader should be able to understand the significant issues, the underlying causes of any weaknesses observed and any recommended actions to improve the management of the area covered in the audit.

10.5.2 Traditionally, reports of compliance audits have not presented the big picture and have simply listed cases of non-compliance, often drawing attention to small or minor errors or waste. If the auditor wants to initiate change, the focus should be redirected onto controls rather than individual cases of non-compliance. If not, the auditor can expect to find similar problems being reported every year.

10.5.3 Except when expressing a financial opinion, all reports should adhere to the structure outlined below. Their focus should be towards encouraging improvements in internal controls and more effective management in the public service.

A report on compliance or performance should draw attention to the key issues and

Structure of the Report

- 10.5.4** The audit report should normally state:
- a) The context (background and description of area audited);
 - b) What was done (audit objective and audit scope);
 - c) What was expected to be found (audit criteria and/or laws and regulations);
 - d) What was found (findings and observations);
 - e) What can be concluded (including what is or can be the impact of what was observed);

- f) What should be done to improve the management of the area (recommendations); and
- g) In some cases, but not necessarily always, management comments.

10.5.5 There are commonly two options for structuring the report to include the content mentioned above. One is to structure the main chapters according to Introduction and Background, Observations, Conclusions, and Recommendations and, within these, address the different lines of enquiry, or audit topics. The other is to structure the main chapters according to the lines of enquiry, or audit topics and, within these, address Background, etc. The latter approach is often better because that structure is normally easier for the reader to follow. Where the report is structured around the audit topics, the statement of scope can either be in an introductory chapter or stated for each audit topic.

10.5.6 Where the report is more than say 10 or 15 pages, there should also be an Executive Summary at the front of the report. It is common to include a list of the major recommendations at the end of the Executive Summary.

10.5.7 There are different styles with regard to taking note of management views and responses to the report. In most cases, the report should be changed in response to management comments if inaccuracies or insufficient information are rectified during the process of clearing the report. When management is asked to comment on the conclusions and recommendations contained in the report it is common practice to include these responses in the report.

Determining the Message

Keep in mind significant issues.

10.5.8 From the beginning of the audit cycle, the auditor needs to keep in mind the significant issues to be addressed. As evidence is gathered, the auditor may find:

- a) some issues relating to suspected weaknesses will disappear as it is found that there are no significant management weaknesses;
- b) new issues will be discovered that had not been identified or anticipated previously; and
- c) other issues will remain because of their importance to the programme, irrespective of whether the area is well managed or not.

10.5.9 Focusing on important issues from the start of the audit will ensure the auditor has a meaningful report at its completion. This means keeping the most important conclusions expected to result from the audit in perspective at all times.

Place findings in context, indicate impact and indicate corrective actions required.

10.5.10 The final audit report must present a clear message. A clear structure also helps the auditor complete the report much faster. Sometimes it is helpful to develop a summary of the main message prior to writing the than the other way around.

Developing Conclusions and Recommendations of the Report

- 10.5.11** The report should convey the message that the auditor developed during the examination phase of the audit. The report should place the findings in context, indicate the impact of what has been observed, and indicate to management the corrective actions required to prevent similar weaknesses occurring in the future.
- 10.5.12** The report should provide a general assessment of the strengths and weaknesses in the area examined whilst avoiding exaggerated or unsubstantiated conclusions. Reports should be based on facts and avoid including assumptions that cannot be substantiated.
- 10.5.13** Sometimes, it is worth dropping some audit findings if they are of much less significance than the others, especially if they are controversial, or poorly substantiated, and of minor importance in comparison with the main issues and concerns. Consideration should be given to excluding minor findings where their inclusion might distract from the main messages to be conveyed to entity management, Parliament and the public.
- 10.5.14** Conversely, where the auditor has an important message to convey, there need to be sufficient supporting evidence and examples to strengthen the message.

Report Style

- 10.5.15** Reports should be written in a style that maintains the reader's interest. The auditor should avoid as far as possible including details in the body of the report that distract from the message that is to be conveyed. Extensive definitions, detailed calculations, large numbers given to the last dollar ("over 35 million rupees" is easier to read, and gets the message across better, than "35,301,472 rupees") and other distracting details can be placed as a footnote or added as an appendix.
- 10.5.16** The use of active rather than the passive tense ("we found" rather than "it was found") is normally considered better writing style.
- 10.5.17** Report writing is not easy and auditors will often benefit from training and practice. Good report writing capabilities and strong editing skills are a prerequisite for promotion to higher positions within the DAGP.

Avoid details that distract from the message to be conveyed.

11 DOCUMENTATION AND WORKING PAPERS

11.1 The Need for Documentation and Working Paper Files

11.1.1 Auditors must have a strong commitment to high professional standards in the collection and documentation of evidence to support the audit work. Audit supervisors must ensure that a high quality of documentation is always maintained.

Ensure that a high quality of documentation is always maintained.

11.1.2 The auditor's documentation, in the form of audit files, is referred to as the "Working Papers". The audit files should be complete in themselves. Reference to external sources of evidence is not normally considered sufficient. Therefore the auditor should keep extracts of the relevant external documentation in the working paper file. Working papers are usually maintained in three categories:

Working papers should be complete in

- a) Permanent file;
- b) Current file; and
- c) Briefing file.

11.1.3 Permanent files typically contain information that can be useful to the auditor for several assignments at the audit entity, whereas current files usually contain the supporting documentation for a specific audit.

11.1.4 Each current file should be kept for a specified time after the completion of the audit, after which it should be archived in accordance with DAGP records management policies. The permanent file remains permanently within DAGP but is updated each time an audit is conducted within the area to which it applies.

11.1.5 In addition, the auditor should maintain a briefing file for the section within the Annual Report covered by the particular audit. The briefing file contains extracts from the other files to provide complete, but concise, support for all contents included in the Annual Report. This is used to provide support to the AG and other officials of DAGP when appearing before the PAC. All statements contained in the Annual Report should be cross-referenced to the specific evidence that supports each statement, including background description, financial information, facts and statistics.

Maintain a briefing file to support the AG and other officials of DAGP when appearing before the PAC.

11.2 The Purpose of Working Paper Files

11.2.1 Working paper files are maintained to:

- a) Provide evidence to support all matters included in the audit report;
- b) Demonstrate adherence to auditing standards and procedures;
- c) Aid supervision of the work;
- d) Facilitate review of work performed; and
- e) Assist in planning the subsequent audit assignment (with background information, key issues identified in previous audits, and matters for follow up).

11.3 The Quality of Working Paper Files

- 11.3.1** Good working papers contribute to the efficiency and effectiveness of the operations of DAGP. By contrast, poor working papers can:
- Reduce the likelihood of including all pertinent findings in the audit report;
 - Lead to inaccurate/incomplete findings and erroneous conclusions in the audit report;
 - Hinder the review of the audit work and supervision of the audit;
 - Compromise the audit as a whole; and
 - Endanger DAGP's reputation.

Every auditor has a professional responsibility to maintain quality working papers.

- 11.3.2** Every auditor has a professional responsibility to maintain high quality working papers. The working papers are the ultimate evidence of the quality of the auditor's work.

Standards and Characteristics of Proper Working Papers

- 11.3.3** Audit offices normally have a records management manual describing the structure, use, review, maintenance, storage and disposal of working papers. The filing systems, filing codes, rules for access and safekeeping should be defined and the auditor should comply with these standards.

- 11.3.4** There should be standards regarding the form and content of working paper files. The existence of standards helps to ensure uniformity in filing material, which makes it easier for a new auditor on the assignment, or a more senior auditor conducting a review of the files, to access the information on file.

- 11.3.5** DAGP's documentation standards require the auditor to ensure that all audit evidence, including the process used to obtain it and the conclusions derived from it, are properly documented in audit working papers.

- 11.3.6** As well as evidence to support the audit report, the files should also include material on:

- The audit plan (including risk assessments and other rationale for audit scope decisions, and audit programmes);
- The management of the audit (including assignment of responsibilities, scheduling and budgeting of the work, minutes of team meetings, changes to audit programme, checklists, list of personnel interviewed, notes on all interviews, meetings and physical inspections);
- Evidence of reviews of audit files and audit work;
- Audit work even if not included within the audit report (such as evidence of evaluations of internal controls);
- All correspondence relating to the audit; and
- Any other material that explains the decisions, activities and results relating to the audit.

- 11.3.7** All follow up work should be cross referenced to the audit working papers.

Form and Content of Working Paper Files

11.3.8 Current File. The Current working paper file should include:

- a) Information concerning the government programme(s), the industry, economic environment and legislative environment within which the entity operates.
- b) Evidence of the planning process including audit programmes and any changes thereto.
- c) Evidence of the auditor's understanding of the accounting and internal control systems and programme performance.
- d) Evidence of inherent and control risk assessments and any revisions thereof.
- e) Analyses of transactions and balances.
- f) A record of the nature, timing and extent of audit procedures performed and the results of such procedures.
- g) Evidence that the work performed by junior auditors was supervised and reviewed.
- h) An indication as to who performed the audit procedures and when they were performed.
- i) Copies of communication with experts and other third parties.
- j) Copies of letters or notes concerning audit matters communicated to or discussed with the entity.
- k) Copies of the auditor's report.

11.3.9 Permanent File. The permanent audit file includes information that will be of continuing importance to the audit activity in the particular area of audit. This may include:

- a) Copies of relevant government legislation, regulations, guidelines and other rules affecting operations.
- b) Role of entity, Vision and Mission Statements, most recent corporate plan.
- c) Copies of the Estimates, kept up-to-date.
- d) Copies of long-term contracts/leases.
- e) Loan agreements, schedules of amortisation for debts and special assets.
- f) Extracts of minutes.
- g) Reports to management and management's response.
- h) Organisation charts, telephone book and building layout and/or locations of operation.
- i) Chart of accounts.
- j) Summary of accounting principles used by the organisation.
- k) Special remuneration conditions for senior officers.

The permanent audit file includes information that will be of continuing importance.

11.3.10 Policies and procedures manuals may be in the permanent file if they are brief or, alternatively, a copy should be in the auditor's bookcase or filing cabinet.

11.3.11 Every working paper should clearly show:

- a) The name of the audit entity and audit area;
- b) A description of the contents;
- c) The period covered by the audit;

- d) The date the work was performed;
- e) Initials of the preparer;
- f) An appropriate index;
- g) Cross-references to schedules, documents, notes that support the working paper and cross-reference of all points in the final audit report to the working paper support;
- h) The source from which the information or explanation was obtained;
- i) The extent of audit work done;
- j) Conclusions drawn from work done;
- k) An explanation of any “tick marks” that appear on the working paper; and
- l) The date and initials of the reviewer.

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

- a) Write legibly or type notes (eventually files will most likely be kept electronically);
- b) Avoid crowding on a page;
- c) Write on one side of the working paper;
- d) Use correct grammar, spelling and punctuation;
- e) Spell the names of individuals or organisations correctly;
- f) When appropriate, identify the titles of persons referred to;
- g) Never use “white out” or correction tape to change information;
- h) Avoid derogatory terms to characterise personnel or procedures; and
- i) Remove all non-evidential matter from files on the completion of the assignment (rough drafts, etc.).

Working papers should be neat and readable.

11.4 Custody and Maintenance of the Working Paper Files

11.4.1 Working paper files are confidential and are the property of DAGP. Material should not be removed from the files without the specific authority of the responsible Competent Authority.

Working paper files are confidential and the property of DAGP.

11.4.2 The auditor is responsible for their custody and safekeeping at all times until they are placed in official archives. Working papers are not for general disclosure. Where they are to be shared with other auditors, or other bodies, the following guidelines should be respected:

- a) No copies of working papers should be given or shown to members of the audit entity;
- b) Working papers should not be made available to third parties except in special circumstances;
- c) Where DAGP is prepared to provide access to working papers by third parties, normally, the consent of the audit entity should be obtained first;
- d) Files and papers should be reviewed before they are made available;
- e) DAGP should at all times retain control over the papers and documents and inspection should take place under the supervision of a representative of DAGP;
- f) Where DAGP is asked to produce working papers in connection with legal proceedings, or investigations by government bodies, for example under a court order, legal advice should be obtained before producing them; and
- g) Where DAGP is required to produce original papers or documents in legal proceedings, copies should be retained.

11.4.3 Access to audit files should be controlled and secure.

12 AUDIT FOLLOW UP

12.1 Introduction

12.1.1 Follow up is an integral part of the audit function. The auditor's objective is not fulfilled unless any errors or deficiencies identified during the audit have been corrected or at least addressed. Both DAGP and the appropriate Public Accounts Committee (PAC) should ensure that entity officials take action to correct all errors found and deal with all recommendations made.

Ensure that entity officials take action to correct all errors found and deal with all recommendations that are

12.1.2 Entity officials themselves are responsible for ensuring that their financial statements are as complete and accurate as possible, and that their internal control structures are operating as efficiently and effectively as possible. They should be encouraged to view the auditor as an ally in this endeavour, and should actively work with the auditor to address any concerns.

12.1.3 To achieve these objectives, there should be a formal follow up of every financial audit. All observations, conclusions and recommendations should be followed up and reported until they are satisfactorily dealt with, or until circumstances have rendered them no longer relevant.

There should be a follow up of every financial audit.

12.1.4 The follow-up phase involves returning to the entity at a later date to determine if entity officials have:

- a) Corrected errors identified during the audit; and
- b) Implemented recommendations made by the auditors.

12.1.5 The errors identified during the financial audit could include:

- a) Monetary errors or related compliance with authority violations that led to a reservation in the auditor's opinion (a qualified, adverse or disclaimer of opinion); and
- b) Other monetary errors and compliance with authority violations.

12.1.6 Recommendations made by the auditor can relate to:

- a) Reservations being expressed in the audit report;
- b) Contentious matters on which DAGP decided not to express a reservation;
- c) Comments on the form and content of the financial statements;
- d) Comments on the accounting policies used to prepare the financial statements;
- e) Compliance with authority violations;
- f) Internal control weaknesses; and
- g) Performance (value-for-money) matters.

12.1.7 This Chapter discusses:

- a) the timing of the follow up of the correction of errors and implementation of recommendations;
- b) the two basic levels of assurance that the auditor can plan to achieve during the performance of the follow up;
- c) the follow up process which first deals with the correction of errors and then with the implementation of recommendations;

- d) reporting the results of the follow up; and,
- e) when the auditor should perform additional follow ups of matters which entity officials have not resolved.

12.2 Timing of the Follow Up

Correction of Errors

Encourage entity to investigate and correct all monetary errors.

- 12.2.1 The auditor should encourage entity officials to investigate and correct all monetary errors that have been detected. This should include investigating and correcting the known errors, investigating the accuracy of the auditor's most likely error, and making a correction for the determined amount.
- 12.2.2 If the most likely error was material, entity officials should normally have performed their investigation at the time of the audit. However, they may not have corrected the error.
- 12.2.3 If the error, material or otherwise, was not investigated and corrected at the time of the audit, the auditor should try to ensure that entity officials perform their work before the completion of the following year's audit. There are two reasons for this:
 - a) As discussed in Chapter 9, errors that affect closing balances in one year will affect the opening balances for the following year. To obtain the most accurate estimate of the most likely error in the opening balances for the following year, it would be best if the investigation was performed before the completion of the following year's audit.
 - b) The same type of error may recur in the following year. Investigating the cause of the error found in the first year might help the auditor to arrive at a more accurate estimate of the most likely error in the following year.

Implementation of Recommendations

- 12.2.4 There is no simple rule as to when the follow up of the implementation of a recommendation should be conducted. The timing of the follow up will depend on:
 - a) The seriousness of the matters raised;
 - b) A realistic time period for entity officials to implement the recommendation;
 - c) The time period reflected in the entity's action plan and agreed to by DAGP and the PAC; and
 - d) How the follow up fits into DAGP's overall strategic plan.
- 12.2.5 With respect to (a), very serious deficiencies that can be corrected quickly should be followed up within a short timeframe. In contrast, the follow up of minor deficiencies can often be postponed until the next regularly scheduled visit.

- 12.2.6** For larger entities, the next regularly scheduled visit for a financial audit will most likely be the following year. For smaller entities it is possible that a visit will not be required in the following year. The auditor should consider whether the matter is important enough to warrant a special visit to the entity to follow up the matter.
- 12.2.7** With respect to (b), the timing of the follow up will depend on the time required for entity officials to implement the necessary changes. If the recommendation calls for staffing changes, these may take several months to be fully implemented. Major changes to computer systems can take several years to be fully implemented.
- 12.2.8** With respect to (c), in cases where implementation may take a protracted amount of time, the auditor should request the officials to produce an action plan, indicating when and how the corrective actions are going to be taken. In some cases, the PAC may request the officials to table this action plan with the Committee.
- 12.2.9** For matters that will require an extensive period of time, such as those that require changes to computer systems, the auditor should also request entity officials to establish interim milestones, and to make interim reports outlining their progress against each milestone.
- 12.2.10** With respect to (d), the follow up must not be ignored or delayed beyond an appropriate time period. To do so would indicate to the entity that the auditor did not really consider the implementation of the recommendation to be important.
- 12.2.11** The schedule for conducting follow up audits should be contained in each directorate's strategic audit plan.

12.3 Determining the Desired Level of Assurance

Correction of Errors

- 12.3.1** There are two basic levels of assurance that the auditor can plan to achieve – an audit level of assurance and a review level of assurance. To achieve the audit level of assurance, the auditor would need to conduct an audit of the error investigation performed by the entity to ensure that:
- a) The work performed was sufficient and appropriate, and done correctly;
 - b) The entity's estimate of the error was calculated correctly; and
 - c) The correcting entry was properly recorded.
- 12.3.2** As noted above, errors that affect closing balances in one year will affect the opening balances for the next year. Therefore, for these types of errors, unless the amount of the error was very small relative to the materiality amount, the auditor would normally need to perform an audit of the entity officials' work.

- 12.3.3** Some errors may have no impact on the subsequent year. Even in these cases the auditor would most likely want to perform an audit of the entity officials' work. This is because the same type of error may recur in the following year if remedial action has not been taken. Investigating the cause of the error found in the first year might help the auditor to arrive at a more accurate estimate of the most likely error in the following year.
- 12.3.4** While the auditor would normally perform an audit of the entity's follow up work, there may be some situations where a review would be sufficient. These would include situations where the amount of the error is very small relative to the materiality amount. The auditor's review would primarily involve asking entity officials what actions they have taken and what the results were, without verifying the work performed.
- 12.3.5** The cost of obtaining an audit level of assurance is often much higher than the cost of obtaining a review level of assurance. The auditor would need to consider the additional benefits and costs associated with performing an audit instead of a review.
- 12.3.6** In some cases, the Principal Accounting Officer may request internal audit to follow up the errors identified by DAGP. In these cases, the DAGP auditor may be able to rely on the work performed by internal audit, and thereby obtain the audit level of assurance at very little cost.

Implementation of Recommendations

- 12.3.7** As with error corrections, the auditor can decide on the appropriate level of assurance that recommendations have been or are being implemented: an audit level of assurance or a review level of assurance. The auditor could decide to:
- a) conduct an audit to determine how well recommendations have been implemented, and to determine if the recommendations were effective in strengthening internal control, reducing compliance with authority violations, etc.; or
 - b) review the actions taken by entity officials without further verifying that changes were actually made.
- 12.3.8** As with the follow up of the correction of errors, the cost of audit-level follow up can be much higher than the cost of review- type follow up.
- 12.3.9** Despite the higher costs, auditors often opt for the audit level of assurance. For example, if the follow up is dealing with a recommendation to strengthen a particular internal control, and if the auditor intends to rely on that control, then the auditor must conduct an audit.
- 12.3.10** However, if the auditor does not intend to rely on the particular internal control, then the auditor does not need to have an audit level of assurance that the recommendation was implemented. In this case, the auditor should consider the costs and benefits of doing an audit or a review.

12.3.11 In some cases, the Principal Accounting Officer may request internal audit to follow up actions taken in response to the recommendations made by DAGP. In this case, the DAGP auditor may be able to rely on the work performed by internal audit, and thereby obtain the audit level of assurance at very little cost.

12.4 Performing the Follow Up

Correction of Errors

12.4.1 When an audit level of assurance is desired, the auditor should determine what work entity officials have performed to investigate the errors. Should the officials have correctly performed sufficient and appropriate work and identified the cause of the errors, then the auditor should consider what impact this should have on the audit programmes for the following year. The auditor should also audit the entity's work to determine the most likely error in the opening balances that should be included in the current year's summary of unadjusted differences.

12.4.2 When a review level of assurance is desired, the auditor's procedures primarily involve asking entity officials what actions they have taken and what the results were, without verifying the work performed.

Implementation of Recommendations

12.4.3 At this stage the auditor will audit or review the work performed by entity officials to deal with the matter raised in the recommendation.

12.4.4 As discussed above, the follow up and implementation of recommendations may take entity officials some time to complete. If so, entity officials should be asked for an action plan. In addition, if entity officials will need an extensive period of time to deal with the recommendation, the officials should also be asked to identify milestones and issue progress reports. This action plan and the progress reports would be an integral part of the material that the auditor should examine during the follow up audit.

12.4.5 During the follow up, the auditor should review the status of management actions against the plan and, where appropriate, validate the reports on actions taken and identify any other issues that need to be reported. The auditor should also assess the effectiveness of the actions.

12.4.6 When doing this work, the auditor's focus should be on determining whether the identified internal control weakness, compliance with authority violation, etc. was appropriately dealt with. It is possible that entity officials will have found a different way to deal with the matter than the auditor recommended. As noted in paragraph 4.0.25 of DAGP's Auditing Standards, *"In formulating and following up recommendations, the auditor shall maintain objectivity and independence and thus focus on whether identified weaknesses are corrected rather than on whether specific recommendations are adopted."*

- 12.4.7** Sometimes, entity officials may inform the auditor that their follow up efforts indicate that the auditor's recommendations will be more difficult to implement than originally expected, and that they do not intend to proceed any further.
- 12.4.8** In such cases, the auditor should review the reasonableness of the entity's position. Assume, for example, that entity officials had not agreed with the findings, conclusions or recommendations at the time that the report was being drafted. The officials may have decided not to argue too strongly at that time, but rather to demonstrate their lack of acceptance of the findings, conclusions and recommendations by their subsequent actions, or rather lack thereof. When the auditor is informed that management no longer intends to implement a recommendation, the motives behind management's actions must be understood.
- 12.4.9** The auditor must recognise that he/she could have been mistaken, and that the recommendations could be much more difficult to implement than originally expected. It is sometimes better for the auditor to accept the entity's perspective than to attempt to force compliance with recommendations that are not accepted by entity officials.
- 12.4.10** On the other hand, if the auditor gives in too often, entity officials may be encouraged to dispute any of the auditor's findings, conclusions and recommendations with which they are uncomfortable. Therefore, before agreeing to retract a recommendation, the auditor should consider reporting the matter to the appropriate PAC to obtain its views.

12.5 Reporting the Results of the Follow Up

Correction of Errors and Implementation of Recommendations

- 12.5.1** Follow up work is often reported in the same way as the original errors or recommendations were reported. They can be included in reservations to the audit opinion or in audit reports or management reports.
- 12.5.2** In addition, if the matter was addressed in a PAC hearing, the auditor would usually need to prepare a report to the PAC outlining the results of the follow up.
- 12.5.3** Even if the PAC had not addressed the matter previously, if the auditor concludes that corrective action is not adequate, the auditor should consider reporting the matter to the appropriate PAC.
- 12.5.4** Senior entity officials must take the follow up reports issued by the auditor seriously. If the Principal Accounting Officer and/or the Chief Executive Officer take the follow up actions seriously, then individual managers are much more likely to take the audit function seriously.

12.5.5 One question that often arises is whether entity officials should be given recognition and credit for the efforts they have made to date. If the auditor judges that the entity officials are just going through the steps without commitment to making improvements, then giving them credit for work done to date would most likely not be appropriate. If, on the other hand, entity officials have agreed with the need for improved controls, the auditor should consider giving them encouragement.

12.6 Performing additional follow ups

12.6.1 When to Perform

12.6.2 When the auditor concludes that the corrective action taken by entity officials is not adequate, the auditor should consider a second follow up of the matter at a later date.

12.6.3 As a general rule:

- a) If the PAC requests DAGP to continue to pursue the matter, DAGP should continue to pursue the matter.
- b) Matters that are serious – either due their size or their significance to the government’s operations – should continue to be followed up until they are no longer relevant.
- c) Other matters should not receive more than one additional follow up unless the appropriate Director General approves additional follow ups.

12.6.4 With respect to (b) and (c), matters reported in audit reports deal with matters of such significance that they require the attention of Members of the National Assembly, a Provincial Assembly, or a District Assembly. As such, these are the matters that one would expect to see followed up until they are no longer relevant. Matters reported in management reports, on the other hand, would more likely fall into category (c) than category (b).

12.6.5 With respect to (c), the appropriate Director General should consider the following matters when deciding whether to authorise an additional follow up of a particular matter:

12.6.6 The additional follow up of matters that the PAC is not interested in pursuing or with which entity officials do not intend to deal is unlikely to produce the desired effect. Entity officials may never agree to implement the recommendation and, even if they ultimately do, they may only do so in a half-hearted way, and only to the extent required to placate DAGP officials.

12.6.7 However, dropping matters too quickly could reduce the likelihood that entity officials will deal with the matter. There are two reasons for this:

- a) Entity officials may think that, if they can get through two follow ups without having to make any changes, then they can avoid the issue.
- b) Entity officials may get the impression that, because the auditor was willing to drop the matter, the auditor did not consider the matter to be all that significant in the first place.

12.6.8 There are practical limits to the extent of follow up that the auditor can pursue. Matters that can be followed up quickly and with very little cost to DAGP could be pursued for a greater length of time than matters that require a great deal of time and cost to perform. In any case, the auditor should document all follow up activities and the decisions that are taken about pursuing or dropping follow up of specific deficiencies, errors or recommendations.

13 QUALITY ASSURANCE

13.1 Introduction

13.1.1 DAGP has a quality assurance framework to ensure its work is performed as efficiently and effectively as possible, and complies with International auditing standards as well as DAGP's own Auditing Standards. Quality is performing an audit effectively, following up all errors and deviations with a rigorous evaluation, reporting clearly on the results, while at the same time respecting the resource and time constraints established by the budget. Therefore quality assurance occurs all through the audit, not at the end.

Quality is performing an audit effectively, following up all errors and deviations.

13.1.2 Elements of this quality assurance framework have been introduced throughout this Manual:

- a) DAGP's Auditing Standards;
- b) annual planning processes; and
- c) the process tools and supervision instruments with which the auditor plans, performs, evaluates, reports and follows up individual audits.

13.1.3 This Chapter provides a summary of the quality assurance procedures and techniques implemented by DAGP.

13.2 General Quality Assurance Techniques Described in this Manual

Quality Assurance through DAGP's Stated Values

13.2.1 DAGP's values are discussed in Chapter 2.

13.2.2 These values provide the auditor with guidance as to how he or she should conduct every aspect of the audit. Anytime the auditor is unsure of how to respond to a situation, reference to DAGP's values should provide the necessary direction. These values are therefore an important component of DAGP's quality assurance foundation.

Quality Assurance through DAGP's Auditing Standards

13.2.3 DAGP's Auditing Standards are discussed in Chapter 4.

13.2.4 By following these standards, DAGP officials and staff, will assure the quality of each audit.

14

Quality Assurance through DAGP's Annual Planning Process

14.1.1 DAGP's annual planning process is discussed in Chapter 6.

14.1.2 The annual planning process helps ensure that DAGP's resources are utilised in the most efficient and effective manner and that each audit is adequately resourced. This contributes to the creation of an environment where the quality of each audit can be maximised.

14.2 Quality Assurance During the Planning Phases for Individual Audits

14.2.1 The detailed discussion of the general and detailed planning phases of an audit in Chapter 7 contains numerous quality assurance procedures. These procedures are summarised below.

Quality Assurance Through Following a Logical Framework

14.2.2 The audit cycle guides auditors through the general and detailed planning processes in a logical order. This helps ensure that;

- a) the most critical planning decisions are made first;
- b) all required planning decisions are made; and
- c) the end result is an audit plan that, if followed, will result in an efficient and effective audit that complies fully with DAGP's Auditing Standards.

Quality Assurance Through Documentation and Approval of Planning Documents

14.2.3 Audit programmes, checklists and forms, all of which are contained in the Standard Audit Working Papers Kit, support many of the general and detailed planning decisions.

14.2.4 Most of these audit programmes, checklists and forms, together with the documentation supporting them, are maintained in an updated permanent file, an updated planning file, an updated audit planning memorandum, and updated audit programmes for staff to use during the fieldwork, evaluation and reporting phases.

14.2.5 Key to maintaining the quality of the planning process itself is a review of the plan, which the Deputy Auditor General (Senior) or the responsible Deputy Auditor General should supervise and approve.

Quality Assurance through Assigning Appropriate Staff

14.2.6 Proper staffing of the audit team is essential to assuring a quality audit. This includes having enough team members to perform all planned audit activities as well as ensuring that all required skills sets, including supervisory and special technical skills, are available to the audit team as needed

Quality Assurance through Budgets

14.2.7 DAGP encourages a formal process for each audit by which budgets are initially set, reviewed and approved. While most of the benefits of these budgets are achieved through the monitoring of the time spent and a comparison of actual hours spent to the budget, the exercise of preparing the budget itself can help to ensure an efficient and effective audit.

14.3 Quality Assurance during the Fieldwork Phase for Individual Audits

14.3.1 There are various quality assurance measures that guide the auditor in performing and documenting the fieldwork, such as:

- a) revising planning decisions should unanticipated matters arise during the fieldwork phase;
- b) applying minimum documentation standards;
- c) providing on-the-job supervision;
- d) reviewing audit working paper files; and
- e) reporting and monitoring time spent by each resource on every audit activity.

14.4 Quality Assurance during the Evaluation Phase

14.4.1 Evaluation activities include an appropriately detailed review and approval of:

- a) All monetary errors, compliance with authority violations and internal control deviations found, and the assessment of their causes;
- b) The calculation of the most likely error and the upper error limit for each test;
- c) The calculation of the most likely error and the upper error limit for each component;
- d) The calculation of the most likely error and the upper error limit for the financial statements as a whole;
- e) The assessment of the overall financial statement presentation and the reasonableness of the overall results;
- f) The assessment of the achieved level of assurance;
- g) The documentation supporting the discussion of the results of the error evaluation with entity officials;
- h) The follow-up work performed by entity officials; and
- i) How unacceptable results were dealt with.

14.5 Quality assurance during the reporting phase

Quality Assurance for Financial Audit Opinions

14.5.1 The following tools are provided to ensure the quality of the auditors opinions and statements:

- a) Management representation letters;
- b) Audit completion checklists; and
- c) Memoranda recommending signature.

- 14.5.2** These documents, and the diligent performance of quality assurance procedures for their use, help ensure that DAGP has the audit evidence that it requires, and that the Auditor-General is signing the most appropriate opinion. Quality assurance for other audit reports
- 14.5.3** A formal process governing how audit observations are developed, cleared and reported, and the most appropriate reporting style has been used. This process helps to ensure that the contents of the report are correct, and the findings, conclusions and recommendations contained in the report are easily understood and appreciated by the readers of the reports.

14.6 Quality assurance during the follow up phase

- 14.6.1** The follow up phase is a major component in assuring the quality and the positive impact of the audit process, which contributes to the quality of the audit work and the use that is made of its findings.
- 14.6.2** Follow up audits can be designed to provide either an audit level of assurance or a less rigorous review level of assurance. The work is guided by quality assurance procedures for the planning, fieldwork, evaluation and reporting phases of the work.

14.7 Other quality assurance procedures

- 14.7.1** There are a number of other procedures that contribute to the overall quality of the audit operation, as follows.

Ongoing Supervision and Review

- 14.7.2** Adequate supervision and review is important throughout all phases of the audit – general planning, detailed planning, fieldwork, evaluation, reporting and follow up.

Ongoing Involvement By Senior Audit Officials

- 14.7.3** Ongoing involvement by senior audit officials in the more complex and critical stages of the audit process ensures a focused, efficient and effective audit. This involvement also provides an opportunity to upgrade the skills of less senior and experienced audit staff through mentoring to transfer their knowledge.

Audit Staff Development

- 14.7.4** Since all audits are conducted by human resources, the most critical elements of quality assurance are the proper composition of the audit team (an appropriate mix of skills and experience) and the adequate preparation of each team member to fulfil their role in the team.
- 14.7.5** DAGP's General Auditing Standards include a requirement to develop and train employees, and to define the basis for their advancement.

- 14.7.6** Audit staff can be developed through a formal programme of classroom training on the concepts behind the audit work supplemented by on-the-job training and continual mentoring by audit seniors. On-the-job training involves more senior and experienced staff training and supervising less senior and experienced staff. This helps to ensure that the less senior and experienced staff acquire the skills and knowledge required to take on more senior responsibilities, and that DAGP's Auditing Standards for planning, fieldwork, evaluation and reporting are complied with.
- 14.7.7** Training and advancement should be a key factor when assigning specific staff to audits.
- 14.7.8** One way of reinforcing the on-the-job learning experience is to provide each auditor with timely feedback on their performance. Those officials doing the review of the working paper files should provide the auditor with feedback on their performance shortly after the review, as opposed to waiting until after the reporting phase.
- 14.7.9** Assignment appraisal forms are one way of documenting the performance of an auditor on an individual assignment, including strengths and areas where improvements are required. Similarly, annual appraisal forms can be used to evaluate an employee on his/her work for the year.
- 14.7.10** Upward appraisals can be used as a means by which auditors can provide constructive feedback about their superiors.

Information Technology and Audit Methods Specialists

- 14.7.11** Proper use of computer technology has a major positive impact on the quality of the records underlying the financial statements and the auditor's ability to review them. All staff members should have a sufficient knowledge of computer-assisted auditing techniques (CAATs) to identify areas where their use would be appropriate, and to assist someone in applying them. It is normally not essential for every auditor to be able to perform every type of CAAT nor to perform some of the more sophisticated analytical procedures, such as regression analysis.
- 14.7.12** These skills should be made available to audit teams as required. Audit offices around the world deal with this by creating specialist positions and teams. For example, various audit offices have created:
- a) Information technology (IT) specialist groups to provide ongoing advice and assistance to audit teams in the performance of CAATs; and
 - b) Audit methods specialists to provide ongoing advice and assistance to audit teams in the performance of analytical procedures, statistical sampling, advanced auditing techniques.
- 14.7.13** These specialists are often also responsible for keeping the audit office's methodology up to date in their areas of expertise, developing and teaching courses, etc.

Outside Experts

14.7.14 Even with the creation of specialist groups, sometimes additional expertise will be required to deal with very specialised and technical matters that arise during some audits. For example, additional expertise could be needed in the areas of law, actuarial science or engineering. When audit teams require specific skills that are not available in-house, DAGP can consider contracting external resources from the private sector.

14.7.15 One of the functions that could be assigned to specialist groups is the development of a list of experts that audit teams could turn to as required.

Quality Assurance Reviews

14.7.16 DAGP's Auditing Standards contain several references to the requirement that audits are carried out in accordance with a high level of professional standards.

14.7.17 One way to ensure this is to review the efficiency and effectiveness of DAGP's own internal standards and procedures as called for in paragraphs 2.1.25 to 2.1.31 of DAGP's Auditing Standards. These paragraphs are reproduced below.

Table 13.1 – Quality Assurance Reviews
<i>The general standards include:</i> The Department of the AGP shall frame policies and develop procedures to review the efficiency and effectiveness of its internal standards and procedures (see paragraph 2.1.2e). The following paragraphs explain quality assurance reviews as an auditing standard.
<i>Because of the importance of ensuring a high standard of work by the Department of the AGP it shall pay particular attention to quality assurance programmes in order to improve audit performance and results. The benefits to be derived from such programmes make it essential for appropriate resources to be available for this purpose. It is important that the use of these resources be matched against the benefits to be obtained.</i>
<i>The Department of the AGP shall establish systems and procedures to:</i> (a) confirm that integral quality assurance processes have operated satisfactorily; (b) ensure the quality of the audit report; and (c) secure improvements and avoid repetition of weaknesses.
As a further means of ensuring quality of performance, additional to the review of audit activity by personnel having line responsibility for the audits concerned, the Department shall establish its own quality assurance arrangements. That is, planning, conduct and reporting in relation to a sample of audits may be reviewed in depth by suitably qualified personnel of the Department not involved in those audits, in consultation with the relevant audit line management regarding the outcome of the internal quality assurance arrangements and periodic reporting to the top management of the Department.
<i>It is appropriate for the Department of the AGP to institute their own internal audit function with a wide charter to assist it to achieve effective management of its own operations and sustain the quality of its performance.</i>
The quality of the work of the Department shall be enhanced by strengthening internal review and by independent appraisal of its work.
The Department shall ensure that applicable standards are followed on all audits and that deviations from the standards which are determined to be appropriate are documented.

14.7.18 To fulfil these requirements, DAGP will perform, or arrange for others to perform, a regular review of its activities. These reviews should be undertaken on a periodic basis, selecting a few audits or activities each year. Each review should yield valuable practical lessons and, over time, this Manual and DAGP's other methodology documents can be updated to reflect the body of knowledge acquired through these reviews. This should result in continuous improvement to the quality, efficiency and effectiveness of the audit work carried out by DAGP.

Entity Feedback

14.7.19 A final quality assurance technique for auditors to assess and improve the quality of their audits is the use of entity feedback. This feedback could be obtained as part of the quality assurance reviews discussed in Section , or as a separate exercise.

14.7.20 Entity officials could be asked to comment on matters such as:

- a) The extent to which the auditors performing the work appeared to have an understanding of the entity being audited;
- b) The apparent qualifications of the auditors performing the work;
- c) The extent to which the auditors liased with, and made use of, the internal audit unit within the entity;
- d) The length of time and the number of hours required to perform the work;
- e) The extent to which the more senior and experienced DAGP officials were on-site;
- f) The extent to which entity input was requested on errors found, contentious issues, etc.;
- g) The fairness of the audit opinion and other reports – both the initial versions and the final versions;
- h) The readability of the various audit reports; and
- i) The overall extent to which they believe the audit will help them to improve their financial statements, compliance with authorities, internal controls and operations in future years.

14.7.21 Ultimately, the quality of the work performed by DAGP will be determined by the commitment of the organisation to fulfilling its Mission, Vision and Values, and the enthusiasm of audit staff at all levels to tackle their challenging job with integrity and pride.

*Commitment
to fulfilling
Mission,
Vision and
Values with
integrity and
pride.*

APPENDIX A

Glossary of Terms

Most of the terms used in the manual are defined in the chapters in which they are first discussed in some detail. This annex defines the key terms that are used throughout the manual.

A

Analytical procedures. Techniques used by the auditor to:

- Study the relationships among elements of financial and non-financial information to form expectations as to what the recorded amounts should be; and
- Compare such expectations with the recorded amounts.

The auditor then follows up all unacceptable differences and reaches a conclusion as to the completeness and accuracy of the recorded amount.

Audit evidence. Information that supports the auditor's opinions, conclusions or reports.

Audit mandate. The auditing responsibilities, powers, functions, discretions and duties conferred on the auditor under the constitution or any other law.

Audit objective. See *overall audit objective*, *objective*, and *specific financial audit objective*.

Audit opinion. A report issued by the auditor in which he/she concludes as to whether:

- The financial statements properly present, in all material respects, the government's financial position, the results of its operations, its cash flows and its expenditures and receipts by appropriation; and
- 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.

Audit planning memorandum. A document that summarises the key planning decisions that have been made, with emphasis on the changes that have been made to the previous year's plan.

Audit procedures. The tasks the auditor undertakes for collecting, analysing, interpreting, and documenting information that allows the auditor to conclude against the specific audit objectives, related compliance with authority objectives and error conditions.

Audit programme. A document that contains the specific audit procedures that the auditor is to perform during the fieldwork phase.

Audit risk. The chance that the auditor is prepared to take that he/she may issue an unqualified opinion on financial statements that are materially misstated.

Audit report. A document, other than an audit opinion, that is issued by the auditor to individuals outside the entity. These individuals could include, for example, members of the National Assembly, a Provincial Assembly, a District Assembly, a Public Accounts Committee, or the general public.

Auditing standards. A framework for the establishment of procedures and practices to be followed in the conduct of an audit. They generally provide the minimum standard of performance that an audit organisation such as DAGP should consider acceptable.

B

Basic precision. The further possible error that could exist in the population even if no errors are found in a sample. It therefore represents the upper error limit when the most likely error is nil.

C

Cause. The underlying factor(s) that explain the findings observed during the audit. Generally the audit recommendations are directed towards correcting the cause(s) of the weaknesses identified.

Compliance with authority. Conformity and adherence to the laws, rules, regulations, policies, plans, etc. governing the entity.

Compliance with authority audit. An examination to determine the extent to which the entity has adhered to the laws, rules, regulations, policies, plans, etc. governing it. A portion of this work is required to be performed as part of a financial audit. (See *Related compliance with authority objective*.)

Compliance with authority objective. A specific purpose or goal used to assess whether the entity's activities, transactions and events are in conformity and adherence to the laws, rules, regulations, policies, plans, etc. governing the entity. A portion of these objectives is required to be performed as part of a financial audit. (See *Related compliance with authority objective*.)

Component. A distinct unit (or part) of the financial statements being audited.

Compliance test. See *test of internal control*.

Conclusion. Statements deduced by the auditor from his/her findings.

Control environment. The overall attitude, awareness, commitment and actions of management concerning the importance of internal control and its emphasis in the entity.

Control risk. The chance that the entity's internal controls will not prevent or detect material error.

Control systems. The controls established and maintained by management to collect, record and process data and report the resulting information.

D

Detection risk. The chance that the auditor's substantive procedures will fail to detect material error.

E

Economy. The acquisition of the appropriate quality and quantity of inputs (financial, human and/or physical resources) at the appropriate time and place and at the lowest cost.

Effectiveness. The extent to which objectives are achieved – the relationship between the intended impact and the actual impact of an activity.

Efficiency. The relationship between the goods or services produced (outputs) and the set of resources used to produce them (inputs).

Entity. The organisation, programme, project, activity, theme or function subject to audit. In the case of a financial audit, the entity is often defined by the applicable accounting policies of the government. For the financial statement audit of the Federation, for example, the entity to be audited would be the aggregate of all of the ministries, departments, agencies, etc. that the accounting policies require to be included in the financial statements of the Federation.

Error condition. A specific way in which a monetary error can occur in the financial statements or a monetary amount may not be in compliance with a related compliance with authority objective. This would include, for example,

specific ways in which an asset, liability, revenue or expenditure item might not be valid, might not be complete, etc. (See *specific financial audit objective* and *related compliance with authority objective* for the complete list.)

F

Financial audit. A type of regularity audit in which the auditor attests to the financial accountability of an entity by examining and evaluating financial records, leading to the expression of an opinion on financial statements. A financial audit includes a significant compliance with authority element.

Findings. An observation, or deduction, that the auditor determines worthy of reporting.

Fraud. The intentional act by one or more individuals to deceive others.

Further possible error. The error in excess of the most likely error that could exist in a population at a given confidence level. It is equal to the difference between the upper error limit and the most likely error. It has two components – basic precision and precision gap widening.

I

Individually significant transactions and events. Transactions and events that are so large or of such a high risk that the auditor wishes to audit 100% of them.

Inherent Risk. The chance of material error occurring, assuming that there are no internal controls in place.

Internal audit. The functional means by which the managers of an entity receive assurance from internal sources that the processes for which they are accountable are operating in a manner which will minimise the probability of the occurrence of fraud, error, compliance with authority violations, internal control deviations, or inefficient and uneconomic practices.

Internal control. A process, established by management and carried out by management and other personnel, to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

Internal control structure. The entire system of financial and other controls, including the organisational structure, methods, procedures and internal audit, established by management within its corporate goals, to assist in conducting the business of the entity in a regular economic, efficient and effective manner; ensuring adherence to management policies and applicable authorities; safeguarding assets and resources; securing the accuracy and completeness of accounting records; and producing timely and reliable financial and management information.

International Organisation of Supreme Audit Institutions (INTOSAI). An international and independent body that aims to promote the exchange of ideas and experience between Supreme Audit Institutions.

K

Known error. An error that the auditor has actually found during an audit.

M

Materiality. 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.

Material error. A single error which exceeds the materiality amount, or the sum of multiple smaller errors that exceeds the materiality amount.

Most likely error. The auditor's best estimate of the error in the population.

O

Objective. A purpose or a goal.

Other substantive procedures risk. The chance that the auditor's analytical procedures, and substantive tests of details will fail to detect material error.

Overall audit objective. The overall purpose or goal to be achieved by performing a particular audit. The objective will be affected by the type of audit to be performed. For example, the overall audit objective for a financial audit is to express an opinion on financial statements (See also *audit opinion*.)

P

Planned precision. The auditor's planned allowance for further possible errors. It represents materiality less the expected aggregate error in the financial statements.

Population. The total set of items from which a sample of items is to be taken.

Performance audit. An audit of the economy, efficiency and effectiveness with which the audited entity uses its resources in carrying out its responsibilities.

Precision gap widening. The further possible error that results from finding errors in a sample.

R

Recommendations. Actions that the auditor proposes the entity take in the belief that they will address compliance with authority violations and internal control weaknesses and deviations, and/or their underlying causes.

Regularity audit. An examination involving one or more of the following activities:

- A financial audit;
- Attestation of financial accountability of the government administration as a whole;
- An audit of financial systems and transactions, including an audit of compliance with authority.
- An audit of internal control and internal audit functions;
- An audit of the probity and propriety of administrative decisions taken within the audited entity; and/or
- The reporting of any other matters arising from or relating to the audit that the SAI considers should be disclosed.

Related compliance with authority objective. Those compliance with authority objectives that are applicable to (related to) a financial audit. Normally the following compliance with authority objectives are considered to be applicable:

Spend –

- The services were actually performed or the goods were actually received;
- The expenditure is consistent with the nature of the appropriation to which it was charged;
- The expenditure is in accordance with the applicable legislation, and the rules and/or regulations issued by such legislation; and
- The expenditure does not result in the total approved expenditure being exceeded.

Borrow –

- The amount and debt terms (period, interest rates, repayment schedule, etc.) were in accordance with the applicable legislation, and the rules and/or regulations issued by such legislation.

Raise revenue –

- The cash received was for an approved tax or other approved revenue source; and
- The cash received is in accordance with the applicable legislation and the rules and/or regulations issued by such legislation.

S

Sampling. The selection of a sub-set of a population.

Sampling unit. The specific item of which the population is assumed to be composed for sampling purposes.

Specific financial audit objective. A specific purpose or goal used to determine whether a component properly presents. For a financial audit, these purposes or goals are determining if:

- The component is valid (the asset or liability exists or the revenue or expenditure has occurred);
- The asset, liability, revenue or expenditure is complete;
- The asset is owned by the entity, or the liability is owed by the entity;
- The asset or liability is properly valued and properly classified, or the revenue or expenditure is properly measured and properly classified; and
- The financial statement presentation is proper.

Statistical sampling. The selection of a sample in such a way that each sampling unit has an equal and known chance of selection.

Substantive tests. Procedures used to gain direct assurance as to the completeness and accuracy of the data produced by the accounting systems. They are often divided between analytical procedures and substantive tests of details.

Substantive tests of details. Substantive tests such as physically inspecting an asset, checking transactions recorded in the books and records to supporting documentation, and confirming amounts with third parties.

Substantive test of details risk. The chance that one key substantive test of details will fail to detect material error.

T

Test of internal control. A procedure used to gain an understanding of the entity's internal control structure. By performing these tests, the auditor can gain assurance that the internal controls are helping to reduce the chance of material error existing in the accounting information, or a material compliance with authority violation occurring.

Tests of internal control include:

- Inquiries of appropriate entity personnel;
- Observation of policies and procedures in use;
- Walk-through procedures; and
- Selecting a sample of transactions and verifying that the appropriate control procedures were followed.

Transaction. A single accounting event, such as the purchase of a good, the receipt of a sales tax amount, or the making of a disbursement.

Transaction cycle. The flow of transactions through the accounting system. An example is the purchase/payables/payments cycle whereby a service or good is acquired, recorded and paid for.

U

Upper error limit. The maximum possible error that could exist in the population at a given confidence level.

W

Walk-through procedure. A test of internal control that involves selecting one or two transactions from the relevant transaction cycle and “walking” them through the cycle. The auditor begins with the initiation of the transaction, and then follows it through the various processing stages until the transactions are ultimately summarised and included in the general ledger.

APPENDIX B

Statistical and Non-Statistical Sampling and the Use of CAATs

B.1 Introduction

- 1.1. This annex illustrates how an auditor can use CAATs software to select audit samples when statistical or non-statistical sampling is being performed.
- 1.2. There are two basic sampling methods – monetary unit sampling (MUS) for substantive testing, and attribute sampling. The latter is primarily used for compliance testing.
- 1.3. For example, Section B.5 discusses MUS for substantive tests of details. It illustrates how the auditor determines the sample size, selects the sample (either statistically or non-statistically), and then evaluates the sample results. If the auditor were performing a compliance with authority audit on a particular contract or project, the auditor could use the same approach to determine the sample size and select the sample.
- 1.4. The auditor could also use the same error evaluation process, only now the auditor's errors would be amounts not in compliance with a particular authority, as opposed to monetary errors in the recorded amounts. The only real difference in the process is that the auditor would normally not need to deal with "taintings" – the percentage by which a particular sample item is in error – because all errors would normally be 100% errors. (We normally cannot have, for example, an invoice that is 50% approved, or a transaction that is 70% consistent with the nature of the appropriation to which it was charged. The invoice will normally be approved or not approved and the transaction will normally be consistent with the nature of the appropriation to which it was charged or not consistent.)
- 1.5. Sampling is only one source of audit assurance. It is important for the auditor to consider the assurance that is derived from all audit procedures when determining whether he/she has sufficient appropriate audit evidence.
- 1.6. Note that the only difference between statistical sampling and non-statistical sampling is the method of selecting sample items. Planning requirements and the evaluation process remain the same.
- 1.7. This Appendix contains guidelines that the auditor can use to plan a sample. These guidelines should not replace the use of professional judgement. No set of guidelines can be expected to be valid on all audits.
- 1.8. In this Appendix, three terms occur often enough that acronyms are used:

MLE	Most likely error
MUS	Monetary unit sampling
UEL	Upper error limit

Use of CAATs

- 1.9. Using a CAATs tool to perform sample size calculations and error evaluations is superior to performing a manual process for a number of reasons:
- 1.10. This will take significantly longer to do the calculations manually than to use CAATs. Error evaluation calculations, in particular, can take a long time to do manually, and can be done in seconds using CAATs.
 - 1.11. Manual calculations are complex and prone to error. For example, auditors may fail to properly rank errors from the largest tainting to the smallest tainting when doing the error evaluation.
 - 1.12. Should the auditor use planning parameters that are not normally used or that are theoretically questionable, CAATs will either provide a warning message or will not allow the calculation to proceed. When a calculation is being performed manually, the auditor loses this protection.
 - 1.13. Manual calculations result in sample sizes that are larger than those produced by the CAATs software, further adding to the time required to perform the audit.
 - 1.14. Statistical tables do not contain every possible confidence level. Using the tables in manual calculations therefore requires rounding up the confidence level, which will further increase the sample size and further increase the time required to perform the audit.
 - 1.15. Manual calculations result in very conservative error evaluations, which could cause DAGP to conclude that the results of the work are unacceptable when, in fact, they are acceptable.
 - 1.16. Because of the above-noted advantages, auditors are strongly encouraged to use CAATs. However, there may be rare circumstances where manual calculations are required. For this reason, the Standard Audit Working Papers Kit contains standard forms that can be used.

2. Basic concepts and definitions

Sampling

- 2.1. Sampling is the selection of a sub-set of a population. The auditor takes a sample to reach a conclusion about the population as a whole. As such, it is important that the sample be representative of the population from which it was selected.

Statistical Sampling

- 2.2. Statistical sampling is the selection of a sub-set from a population in such a way that each sampling unit has an equal and known chance of selection.
- 2.3. The main advantages of statistical sampling over non-statistical sampling are:
- a) because each sampling unit has an equal and known chance of selection, there is a better chance that the sample will be

representative of the population than is the case with a non-statistical sample. When expressing an opinion on financial statements, having a representative sample is very important.

- b) Because there is a better chance that the sample will be representative of the population, the sample results are more objective and defensible, as are the projections of those results to the population as a whole.
- c) It provides a direct estimate of the maximum possible error (referred to as the upper error limit (UEL) in some CAATS).

Non-statistical sampling

2.4. Non-statistical samples are samples selected by other means which are intended to approximate the representative character of a statistical sample. However, they lack the objectivity of a statistically selected sample.

2.5. Given the advantages of a statistical sample, a non-statistical sample should, in theory, always be larger than a statistical sample. When non-statistical sampling is used, it may be appropriate to increase the sample size by 20% to 50%.

Sampling Unit

2.6. The *sampling unit* is the specific item of which the population is assumed to be composed for sampling purposes.

2.7. As an example, consider a population of purchases for the year. Assume that the purchases are recorded by cash disbursement, that each disbursement may relate to several supplier invoices, and that each supplier invoice may relate to several purchases. In this example, the sampling unit could be:

- a) Each cash disbursement;
- b) Each supplier invoice within each cash disbursement;
- c) Each purchase within each supplier invoice; or
- d) Each Rupee of value within each purchase.

2.8. If the auditor sets an individual cash disbursement as the sampling unit, the sample selection process would be much simpler than if the auditor set an individual purchase within a supplier invoice as the sampling unit. However, by setting each cash disbursement as the sampling unit, the auditor would have to audit all supplier invoices and all purchases within each selected cash disbursement.

Physical Unit

2.9. The physical unit is the specific document (cash disbursement, individual supplier invoice or individual purchase, for example) to which the sampling unit is assumed to relate.

2.10. The physical unit is normally the same as the sampling unit. The primary exception is MUS where the sampling unit is each individual monetary unit (Rupee).

Population Size

- 2.11. The population size is the number of sampling units (cash disbursements, supplier invoices, purchases or Rupees) in the population.
- 2.12. The population size will vary depending on the sampling unit being used. For example, our population of purchases for the year may be composed of 16,000 cash disbursements, 30,000 supplier invoices, 70,000 purchases, and 100,000,000 individual Rupees. Depending on which sampling unit has been selected, any of these amounts could constitute the population size.
- 2.13. Except for small population sizes, the size of the population does not influence the size of the sample selected. For other than very small populations, the sample size is dependent on the assumed variability (error rate) of the population, on the accuracy required from the sample (determined by consideration of materiality) and the confidence level (determined by consideration of risk). Accordingly, the auditor should not think in terms of selecting a percentage of the population. Taking a fixed percentage will tend to under-sample a small population and over-sample a large population.
- 2.14. The following table illustrates the relationship between sample size and population size. Note how, after a certain size, the population size does not influence the sample needed to achieved the desired level of confidence.
- 2.15. A simple approach when using automated tools to calculate sample size, is, if the calculated sample is as large as or larger than the population, then take the whole population into the sample.
- 2.16. Table: Sample sizes for attributes sampling, expected error rate not over 5%, confidence level 95%

Population Size	Sample Size for Precision Percentage of Plus or Minus			
	1.00	2.00	3.00	4.00
50	48	45	40	34
100	94	82	66	53
150	138	112	86	64
200	180	139	100	72
250	219	161	111	78
500	392	238	144	92
1000	645	313	168	102
2000	954	371	184	107
5000	1336	418	194	111
10000	1543	436	198	112
20000	1672	446	200	113
50000	1760	452	201	113
100000	1792	454	202	113

Population Value

- 2.17. The population value is the monetary amount of the population being sampled. In the above example, it would be Rs. 100,000,000.
- 2.18. There may be individually significant transactions that the auditor wants to examine. These could be very large transactions or transactions with high risk. Auditors often audit 100% of these transactions, and take a sample of the remaining transactions.
- 2.19. To arrive at the population value for sampling purposes, the auditor needs to subtract the total value of the individually significant transactions from the total population value. For example, if the auditor decides to audit all transactions greater than Rs. 500,000 and to take a sample of the remaining transactions, the total value of the items greater than Rs. 500,000 would be removed from the population value when determining the required sample size.
- 2.20. Sometimes the auditor does not know the population value when determining the sample size. For example, the auditor may wish to select a sample of supplier invoices for the year, and may start auditing the transactions before the end of the year. In this case, the auditor will make an estimate of the population value at the planning stage.

Sampling Risk

- 2.21. Sampling risk is the chance that a sample is not representative of the population from which it was selected.

- 2.22. If the sample is not representative the auditor could reach an incorrect conclusion about the population from which the sample was selected. The auditor could incorrectly conclude that:
- a) The population is not materially misstated when, in fact, it is materially misstated; or
 - b) The population is materially misstated when, in fact, it is not materially misstated.
- 2.23. When planning an audit, auditors normally try to control the first risk and ignore the second. This is because, should an auditor conclude that a population is materially misstated, entity officials will normally conduct an investigation to determine if the auditor is correct. This follow-up work would normally lead the auditor to the correct conclusion.

Confidence Level

- 2.24. The *confidence level* is the degree of assurance that the auditor has that the sample is representative of the population from which it was selected. This is the converse of the sampling risk.
- 2.25. If the auditor uses a 90% confidence level, this means that there is a 90% chance that the sample will be representative of the population from which it was selected, and that the audit results will be correct. Put another way, there is a 10% chance that the sample is not representative of the population, and therefore the auditor may not reach a correct conclusion from the results of the work. For example, the auditor may conclude that the population does not contain a material error when, in fact, it does.

Precision Gap Widening and Basic Precision

- 2.26. Planned precision is the materiality amount less the expected aggregate error for the financial statements as a whole.

To illustrate using our example:

Materiality	<u>Rs. 3,000,000</u>
Expected aggregate error in financial statements	<u>816,500</u>
Planned precision	<u>Rs. 2,183,500</u>

- 2.27. When planning a statistical sample, though, there is one other factor that needs to be taken into account – precision gap widening.
- 2.28. The reason why we need to consider precision gap widening is because, for each additional Rs. 1 in the MLE, the UEL increases by more than Rs. 1. Simply subtracting the expected aggregate error from materiality does not deal with this effect. Therefore, planned precision needs to be reduced by a further amount. This further amount is referred to as precision gap widening.
- 2.29. Planned precision less precision gap widening is referred to as “basic precision”. It is equal to the error that could exist in the population even if

no errors were found in the sample. It therefore represents the UEL when the MLE is nil.

- 2.30. Basic precision and precision gap widening are calculated automatically by some CAATS.

3. Factors Affecting Sample Size

Possible Factors and Impact

- 3.1. Various factors will affect the sample size, as illustrated in the following table:

Factor	Impact on Sample Size if Factor Increases	Comments
Population value	Increase	If population value increases with all other factors remaining the same, materiality and planned precision become smaller percentages of the population value. Hence, the auditor would need a more precise estimate of the error in the population. This would require a larger sample size.
Population size	Nil, except for very small populations	See discussion in Section B.2
Variability of sampling units	Nil for the types of sampling discussed in this annex	Variability is only a factor for those types of sampling plans based on a standard deviation. These types of sampling plans are rarely used in practice.
Materiality	Decrease	If materiality increases while all other factors remain the same, materiality and planned precision become larger percentages of the population value. Hence the auditor would not need to have as precise an estimate of the error in the population. The auditor could then decrease the required sample size.
Planned precision	Decrease	Same discussion as materiality.
Expected aggregate error	Increase	The expected aggregate error is subtracted from the materiality amount to arrive at planned precision. Increasing the expected aggregate error decreases planned precision, which increases the required sample size.
Confidence level	Increase	Increasing the confidence level means that the auditor wants to be more certain about the results of his/her procedure. The auditor will need to take a larger sample to achieve this.
Sampling risk	Decrease	Increasing the sampling risk is the same as decreasing the confidence level. The auditor is willing to be less certain about the results of his/her procedure, and can therefore take a smaller sample.

4. Sample selection

- 4.1. This section considers the basic sample selection rules and methods. It also illustrates how these are applied in the case of (i) MUS for substantive tests of details, (ii) MUS for compliance tests (tests of internal control), and (iii) attribute sampling for compliance tests (tests of internal control).
- 4.2. The difference between statistical sampling and non-statistical sampling is the method of selecting the sample items. All of the planning requirements remain the same, and the evaluation process remains the same.

- 4.3. There are two basic sample selection rules:
1. The sample conclusion only applies to the population from which it is selected; and
 2. The sample should be representative of the population from which it is selected.
- 4.4. The rule in (1.) applies equally to statistical and non-statistical sampling.
- 4.5. The auditor has a better chance of achieving (2.) with a statistical sample than with a non-statistical sample. When using a non-statistical sample, though, the auditor should still strive to ensure the sample is as representative of the population as is possible.
- 4.6. There are several sample selection methods that are very good at ensuring that the sample is representative of the population from which it is selected, as follows:
- a) Random;
 - b) Fixed interval (systematic);
 - c) Cell (random selection); and
 - d) Stratified random.
- 4.7. These are discussed below. The example used assumes that the auditor wishes to select 200 supplier invoices from a population of 30,000 supplier invoices.
- 4.8. For non-statistical sampling, the objective is to try to approximate one of these methods.
- 4.9. For both statistical and non-statistical sampling, there normally needs to be a complete listing of the valid transactions that adds up to the total amount reported on the financial statements.
- 4.10. To satisfy the validity objective, there needs to be a way in which the auditor can locate the individual items that have been selected from the listing.
- 4.11. To satisfy the completeness objective, there needs to be a way that the auditor can go from the individual items contained in boxes and filing cabinets to the listings that make up the total amount reported on the financial statements.
- 4.12. In some cases the listings used may be totals of other listings. In these cases, the auditor will first make a selection from among the totals, and will then make a second selection of individual transactions from the listing supporting each selected total.

Population from Which to Select

- 4.13. The first basic rule states that the sample conclusion only applies to the population from which it is selected. Therefore, if the auditor wants to rely on the internal control structure for the entire year, it would be best if the auditor sampled from the entire year. A less effective (but still generally

accepted) method is to select a sample of transactions up to some interim date, reach a conclusion on that period, and then conduct inquiries, observations and walk-through procedures to reach a conclusion on the internal control structure for the rest of the year.

- 4.14. As the second approach is not as good as the first, it would normally not be acceptable when a high level of reliance is being placed on the internal control structure.
- 4.15. As another example, if the auditor selects a sample of transactions from only one month, the auditor's conclusion only applies to that one month – the auditor really does not have any assurance with respect to the other 11 months.
- 4.16. Another unacceptable approach is block or cluster sampling. Here, for example, the auditor may select all revenue receipts in a month, audit them, and attempt to conclude as to the revenue receipts for the entire year based on this “sample”. In reality, the auditor has not done any sampling at all, and cannot reach a conclusion on the periods of time not covered by the test.

Random Selection

- 4.17. Random selection involves numbering all of the items in the population and then using a random number table or software programme to select 200 random numbers. The auditor then identifies the sampling unit that corresponds to each number.
- 4.18. This method is difficult to use unless the sampling units are already pre-numbered (pre-numbered sales invoices, for example) or can easily be numbered (30 supplier invoices per page and the pages are numbered, for example).

Fixed Interval (Systematic) Selection

- 4.19. This method involves selecting a random start and then every nth item. In our example, the auditor could select every 150th supplier invoice – 30,000 divided by 200. The random start would be a number between 1 and 150. If, say, the auditor picked a random start of 50, he/she would select the 50th item, the 200th item, the 350th item, etc.

Cell (Random Interval) Selection

- 4.20. This method essentially combines the previous two methods. The auditor divides the population into cells and then picks a random item from within each cell. In our example, the first cell would contain the first 150 items, the second cell items 151 to 300, the third cell items 301 to 450, etc.

Stratified Random Selection

- 4.21. CAATS tools may offer a fourth method – stratified random sampling. Using this approach, the population is first stratified based on monetary

ranges, type of expenditure, etc., and then a random sample is drawn from each range. This could be used, for example, to weight an attribute sample to the larger dollar items or specific expenditure types, or to ensure that at least one sample item is drawn from each expenditure type.

Non-statistical Selection

- 4.22. Here the auditor uses judgement to approximate one of the methods described above. If done with care, this can be an acceptable way to select a sample. However, it would be prudent to increase the sample size by 20 to 50 percent to compensate for the fact that the sample may not be truly representative. The size of the increase would depend on how close the auditors believed they had come to approximately a statistical sample.

5. Monetary unit sampling (MUS) for substantive tests of details

Introduction

- 5.1. The key feature of MUS is that the population is considered to be composed of individual monetary units, as opposed to physical transaction vouchers like individual supplier invoices, cash disbursements, etc. The auditor selects an individual Rupee from the population and uses it as a hook to catch the voucher in which it occurs, so it can be audited.
- 5.2. To illustrate, let's return to our population of 30,000 supplier invoices that had a population value of Rs. 100,000,000. When using MUS, the auditor would consider the population to be composed of 100 million individual Rupees, as opposed to 30,000 invoices.
- 5.3. Under MUS, all sampling units (individual Rupees) will have the same chance of being selected. This means that, the larger the supplier invoice, the greater the chance of it being selected. This is why MUS is sometimes referred to as sampling proportionate to size.
- 5.4. If, for example, fixed interval selection is being used and the sampling interval is Rs. 1,000,000, then:
- a) A Rs. 100,000 invoice would have a 10% chance of selection;
 - b) A Rs. 500,000 invoice would have a 50% chance of selection; and
 - c) A Rs. 1,000,000 invoice (or larger) would have a 100% chance of selection.

Determining the Sample Size

- 5.5. The material in this section applies equally to statistical and non-statistical sampling. In this respect, it should be noted that the auditing standards in several developed countries now require the auditor to consider the same factors regardless of whether statistical sampling or non-statistical sampling is being used. As noted previously, though, when non-statistical sampling is being used, it may be appropriate to increase the sample size by 20% to 50%.

5.6. Assume the auditor wishes to take a sample of supplier invoices from a population of 30,000 supplier invoices with a total value of Rs. 100,000,000. The auditor needs to know:

- d) The population value;
- e) The materiality amount for the financial statements as a whole;
- f) The expected aggregate error in the financial statements; and
- g) The confidence level to be used for the test.

5.7. Assuming there are no individually significant transactions that the auditor wants to examine (very large transactions or high risk transactions), the population value in this case is Rs. 100,000,000. The materiality amount and the expected aggregate error are for the financial statements as a whole and therefore would be determined at the start of the planning process. For this example, we will use a Rs. 3,000,000 materiality amount and a Rs. 816,500 expected aggregate error.

5.8. The confidence level represents the amount of assurance that the auditor wishes to derive from the substantive test of details. The auditor normally determines this by using the audit risk model. Using that model, the confidence level is the converse of the substantive test of details risk (STDR) that results from the use of the audit risk model. For example, if STDR is determined to be 15%, the auditor will use an 85% confidence level for his/her sampling procedures.

5.9. While guidelines should not replace the use of professional judgement, the following may be useful:

Sources of Assurance	Possible Confidence Level
Very high level of assurance desired from the substantive test of details (because, for example, it is the only source of assurance)	95%
High level of assurance desired from the substantive test of details (because, for example, only limited reliance is being placed on the internal control structure and on analytical procedures)	90%
Moderate level of assurance desired from the substantive test of details (because, for example, moderate reliance is being placed on the internal control structure and/or on analytical procedures)	80%
Low level of assurance desired from the substantive test of details (because, for example, high reliance is being placed on the internal control structure and/or on analytical procedures)	70%

5.10. Let's assume that the auditor wants a very high level of assurance from the substantive test of details and selects a 95% confidence level. Using CAATS, the auditor would key in:

- 1. Confidence level (95);
- 2. Population value (100,000,000);
- 3. Materiality (3,000,000); and
- 4. Expected aggregate errors (816,500).

5.11. Assume the CAATS software will then produce a sample size of 181.

- 5.12. CAATS also offers the auditor several additional options – splitting the expected aggregate error between sampling applications and other audit tests, assuming that all errors found in the sample will be less than 60%, and changing the basic precision pricing. All of these will reduce the sample size. However, they need to be used with caution. A description of their use is beyond the scope of this annex.

Selecting the Sample – Statistical Sampling

- 5.13. The “standard” sample selection technique with MUS is fixed interval (systematic) selection. Cell (random interval) selection can also be used if the population has been downloaded into a computer and a CAATS software tool is being used to do the selection.
- 5.14. Random selection is also possible, but contains all of the difficulties of cell selection. In addition, it has a further disadvantage – should fixed interval or cell selection be used, the sample size will automatically be adjusted for any over or underestimations of the population value. With random selection, this will not occur. Hence random selection is rarely used with MUS.
- 5.15. For both fixed interval selection and cell selection, the auditor needs to know the sampling interval. This is simply the population value (Rs. 100,000,000 in our example) divided by the sample size (181 in our example). The resulting interval is Rs. 553,350.
- 5.16. Note: some CAATS do not round the sample size to the nearest whole number when calculating the sampling interval. Thus the sampling interval may be slightly different than you get if you do the arithmetic manually.
- 5.17. Using CAATS for fixed interval selection, the auditor will key in:
1. The interval (Rs. 553,350 in our example); and
2. A random starting point (in our example a number between 1 and 553,350).
- 5.18. The CAATS will then select the 181 items.
- 5.19. For cell selection using CAATS, the auditor keys in:
1. The interval (Rs. 553,350 in our example); and
2. A “seed” number (a number to be used for the random number generator).
- 5.20. CAATS will then select the sample of 181 items. This sample will most likely not contain the same 181 items as were selected using fixed interval selection.
- 5.21. For both fixed interval selection and cell selection, the auditor does not need to key in the population value or the sample size – only the sampling interval. This is good because the auditor may not know the population value at the time he/she determines the sample size.

- 5.22. In our illustration, for example, the auditor is selecting a sample of supplier invoices for the year. The auditor may have estimated the Rs. 100,000,000 population value at the planning stage, which may occur well before the end of the year. The auditor may also wish to take a sample of, say, the first 8 months and then another sample of the last 4 months. By having the CAATS tool select every 553,350th Rupee (or create cells of that width), the sample size will automatically be adjusted for any overestimations or underestimations of the population value.

Selecting the Sample – Non-Statistical Sampling

- 5.23. To select a non-statistical sample that approximates a monetary unit sample, the auditor needs to find a way to bias the sample towards the larger monetary items. Some form of value-oriented selection is therefore required.
- 5.24. With a monetary unit sample, any item in the population greater than the sampling interval will automatically be selected, any item with a value of 80% of the average sampling interval will have an 80% chance of being selected, any item with a value of 50% of the average sampling interval will have a 50% chance of being selected, and so on.
- 5.25. Therefore, to approximate a monetary unit sample, the auditors could divide the population to be sampled into ranges, and then select an appropriate percentage of items from each range. For example, let's assume that there are approximately 10 items in the population with a value greater than the sampling interval, 40 items in the population with a value of 80% to 100% of the sampling interval, 110 items in the population with a value of 60% to 80% of the average sampling interval, and so on. The auditors could then randomly select all of the items in the first group, 90% (36) of the items in the second group, 70% (77) of the items in the next group, and so on.
- 5.26. To further approximate a monetary unit sample, the auditor should also select the sample from throughout the year. For example, when selecting the 36 items in the second group, the auditor could select three from each month.
- 5.27. If the auditor has a good knowledge of the population, the above approach would most likely result in a good approximation of a monetary unit sample, and increasing the statistical sample size by only 20% would most likely be sufficient. If, on the other hand, the auditor only had a limited knowledge of the population and had to guess at the monetary distribution, then it would most likely be prudent to increase the statistical sample size by 50%.

Sample Evaluation – Most Likely Error

- 5.28. The material in this section applies equally to statistical and non-statistical sampling. In this respect, it should be noted that the auditing standards in several developed countries now require the auditor to project the sample results over the population and to consider further possible errors,

regardless of whether statistical sampling or non-statistical sampling is being used.

- 5.29. Let's assume that the auditor tests the 181 items and finds 5 overstatement errors, as follows:

	Book Value	Audit Value	Error	Error % (Tainting)
1	600	Nil	600	100.00
2	1000	300	700	70.00
3	3000	1200	1800	60.00
4	1800	1200	600	33.33
5	2000	1700	300	15.00
Total	8400	4400	4000	

- 5.30. The auditor has a *known error* of Rs. 4,000. However, he/she has only selected a sample of 181 supplier invoices out of the 30,000 supplier invoices in the population. The auditor needs to determine the *most likely error* (MLE) in the population.

- 5.31. To arrive at the MLE, MUS uses a concept called tainting. Tainting is the percentage by which each physical unit is in error. In our example, we have the following:

	Book Value	Audit Value	Error	Error % (Tainting)
1	600	Nil	600	100.00
2	1000	300	700	70.00
3	3000	1200	1800	60.00
4	1800	1200	600	33.33
5	2000	1700	300	15.00
Total	8400	4400	4000	

- 5.32. What we have, then, are 5 items in the sample having errors totalling 278.33% and 176 items in the sample having no errors. The average percentage error in the sample is therefore 1.53775% (278.33% ÷ 181).

- 5.33. Assuming the sample is representative of the population, then the average percentage error in the population would be 1.53775%, and the MLE for the population as a whole would be Rs. 1,537,750 (Rs. 100,000,000 x .0153775).

- 5.34. Many CAATS packages use the same theory but rearrange the formula somewhat. In the example above we took the sum of the taintings, divided by the sample size, and multiplied by the population value, as follows:

$$\begin{aligned}
 \text{MLE} &= \frac{\text{Sum of taintings}}{\text{Sample Size}} \times \text{Population Value} \\
 &= \frac{2.7833}{181} \times 100,000,000 \\
 &= \text{Rs. 1,537,750.}
 \end{aligned}$$

- 5.35. Rearranging this formula:
- $$\begin{aligned} \text{MLE} &= \text{Sum of Taintings} \times \frac{\text{Population Value}}{\text{Sample Size}} \\ &= \text{Sum of Taintings} \times \text{Sampling Interval.} \end{aligned}$$
- 5.36. To use a CAATS, the auditor creates an Excel (or other acceptable) spread sheet containing the book values and audited values for each item in error. The auditor then imports the file into the CAATS and keys in:
1. The confidence level (95);
 2. The sampling interval (553,350); and
 3. The sample size (181).
- 5.37. The CAATS then calculates the MLE of Rs. 1,540,150.
- 5.38. This approach produces a MLE of Rs. 1,540,150 (2.7833 x Rs. 553,350). The slight difference between the manually calculated solution and the CAATs result (Rs. 1,537,750 vs. Rs. 1,540,150) is due to the fact that the CAATS does not round the sample size to the nearest whole number when calculating the sampling interval.

Sample Evaluation – Upper Error Limit – Overstatements

- 5.39. The MLE of Rs. 1,540,150 is the auditor's best estimate of the error in the population. However, because the auditor has only taken a sample, the actual error in the population could be larger or smaller than Rs. 1,540,150.
- 5.40. MUS is designed to produce an UEL as opposed to a range. To get a range, the auditor does two error evaluations – one for overstatement errors and one for understatement errors. The auditor then combines the results of the two evaluations.
- 5.41. The information imported or keyed in by the auditor is all the information the CAATS needs to calculate the UEL. In our example, all five errors were overstatement errors. In addition to calculating the MLE of Rs. 1,540,150, CAATS calculates an UEL of Rs. 3,584,850.
- 5.42. The error evaluation indicates that the auditor is 95% confident that the population is most likely overstated by Rs. 1,540,150, and that the population is not overstated by more than Rs. 3,584,850. As the materiality amount was Rs. 3,000,000, this is an unacceptable result.
- 5.43. The reason for the unacceptable result is that the MLE of Rs. 1,540,1500 is larger than the Rs. 816,500 expected aggregate error that was allowed for when planning the audit. As a general rule, if the MLE found in the sample exceeds the expected aggregate error allowed for when determining the sample size, then the results will be unacceptable.
- 5.44. Section 9.7 describes how the auditor deals with unacceptable results.

- 5.45. The error evaluation produces two additional amounts – basic precision of Rs. 1,644,040 and precision gap widening of Rs. 400,660. These amounts make up the Rs. 2,044,700 difference between the MLE of Rs. 1,540,150 and the UEL of Rs. 3,584,850.

Error Evaluation – Upper Error Limit – Understatements

- 5.46. As noted above, the evaluation of understatements is done separately from evaluation of overstatements. The approach used is identical, and the data keyed in are identical.
- 5.47. The example includes no understatement errors so the MLE for understatement errors is nil. The UEL will be Rs. 1,644,040, being the basic precision amount.

Error Evaluation – Upper Error Limit – Combining Overstatements And Understatements From The Same Test.

- 5.48. To arrive at a net MLE and a net UEL, the results of the two separate evaluations are combined, as follows:

Net MLE	=	MLE (over) - MLE (under)
Net UEL (over)	=	UEL (over) - MLE (under)
Net UEL (under)	=	UEL (under) - MLE (over)

- 5.49. In our example we have:

Net MLE	=	MLE (over) - MLE (under)
	=	Rs. 1,540,150 - nil
	=	Rs. 1,540,150.
Net UEL (over)	=	UEL (over) - MLE (under)
	=	Rs. 3,584,850 - nil
	=	Rs. 3,584,850.
Net UEL (under)	=	UEL (under) - MLE (over)
	=	Rs. 1,644,040 – Rs.1,540,150
	=	Rs. 103,890.

- 5.50. CAATS does this netting automatically.
- 5.51. The result is that the auditor can conclude with 95% confidence that:
1. The population is most likely overstated by Rs. 1,540,150;
 2. The population is not overstated by more than Rs. 3,584,850; and
 3. The population is not understated by more than Rs. 103,890.

- 5.52. As materiality is Rs. 3,000,000, this is again an unacceptable result.

- 5.53. Section 9.7 describes how the auditor deals with unacceptable results.

6. MUS for compliance tests

Introduction

- 6.1. “Compliance test” is another term for a test of internal control.

6.2. MUS for compliance testing is not used as frequently as attribute sampling for compliance tests. However, it has a significant advantage over attribute sampling – unlike attribute sampling, larger transactions have a greater chance of selection using MUS. In effect, the auditor is taking the position that internal control deviations (unapproved supplier invoices, for example) in large monetary items are more significant than internal control deviations in small monetary items.

Determining the Sample Size

6.3. The material in this section applies equally to statistical and non-statistical sampling. Note that the auditing standards in several developed countries now require the auditor to consider the same factors regardless of whether statistical sampling or non-statistical sampling is being used. When non-statistical sampling is used, it may be appropriate to increase the sample size by 20% to 50%.

6.4. For MUS for compliance testing, the information that the auditor needs to key into CAATS is somewhat different than for substantive testing, as follows:

MUS for Substantive Test of Details	MUS for Compliance Test
Population value	Population value
Materiality	Materiality
Expected aggregate error	Tolerable number of internal control deviations (in the sample)
Confidence level	Confidence level
- N/A-	Multiplier

6.5. An *internal control deviation* is the result of the failure to properly perform a particular internal control. For example, if a DDO is supposed to approve a particular document, then failure to properly approve the document would be an internal control deviation.

6.6. The *multiplier* used for test of compliance reflects the fact that not all internal control deviations result in a monetary error. Just because a supplier invoice is not properly approved, for example, does not mean that it is incorrect. The higher the number of internal control deviations that can occur before a monetary error occurs, the higher the number of internal control deviations that the auditor can tolerate. The multiplier is used to take this fact into account.

6.7. The reason why the multiplier is not applicable for substantive testing is because every substantive error is a monetary error, so the multiplier would always be 1.0.

6.8. What is a reasonable estimate of the multiplier for compliance tests (tests of internal control)? We know that the multiplier will be greater than 1 because, if every internal control deviation resulted in a monetary error, the auditor would really be performing a substantive test as opposed to a compliance test. Similarly, if the multiplier was really high (say around 20

or more), we would be saying that the failure of the internal control rarely results in a monetary error. In that case, there is really no need for the auditor to test the internal control at all. Accordingly, auditors normally set the multiplier at a conservative low number – 3.

6.9. Assume that the internal control deviation in which we are interested is the improper approval of the supplier invoices. Using this example and the multiplier of 3, we are saying that, if Rs. 9,000,000 worth of supplier invoices are not properly approved, the internal control will have failed often enough to permit errors aggregating to more than Rs. 3,000,000 to occur in the recorded amount.

6.10. For the *tolerable number of internal control deviations*, a low number (1 or 2) is often used. This is because there is no point testing an internal control that we know is not working well simply to prove that it cannot be relied on. Auditors therefore normally only test internal controls that are expected to be working well, and these are the controls that have a low internal control deviation rate. Auditors rarely use “zero” as the tolerable number of internal control deviations.

6.11. The *confidence level* relates to how much assurance the auditor wishes to obtain from his/her specific compliance test.

6.12. As noted previously, the confidence level for a substantive sample is the converse of substantive test of details risk in the audit risk model. For compliance testing, this is not the case – the confidence level is not the converse of control risk in the audit risk model. This is because:

1. usually several key internal controls need to work together to prevent or detect material error; and
2. The auditor is also usually performing non-sampling procedures as well, such as inquiries, observations and walk-through procedures.

6.13. While guidelines should not replace the use of professional judgement, the following may be useful:

Level of Reliance	Possible Confidence Level
High level of reliance on the specific internal control (control risk set at low – 20%)	95%
Moderate level of reliance on the specific internal control (control risk set at moderate – 50%)	90%
Low level of reliance on the specific internal control (control risk set at high – 80%)	80%

Assume the auditor decides to place moderate reliance on a particular internal control (approval of the supplier invoices in our example), wishes to use the “standard” multiplier of 3, and allows for one internal control deviation. Using the CAATS software, the auditor would key in:

1. Confidence level (90);
2. Population value (100,000,000);
3. Materiality (3,000,000);
4. Multiplier (3); and
5. Tolerable # of internal control deviations (1).

6.15. This results in a sample size of 43.

Selecting the Sample

6.16. The sample selection for MUS for compliance testing is identical to the sample selection for MUS for substantive testing illustrated previously.

15 Sample Evaluation

6.17. To evaluate a MUS for compliance test, the auditor uses the same evaluation software as for attribute sampling. This is illustrated below.

7. Attribute sampling for compliance tests

Introduction

7.1. As noted earlier, a compliance test is the same as a test of internal control.

7.2. Attribute sampling involves the selection of a sample of physical units (supplier invoices, for example), as opposed to individual monetary units (Rupees).

7.3. Because the auditor is selecting individual supplier invoices as opposed to individual Rupees, all physical units, regardless of their size, will have an equal chance of selection. In effect, the auditor is taking the position that internal control deviations (unapproved supplier invoices, for example) in small monetary items are just as significant as internal control deviations in large monetary items. If this not the case, the auditor should stratify the population and have more than one sample, or should use MUS for compliance tests.

Determining the sample size

7.4. The material in this section applies equally to statistical and non-statistical sampling. The auditor should consider the same factors regardless of whether statistical sampling or non-statistical sampling is being used. However, when non-statistical sampling is used, the auditor should increase the sample size by 20% to 50%.

7.5. The main consideration in selecting a sample is controlling the risk of incorrectly accepting the population (called beta risk). There is a complementary risk of incorrectly rejecting the population (called alpha risk).

7.6. In this Appendix we only consider beta risk. Auditors normally do not concern themselves with the risk of incorrectly rejecting the population.

7.7. The information that the auditor needs to key into a CAATS for attribute sampling is somewhat different from what the auditor keys into CAATS for MUS, as follows:

MUS for Compliance Testing	Attribute Sampling for Compliance Testing
Population value	Population size
Materiality	Tolerable deviation rate
Tolerable number of internal control deviations	Expected deviation rate
Confidence level	Confidence level
Multiplier	- N/A -

- 7.8. Auditors normally do not know the population size – the number of physical units in the population. However, for the purposes of determining the sample size, this is not normally a problem because the population size only affects the sample size when the population size is less than 10,000 units.
- 7.9. While knowing the population size may not be required to determine the sample size, it is required to select the sample using either fixed interval selection or cell selection. Both these methods require the auditor to determine the sampling interval which, in the case of attribute sampling, requires the auditor to know the population size.
- 7.10. The *tolerable deviation* rate represents the maximum percentage of internal control deviations that can occur in a population before errors aggregating to more than materiality occur. For example, if the auditor used 9%, he/she would be saying that, if more than 2,700 supplier invoices (9% of the 30,000 supplier invoices) are not properly approved, the internal control will have failed often enough to permit errors aggregating to more than Rs. 3,000,000 to occur in the recorded amount.
- 7.11. The tolerable deviation rate has a relationship to the population value, the materiality amount, and the multiplier. To illustrate:
1. If the population value doubled then, on average, each of the 30,000 supplier invoices would have twice the value. One would logically expect that it would then take fewer than 2,700 improperly approved supplier invoices to allow errors aggregating to Rs. 3,000,000 to occur. The tolerable deviation rate would therefore decrease.
 2. If materiality was increased from Rs. 3,000,000 to Rs. 6,000,000, one would logically expect that it would then take more than 2,700 improperly approved supplier invoices to allow errors aggregating to materiality to occur. The tolerable deviation rate would therefore increase.
 3. If it took 6 improperly approved supplier invoices to produce a monetary error instead of 3 improperly approved invoices, one would logically expect that it would then take more than 2,700 improperly approved invoices to allow errors aggregating to Rs. 3,000,000 to occur. The tolerable deviation rate would therefore increase.
- 7.12. Generally accepted auditing standards in Pakistan and most other countries do not require the auditor to relate the tolerable deviation rate to

the population value, the materiality amount or the multiplier. However, if the auditor wishes to do so, the following formula could be used:

$$\text{Tolerable Deviation Rate} = \frac{\text{Materiality} \times \text{Multiplier}}{\text{Population Value}}$$

- 7.13. Using the data used earlier, we arrive at a Tolerable Deviation Rate of 9%, determined as follows:

$$\begin{aligned} \text{Tolerable Deviation Rate} &= \frac{\text{Materiality} \times \text{Multiplier}}{\text{Population Value}} \\ &= \frac{3,000,000 \times 3}{100,000,000} \\ &= 9\%. \end{aligned}$$

- 7.14. For the *expected deviation rate*, a low rate, such as 1%, is often used. For the confidence level, the same considerations apply as for MUS, discussed earlier.

- 7.15. Assuming the auditor decides to place moderate reliance on a particular internal control, has set the tolerable deviation rate at 9% (as above) and the expected deviation rate at 1%. Using CAATS, the auditor would key in:

- a) Population size (30,000);
- b) Tolerable deviation rate (9);
- c) Expected deviation rate (1); and
- d) Confidence level (90).

- 7.16. This then produces a sample size of 42 – virtually the same as the 43 calculated in the MUS for compliance testing example. This is because, by using a 9% tolerable deviation rate, we are effectively using the same parameters.

- 7.17. It should be noted that, when using CAATS, any expected deviation rate between 0 and 2.38% would result in the same sample size. This is because internal control deviations are virtually always whole numbers – most internal controls are either performed or they are not performed. (You cannot have an invoice that is partly properly approved, for example.) Any error rate up to 2.38 percent allows for one internal control deviation in a sample of 42.

Selecting the Sample – Statistical Sampling

- 7.18. The sample selection technique most often used for attribute *sampling is random selection*. Fixed interval selection is sometimes used. A third option, *cell selection*, exists but is rarely used.

- 7.19. Both fixed interval selection and cell selection require the auditor to know the sampling interval, which, in turn, requires an estimate of the population size. As such, they are not used that often. Another weakness of fixed interval selection is that there may be a pattern in the population of which the auditor is not aware. For example, there may be 19

employees for each supervisor, and the payroll register may list the supervisor followed by the employees for each group. If the auditor were to select every 20th employee, he/she will have a sample that contained either no supervisors or nothing but supervisors.

- 7.20. With MUS, the risk of this occurring is remote. The total payroll of each group would have to be same, and would have to be equal to the sampling interval for this to happen.
- 7.21. To select a random sample using CAATS, the auditor would key in:
 - 1. The number of records to select (the sample size);
 - 2. A random number “seed” (a number to be used for the random number generator); and
 - 3. The starting record number and the ending record number (to produce a range for the random numbers). The difference between the two would be the population size.
- 7.22. If the auditor does not have an exact estimate of the population size, he/she could key in a conservative estimate and discard unused sample items. The auditor, though, would have to increase the sample size to ensure that the resulting sample was adequate.
- 7.23. For both fixed interval selection and cell selection, the data that the auditor is required to key in is the same as for MUS for substantive tests of details.

Selecting the Sample – Non-Statistical Sampling

- 7.24. As noted above, the “standard” sample selection technique for attribute sampling is random selection. Fixed interval selection is sometimes used; cell selection is rarely used.
- 7.25. The non-statistical approximation of a random sample is often referred to as “haphazard selection”.
- 7.26. The various ways in which the auditor could approximate a statistical sample are discussed below. The illustrations assume that the auditor increases his/her statistical sample size from 42 to 60 to compensate for not taking a statistical sample.
- 7.27. *Periodic selection.* The auditor could divide the sample size by 52 to determine how many sample items should be selected from each week of the year, and then select the appropriate number of items from the transactions processed in each of those weeks. If there are fewer than 52 sample items, the auditor could use half-months or months.
- 7.28. In our illustration (a sample size of 60), the auditor could select 1 sample item from most weeks, and 2 sample items from the other weeks.
- 7.29. *DDO selection.* The auditor could assign numbers to the Drawing and Disbursing Officers (DDOs) responsible for the transactions being sampled, haphazardly select the required number of DDOs, and then

select a transaction from each of the selected DDOs. To better approximate a statistical sample, the auditor could then select the transactions from throughout the year using the periodic approach.

- 7.30. For example, if there are 900 DDOs and the auditor wishes to select a sample of 60 transactions, the auditor could haphazardly select 60 of those DDOs and then select 1 transaction from each of the selected DDOs. The sample selection could be done in such a way that 1 sample item is selected from most weeks, and 2 sample items are selected from the other weeks for a total of 60 transactions.
- 7.31. *Page selection.* The auditor could divide the number of pages on which the transactions are listed by the sample size, and then select the appropriate number of items from each group of pages.
- 7.32. For example, if there are 300 pages of transactions and the auditor wishes to select a sample of 60 transactions, the auditor could select one sample item from each fifth page, or from each group of five pages.
- 7.33. *Selecting from boxes, filing cabinets, etc.* The auditor could divide the sample size by the number of boxes or filing cabinets of transactions in which the documents are stored, and then select the appropriate number of items from each of the boxes or filing cabinets. If there are fewer sample items than boxes or filing cabinets, the auditor could group the boxes or filing cabinets into groups, and then select a transaction from each group of boxes or filing cabinets.
- 7.34. For example, if there are 600 boxes, the auditor could group the boxes into sets of 10, and then select 1 transaction from each set of boxes. To better approximate a statistical sample, the auditor could select the transactions from throughout the year using the periodic approach.

Sample Evaluation

- 7.35. The material in this section applies equally to statistical and non-statistical sampling. Auditing standards in several developed countries now require the auditor to project the sample results over the population and consider further possible errors, regardless of whether statistical sampling or non-statistical sampling is being used.
- 7.36. Some CAATS offers two options when evaluating the sample results: a one-sided evaluation in which an upper limit is determined, and a two-sided evaluation in which both an upper limit and a lower limit are determined.
- 7.37. In this Appendix, we will only deal with the former option. Auditors normally do not concern themselves with the lower limit.
- 7.38. When evaluating a monetary unit sample, the auditor determines if the upper error limit in the population exceeds the materiality amount. When evaluating an attribute sample, the auditor determines if the maximum

possible deviation rate in the population exceeds the tolerable deviation rate.

- 7.39. Assume the auditor finds 2 deviations in the sample of 42. Using CAATS, the auditor would key in:
1. Population size (30,000);
 2. Sample size (42);
 3. Number of deviations in sample (2); and
 4. Confidence level (90).
- 7.40. The CAATS then calculates a maximum possible deviation rate of 12.18%.
- 7.41. This indicates that the auditor has 90% confidence that the internal control will function often enough to ensure that, at most, 12.18% of the supplier invoices contain internal control deviations. However, the auditor had concluded that a deviation rate above 9% could produce errors aggregating to more than materiality. Therefore, the sample results are unacceptable and the auditor must normally reduce reliance on the internal control.
- 7.42. By how much must the auditor reduce reliance on internal control? Some CAATs tools provide the auditor with an indication of this. The sample size calculation shows the achieved confidence level that will be associated with several different numbers of internal control deviations. For example, in our illustration the CAATS informs the auditor that, should he/she find 2 internal control deviations in a sample of 42, the achieved confidence level would be 74.17%. Therefore, an alternative conclusion is that the auditor has 74.17% confidence that the internal control will function often enough to ensure that, at most, 9% of the supplier invoices contain internal control deviations. However, the auditor wanted to have 90% confidence. Therefore, the auditor must normally reduce his/her reliance on the internal control.
- 7.43. As a general rule, if the most likely error found in a monetary unit sample exceeds the expected aggregate error allowed for when determining the sample size, then the results will be unacceptable. For attribute sampling, we have an equivalent rule – as a general rule, if the actual number of deviations found in the sample exceeds the number of deviations allowed for when determining the sample size, then the results will be unacceptable.
- 7.44. In our illustration, we allowed for 1 deviation and found 2. Therefore, we knew that the results would be unacceptable.
- 7.45. This is why auditors usually allow for at least one internal control deviation in their samples. While auditors will get smaller sample sizes if they do not allow for any internal control deviations, the discovery of a single deviation will produce unacceptable results.

APPENDIX C

Computer-Assisted Auditing Techniques (CAATs)

1. Introduction

The Concept

- 1.1. Computer-assisted auditing techniques (CAATs) are powerful tools that can be used to perform different audit procedures. With the use of a CAAT, the auditor can, for example:
 - a) perform various calculations on the data;
 - b) perform various analytical procedures;
 - c) identify unusual items, duplicate items, or missing items;
 - d) compare data in one file to the equivalent data in another file; and
 - e) determine a sample size, select the sample and evaluate the sample results.
- 1.2. To help the auditor analyse the data, most CAATs enable an auditor to:
 - a) list transactions in chronological order, or in increasing/decreasing order of magnitude;
 - b) group transactions according to various criteria, such as those with the same date or the same supplier or customer number;
 - c) search for fields with values greater than a reasonable amount;
 - d) calculate aggregate figures for a particular period; and
 - e) conduct various calculations on the data, such as the average payment amount for the acquisition for a particular service or product.
- 1.3. With CAATs many of these procedures can be done almost instantaneously. If performed manually, the equivalent work could consume considerable audit effort.
- 1.4. These procedures can be performed on all types of audits, such as financial audits, compliance with authority audits, performance audits, and reviews of internal control structures. In particular, CAATs are a logical method for performing audits of Information Technology (IT) systems.
- 1.5. The auditor needs to specify the procedures to be performed. After running the CAATs procedures, the auditor follows up the results and obtains explanations for any anomalies found.
- 1.6. This annex provides a summary of the steps performed when using CAATs.

2. Steps to using CAATs

Introduction

- 2.1. There are basically seven steps involved:
 - a) Determine objectives;
 - b) Determine scope;
 - c) Understand the operating system;
 - d) Understand the characteristics of the data;
 - e) Access the data;
 - f) Apply the CAAT; and
 - g) Follow up the results.

2.2. Each is discussed in turn below.

Determine Objectives

2.3. Although often the use of a CAAT tool involves some degree of exploration, the auditor should define, up front, what he/she hopes to achieve through the use of the CAAT.

2.4. In the case of a financial audit, the specific objective that the auditor determines should relate to a specific financial audit objective or a related compliance with authority objective.

2.5. Some examples of specific objectives are:

- a) Match quantities and unit costs on supplier invoices with equivalent amounts on purchase orders and/or contracts to obtain assurance that the expenditures are valid and that they have been properly authorised;
- b) Look for duplicate cheque numbers to obtain assurance that all payments are valid and have been properly authorised;
- c) Look for two invoices from the same supplier at approximately the same time and/or two cheques to the same supplier at approximately the same time to check for split invoices/payments, which might indicate evasion of approval limits; and
- d) Compare expenditures against the appropriation to identify expenditures in excess of the authorised amount.

Determine Audit Scope

2.6. The auditor has to decide what audit coverage is required. The auditor may decide to examine the total database, or restrict the examination to particular areas or functions within the organisation.

2.7. Further, the auditor has to decide what periods to examine. The auditor may decide to examine the current year, or to go back three or four years. If the auditor wishes to determine if there is some pattern to the expenditure or revenue, the auditor may want to take discrete periods and compare them with other periods.

Understanding the Operating System

2.8. The auditor should develop a clear understanding of each computer system to be examined. This understanding should include:

- a) The processing procedures and practices;
- b) The specific internal controls for the operating system, and the tests of internal control needed to determine whether the controls are working properly; and

2.9. Security and other environmental considerations, such as access controls and back-up procedures.

2.10. The auditor would probably want to build into his/her review of the internal control structure the understanding of the operating system that is required to perform the CAAT. This would include, for example, ensuring that:

- a) Any flow charts, questionnaires or narratives that are being used to review the internal control structure deal with the operating system on which the CAAT is to be applied; and
- b) The tests of internal controls will identify any internal control weaknesses in the operating system that could affect the CAAT.

Understand the Characteristics of the Data

- 2.11. The auditor should examine documentation about the data. The documentation should include:
 - a) The characteristics of the files, records, and data fields;
 - b) The processing logic built into the software; and
 - c) Any anomalies, such as changes to the database, gaps in the continuity of the data, coding problems or changes in definitions.
- 2.12. The auditor may decide to test some of these characteristics using the CAAT tool itself. For example, the auditor may test for any records containing a coding structure that is not defined in the chart of accounts.

Access the Data

- 2.13. The auditor may require assistance in obtaining access to the data. The auditor must be satisfied that the data examined is valid and complete. The auditor may use current data or data from a specific prior time period.
- 2.14. The CAAT may be applied on live data or, alternatively, a copy of the data may be made on which the CAAT is applied off-line.
- 2.15. When the CAAT is applied on live data, the auditor must ensure that the CAAT has full access to all data and is not subject to any access controls.
- 2.16. When the CAAT is operated on a copy of the data, the auditor should conduct various tests to determine the number of records, file totals, etc. in the live data, and compare those to the number of records, file totals, etc. in the file provided for the CAAT.
- 2.17. Also, the auditor should ensure that the records contained in the file provided for his/her CAAT are for the period under examination. The auditor should perform a test to determine if any transactions included in his/her database took place outside the period under examination.

Apply the CAAT

- 2.18. Most software packages are capable of automatically determining the record layout of the data file. If the package being used is not capable of doing this, the auditor will be required to determine the record layout and tell the software how to read the data in the file.
- 2.19. The auditor should perform tests to confirm that the specific internal controls on which he/she intends to rely are working properly. For example if the system is meant to have data entry controls such as not

accepting a record unless there is a monetary value in a particular field, the auditor can test to see if any records exist that violate that requirement.

- 2.20. Also, the auditor may wish to test the built-in formulae that are used to automatically perform calculations.

Follow Up the Results

- 2.21. The auditor has to decide which anomalies and other transactions identified by the tests should be followed up.
- 2.22. Normally, all items listed for follow up should be examined. In some cases, though, the auditor may check a few items and discover an underlying cause. The auditor may then conclude that it is not necessary to test all of the other items that could have been caused by the same factor.
- 2.23. Explanations for the items discovered may be a systemic problem or may be due to an individual error. Explanations may be discovered very easily and quickly, or may consume extensive audit effort.
- 2.24. The auditor needs to apply professional judgment when determining how much audit effort should be applied to follow up the anomalies.

Appendix D

Assurance and Materiality

1. Introduction

- D.1.1. Chapter 7 provides details of how the auditor updates:
- a) assessment of materiality, planned precision and audit risk;
 - b) determination of components;
 - c) determination of specific financial audit objectives, related compliance with authority objectives, error conditions and irregularities;
 - d) assessment of inherent risk and control risk; and
 - e) assessment of the optimum mix of tests of internal control, analytical procedures and substantive tests of details.
- D.1.2. As summarised in Chapter 7, the optimum mix of tests of internal control, analytical procedures and substantive tests of details for one specific financial or compliance with authority audit objective for one component may be different than for a different objective for the same component, or for different components.
- D.1.3. As such, the auditor may be:
1. placing a lot of reliance on the internal control structure for some objectives and components, but placing little reliance on the internal control structure for others;
 2. Doing detailed predictive or statistical analysis for some objectives and components but only reviews for reasonableness or comparative analysis for other objectives and components; and
 3. Using a low confidence level to perform substantive tests of details for some objectives and components, while adopting a high confidence level for other substantive tests of details.
- D.1.4. The challenge is to combine all of these different sources of assurance to reach an overall conclusion on the financial statements.
- D.1.5. This Appendix does not attempt to provide a mathematical proof; rather, it presents a non-technical discussion. It first considers what the overall error evaluation would be like if the auditor used one substantive sample as the sole source of assurance for the financial statements as a whole. It then considers what the overall error evaluation would be like if the auditor divided the financial statements into components but continued to obtain all of his/her assurance for each component from a substantive sample. Finally, it considers what the overall error evaluation would be like if the auditor used substantive tests of details as only one source of assurance for each component, and used different confidence levels for different components and objectives.

One overall substantive sample as the sole source of assurance for the financial statements as a whole

- D.1.6. Assume the auditor sets materiality at Rs. 3,000,000, expected aggregate error at Rs. 816,500 and audit risk at 5%. Also assume that the auditor does not divide the financial statements up into components, and does not obtain any inherent assurance, or any assurance from testing the internal control structure or from analytical procedures. Instead, the auditor decides to use one overall substantive sample for the financial statements as a whole. The confidence level used would be 95% – the converse of the 5% audit risk.
- D.1.7. It is extremely unlikely that such an approach would be practicable, or cost-effective. However, if it was possible, the auditor would:
- a) treat all of the transactions and balances in the financial statements as one population;
 - b) use the Rs. 3,000,000 materiality amount and the Rs. 816,500 expected aggregate error; and
 - c) use a confidence level of 95% to sample the population.
- D.1.8. In this scenario, some of the selected sample items would be payroll expenditures, some would be revenue transactions, some would be part of the year-end cash balance, some would be part of the year-end long-term debt balance, etc. The auditor would perform the appropriate audit procedures on each sample item.
- D.1.9. Using this approach, the error evaluation for one substantive sample would become the overall error evaluation. The auditor would have one most likely error for the financial statements as a whole, one upper error limit for overstatements for the financial statements as a whole, and one upper error limit for understatements for the financial statements as a whole.

Substantive samples as the sole source of assurance for each component

- D.1.10. Next, assume the auditor divides the financial statements into components but continues to obtain all of his/her assurance from a substantive sample performed at a 95% confidence level.
- D.1.11. In this scenario, the auditor would likely have virtually the same sample size in total as he/she had in the previous scenario. The sample size for payroll expenditures would be virtually the same as the number of sample items in the global sample that represented payroll expenditures; the sample size for revenue transactions would be virtually the same as the number of sample items in the global sample that represented revenue transactions, etc. In other words, really nothing would change.
- D.1.12. The reason is that:
- a) the auditor continues to use the same Rs. 3,000,000 materiality amount, and the same Rs. 816,500 expected aggregate error;
 - b) the auditor continues to use the same 95% confidence level; and
 - c) the population value, in total and for each component, has not changed.
- D.1.13. Given this fact the auditor would add up the most likely errors from each component, and calculate an overall most likely error, an overall upper

error limit for overstatements and an overall upper error limit for understatements. It is likely that the overall most likely error would be virtually the same as it was when the auditor used one overall substantive sample as the sole source of assurance.

D.1.14. As for the upper error limit, the error evaluation process results in a very conservative overall error evaluation. This is because the largest basic precision for each of overstatements and understatements is being used, and because the sum of the precision gap widenings will almost always be much higher than if the entire financial statements were treated as one population and one overall sample had been taken.

Substantive samples as only one source of assurance for each component and performed using different confidence levels

D.1.15. Next we move on to the approach described in this manual, where substantive samples are only one source of assurance. The auditor also obtains inherent assurance, assurance from tests of internal control, and assurance from analytical procedures. Furthermore, the auditor may obtain different amounts of assurance from these other sources, resulting in different confidence levels for different substantive samples.

D.1.16. Under this scenario, the auditor can still use the error evaluation described above.

D.1.17. The reason is that the auditor:

- a) continues to use the same Rs. 3,000,000 materiality amount and the same Rs. 816,500 expected aggregate error; and
- b) while the confidence levels being used for the substantive tests of details are not the same, the auditor is obtaining, in total, the same 95% overall assurance with respect to each component and objective as he/she was obtaining in the previous scenarios.

D.1.18. In effect, then, all the auditor has done is change the sources of assurance to obtain the same overall audit assurance of 95%.

D.1.19. To make this work, though, the auditor needs to address two other matters.

D.1.20. First, in order to ensure that he/she is, indeed, getting the required 95% assurance from all of the tests, the auditor needs to deal with any conflicting audit evidence.

D.1.21. Second, while the most likely error is not affected by the confidence level being used, and can therefore be added together just like in the previous scenarios, the further possible error (the difference between the upper error limit and the most likely error) is affected by the confidence level being used. To deal with this, the auditor will need to make a conservative estimate of the further possible error.

2. Why Allocation of Materiality is Not Required

Introduction

- D.2.1. As noted in the Manual, the materiality amount that is determined during the audit planning phase is used for the audit of all components. There is no need to allocate the amount to the various financial statement components. If materiality is set at Rs. 3,000,000 for the financial statements as a whole, the same Rs. 3,000,000 can be used for each financial statement component, and for each specific financial audit objective and error condition.
- D.2.2. While a mathematical proof of this is beyond the scope of this manual, it can be illustrated with a numerical example.

Some basic concepts

- D.2.3. This example makes use of two basic concepts.
- D.2.4. The first concept is that risk and assurance are converses of each other. 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.
- D.2.5. The second basic concept is that the probability of two mutually exclusive events occurring is the probability of the first event occurring times the probability of the second event occurring. If there is a 5% chance that Event A will occur, and a 5% chance that Event B will occur, the probability that both Event A and Event B will occur is 5% times 5% or 0.25% ($.05 \times .05 = .0025$).

Numerical example

- D.2.6. Let's assume that the auditor wants to have 95% assurance that a financial statement is not misstated by more than Rs. 3,000,000. Let's also assume that the financial statement is composed of two components – Component 1 and Component 2.
- D.2.7. Based on the theory contained in this manual, the auditor could plan the audit in such a way as to be able to conclude that he/she has:
- a) 95% assurance that Component 1 is not misstated by more than Rs. 3,000,000; and
 - b) 95% assurance that Component 2 is not misstated by more than Rs. 3,000,000.
- D.2.8. How can this be? If the auditor has 95% assurance that Component 1 is not misstated by more than Rs. 3,000,000, and 95% assurance that Component 2 is not misstated by more than Rs. 3,000,000, how can the auditor have 95% assurance that the two components, in total, are not misstated by more than Rs. 3,000,000? Shouldn't the total be Rs. 6,000,000?

D.2.9. The reason why the total is not Rs. 6,000,000 is that the probability of both Component 1 being misstated by more than Rs. 3,000,000 and Component 2 being misstated by more than Rs. 3,000,000 (i.e., that, in total they are misstated by more than Rs. 6,000,000) is not 5%. Using the second basic principle noted above, the probability that the components are misstated, in total, by more than Rs. 6,000,000 is 5% times 5% or only 0.25% ($.05 \times .05 = .0025$). Therefore, the auditor has 99.75% ($100.00\% - 0.25\%$) assurance that, in total, the two components are not misstated by more than Rs. 6,000,000.

D.2.10. If the auditor has 99.75% assurance that, in total, the two components are not misstated by more than Rs. 6,000,000, how much assurance does the auditor have that, in total, the two components are not misstated by more than Rs. 3,000,000?

D.2.11. Logically, the answer is a lower level of assurance than 99.75%. If, for example, the auditor finished performing his/her work and concluded that the most likely error in the financial statements is Rs. 100,000,000, the auditor may be:

- a) Virtually certain that the maximum possible error in the financial statement is less than Rs. 6,000,000;
- b) Reasonably confident that the maximum possible error is less than Rs. 3,000,000; and
- c) Only somewhat confident that the maximum possible error is less than Rs. 1,500,000.

D.2.12. Therefore, decreasing the materiality amount decreases the amount of assurance that one can get from the same amount of work.

D.2.13. Using monetary unit sampling, the sample size required to obtain 95% assurance that a component is not misstated by more than Rs. 3,000,000 is exactly the same as the sample size required to obtain 77.65% assurance that the component is not misstated by more than Rs. 1,500,000. Therefore, instead of concluding that he/she has 95% assurance that Component 1 is misstated by more than Rs. 3,000,000, the auditor can conclude that he/she has 77.65% assurance that the component is misstated by more than Rs. 1,500,000. The auditor can do the same with Component 2. And in total? Well, if there is a 22.35% ($100.00\% - 77.65\%$) risk that Component 1 is misstated by more than Rs. 1,500,000, and a 22.35% risk that Component 2 is misstated by more than Rs. 1,500,000, then the risk that, in total, the financial statement is misstated by more Rs. 3,000,000 is 22.35% times 22.35%, or 5% ($.2235 \times .2235 = .05$). This is, of course, exactly the same as the risk that the auditor is prepared to take that each component is misstated by more than Rs. 3,000,000.

D.2.14. The same result will occur no matter which combination of amounts adding up to Rs. 3,000,000 is used. For example, the sample size required to obtain 95% assurance that a component is not misstated by more than Rs. 3,000,000 is exactly the same as the sample size required to obtain:

- a) 83.40% assurance that the component is not misstated by more than Rs. 1,800,000; and

- b) 69.88% assurance that the component is not misstated by more than Rs. 1,200,000.

D.2.15. Therefore the risk that, in total, Component 1 is misstated by more than Rs. 1,800,000 and that Component 2 is misstated by more than Rs. 1,200,000 (i.e., that, in total, the two components are misstated by more than Rs. 3,000,000), is 16.60% (100.00% – 83.40%) times 30.12% (100.00% – 69.88%), or 5% (.1660 x .3012 = .05).

D.2.16. The same result will also occur no matter how many components are used. As long as the amounts being used sum to Rs. 3,000,000, the risk will always multiply out to 5%.

D.2.17. In conclusion, then, there is no need to allocate materiality – the auditor can use the Rs. 3,000,000 materiality amount on each component, and can still conclude with respect to Rs. 3,000,000 overall.

Appendix E

1. Analytical Methods

E.1.17. Analytical methods are a very efficient and effective way to obtain audit assurance. They should be performed on every audit.

E.1.1. Computer-assisted auditing techniques (CAATs) are a useful tool for performing analytical methods. With the use of a CAAT, the auditor can perform numerous analyses instantaneously. If performed manually, the equivalent work could consume extensive audit effort.

E.1.2. Analytical methods are techniques used by the auditor to:

- a) Study the relationships among elements of financial and non-financial information to form expectations as to what the recorded amounts should be; and
- b) Compare such expectations with the recorded amounts.

E.1.3. Analytical methods are substantive tests. They primarily involve a comparison of the recorded amount being audited to an amount that the auditor expects. The auditor's expectation of the amount is derived from his/her knowledge of relationships between the amount being audited and other data. The data used in arriving at the auditor's expectation of the amount may be financial or non-financial and may originate from within or outside the entity being audited.

E.1.4. Analytical methods vary from simple comparisons, such as comparing the current year's amounts with the prior year's amounts, to complex analysis using ratios, advanced statistical techniques and computer audit software, such as multiple regression analysis software.

E.1.5. Analytical methods are often thought of as simply comparing amounts in one year to amounts in previous years. However, analytical methods can be used to perform many more comparisons. They can include, for example:

- a) An analysis of ratios among various accounts. For example, the auditor could calculate the ratio of the total remuneration to the average number of employees, and compare that ratio to previous years.
- b) An analysis of the composition of accounts. For example, the auditor could compare the ageing of the accounts receivable or the mix of stocks to previous years.
- c) Determining concentrations. For example, the auditor could determine the proportion of purchases from a single supplier, or the proportion of sales to a single market or a single customer.

E.1.6. Analytical methods involve performing a comparison or other test on aggregate data – the total expenditures for each month, the total amount of sales tax revenue for the year, etc. If the aggregate amount appears reasonable, the auditor concludes that the individual transactions and balances making up the aggregate amount are reasonable. As such, analytical methods follow a "top down" substantive approach where the

reliability of individual recorded transactions and balances is inferred from evidence of the reasonableness of the aggregate results.

E.1.7. In contrast, a substantive test of details is a "bottom up" substantive approach where the reasonableness of the aggregate results is inferred from the evidence provided by examining individual recorded transactions. The auditor selects a representative sample of transactions and uses that sample to reach a conclusion about the population as a whole.

E.1.8. Like other substantive tests, analytical methods can rarely be used exclusively as the sole source of audit assurance, except when dealing with immaterial balances. When combined with other audit evidence however, analytical methods may provide a significant portion of the assurance as to the reliability of the financial statements.

E.1.9. Analytical methods may be used in all stages of the audit to achieve various objectives.

E.1.10. These include:

Planning phase:

- a) To obtain knowledge of the entity's business operations;
- b) To identify areas for particular audit attention, such as large projects, large transactions, potential irregularities;
- c) To identify high inherent risk and high control risk areas in order to better focus the audit work; and
- d) To obtain some degree of audit assurance.

Conducting phase:

- a) To obtain some degree of audit assurance; and
- b) To explore for anomalies or transactions that require detailed examination.

Evaluation phase:

- a) To assess the internal consistency and overall reasonableness of the financial statements using the auditor's knowledge of the entity; and
- b) To obtain some degree of audit assurance.

E.1.11. Analytical methods require a great deal of professional judgment and, therefore, it is important that experienced audit personnel participate in the application and monitor the decisions made by their audit staff.

E.1.12. Basic factors to consider before deciding to use analytical methods as a source of audit assurance

E.1.13. Deciding whether to use analytical methods as a source of audit assurance is a matter of professional judgment. Some of the factors the auditor

should consider before using an analytical procedure are discussed in the following paragraphs.

E.1.14. *Audit team attributes.* To properly plan, perform and evaluate the results of an analytical procedure, one must have a sound understanding of the entity, the industry and the data being analysed. Should the audit team not possess a sufficient understanding to perform a particular analytical procedure, then the procedure should not be performed.

E.1.15. *The inherent risk and the control risk.* The higher these risks, the greater the possibility that the data to be used in the analytical procedure is unreliable. In particular, should management officials be able to override specific internal controls and manipulate the data, they may be able to alter the data so as to hide significant fluctuations, over-expended appropriations, etc.

E.1.16. *The component and the specific financial audit objective(s) for which audit evidence is required.* Analytical methods are generally more useful in providing assurance for revenue and expenditure accounts than for balance sheet accounts. For example, analytical methods may be very useful in providing assurance as to the completeness and measurement of many revenue and expenditure accounts. However, they are usually not very good at testing the validity or ownership of assets.

E.1.17. *Related compliance with authority objective for which audit evidence is required.* Analytical methods are often not particularly good at obtaining assurance with respect to most compliance with authority objectives. For example analytical methods will not be very good at determining whether:

- a) The services were actually performed or the goods were actually received;
- b) The expenditures are consistent with the nature of the appropriation to which they were charged;
- c) The expenditures, borrowings or cash received are in accordance with the applicable legislation; or
- d) The cash received was for an approved tax or other approved revenue source.

E.1.18. For all of the above, a detailed examination of specific expenditure transactions, borrowing transactions, or revenue transactions is normally the best way to obtain assurance with respect to these compliance with authority objectives.

E.1.19. Similarly, analytical methods are often not good at determining if there are appropriations that have been exceeded but have not been so disclosed. This is because entity officials may simply adjust the books or defer the recording of expenditures to hide such situations. A detailed examination of journal vouchers and the coding on specific transactions, and a detailed review of the year-end cut-off, are normally the best way to obtain assurance with respect to this particular compliance with authority objective.

- E.1.20. *Costs and benefits of obtaining assurance from analytical methods.* Generally, analytical methods take less time to apply than a test of details and, therefore, have the potential to be a more efficient source of audit evidence. Cost and benefit considerations include:
- a) The ease and cost of obtaining and assessing the reliability of the data to be used in the analytical procedure;
 - b) The ease and cost of applying the analytical procedure, including obtaining appropriate explanations for all significant fluctuations; and
 - c) The ease and cost of obtaining assurance from other sources of audit assurance.

Categories of Analytical Methods

- E.1.21. In this appendix analytical methods are grouped into several general categories.
- E.1.22. As a general rule, each category can provide a greater amount of assurance than the previous category. However, there are numerous factors, other than the type of analytical procedure being performed, that affects the amount of assurance that can be obtained from a particular procedure. These other factors are discussed below.

Scanning for Anomalies

- E.1.23. Scanning is a useful technique for searching out significant events or transactions that may require further review. Significant items may be items of unusual size or unexpectedly high or low frequency, of a questionable nature, or inconsistent with other known information. For example, more than one payment for a particular item, on the same day, or for exactly the same amount can indicate duplicate payments, fraud or other procurement problems. Scanning is most easily accomplished with the use of CAATs.
- E.1.24. Sometimes the data need to be manipulated to be in a form that anomalies can be more easily detected. For example, calculation of a unit price, or cost per unit measurement, can identify unusual situations that would not show up easily without the calculation. If methods of payment are uneven through the year, aggregation for the year can identify differences more easily.
- E.1.25. Transactions, or sets of transactions, can be compared to a standard or an acceptable range of values. Examination of payroll, for example, could include a search for any salary payments in excess of the salary ranges for the respective employees' positions. This can identify unusual payments, or can direct attention to excessive overtime payments.

General Reviews for Reasonableness

- E.1.26. This category of analytical methods involves a high level comparison of current information with that of previous periods, with budgets or with statistics available from the entity. No pre-determined threshold amount is specified for identifying significant fluctuations. The process is

sometimes referred to as “eyeballing” the financial statements – the auditor looks for accounts that appear to be unusual in amount, in volume of activity, etc.

E.1.27. The objective of this type of analysis is generally attention directing as opposed to obtaining audit assurance.

E.1.28. Although this type of analytical procedure normally does not provide any assurance, it can contribute immensely to an understanding of how the entity operates, how different components should interrelate, and how the financial statements should present the underlying events.

E.1.29. As a result, general reviews for reasonableness should be conducted during the general planning phase and the evaluation phase of the audit.

Comparative Analysis

E.1.30. This category of analytical methods involves comparing the current year's reported amounts (or ratios) with those of the prior year (or years). The data from the previous year(s) are not adjusted for known changes in the factors affecting the data. Comparative analysis assumes that the prior year's data provide a sufficiently accurate estimate of the current year's amount and, therefore, can be used to identify any significant fluctuations from the current year's recorded amount. A pre-determined threshold amount is specified for identifying significant fluctuations.

E.1.31. For example, the auditor may decide to compare the employee related expenses (pay, allowances, etc.), operating expenses (fees, communications, utilities, etc.) and income tax receipts to the equivalent amounts for the previous year. The auditor would then follow up differences greater than the threshold amount.

E.1.32. This type of analytical procedure can provide a low level of substantive assurance.

Exploratory Analysis

E.1.33. The auditor can obtain useful information by exploring databases and identifying large size transactions, duplicate transactions, or other anomalies.

Predictive Analysis

E.1.34. Predictive analysis involves comparing the current year's reported amounts (or ratios) with a prediction of what the current year's amounts (or ratios) should be based upon the trend of the amounts (or ratios) from the previous year (or years). The data from the previous year(s) are adjusted for all known changes in the factors affecting the data. A pre-determined threshold amount is specified for identifying significant fluctuations.

E.1.35. For example, before making a comparison of the employee related expenses for the current year to the equivalent expenses for the previous

year, the auditor could adjust the previous year's amounts for known changes in the average pay scales and in the number of staff within the specific entity for which the comparison is being made.

E.1.36. Similarly, before making a comparison of income tax receipts for the current year to the equivalent amounts for the previous year, the auditor could adjust the previous year's amounts for known changes in income tax rates.

E.1.37. Because the prior year's amounts are adjusted for known changes before the comparison is made, this type of analytical procedure can produce a more precise estimate than would be the case with comparative analysis. As a result, it can provide a higher level of substantive assurance than comparative analysis.

Statistical Analysis

E.1.38. This category of analytical methods involves analysing the known behaviour of variables and developing an equation (model) that explains the relationship between these variables. A pre-determined threshold amount is specified for identifying significant fluctuations.

E.1.39. For example, the auditor could input data on employee related expenses for the previous several years into the software package. The software package would then estimate the amount of employee related expenses for the current year.

E.1.40. Although this category is similar to predictive analysis, statistical analysis provides more accurate predictions and objectively measures the confidence level and the achieved level of precision of the prediction. As a result, it can provide an even higher level of substantive assurance than predictive analysis.

Overall Verification Methods

E.1.41. This category of analytical methods involves building up an estimate of an account balance from known and verified (as opposed to analysed) data. For example, the auditor could verify the number of rental units by type of unit, the average rent by type of unit, and the vacancy rate by type of unit. For each type of unit the auditor could then multiply the number of units times the average rent times the vacancy rate and compare the result to the revenue received from the rents.

E.1.42. As another example, the auditor could verify the monthly salary for each employee on the payroll and use that data to estimate the total payroll expenditure for salaried employees.

E.1.43. A pre-determined threshold amount is specified for identifying significant fluctuations.

E.1.44. Overall verification methods usually result in a very accurate estimate of the account. For this reason, and because the inputs are verified (as

opposed to analysed), this category of analytical methods generally produces a very high level of substantive assurance.

2. Factors Affecting the Assurance that Can Be Derived from Different Methods

E.2.1. The degree of assurance derivable from a particular type of analytical procedure depends on many factors that must be considered by the auditor. Outlined below are the key factors affecting the effectiveness of an analytical procedure.

Category to Which the Procedure Belongs

E.2.2. The quality of an analytical procedure depends on the category to which it belongs. As we move from general reviews for reasonableness through to overall verification methods, a more comprehensive analysis of the underlying relationships is usually performed. This, in turn, results in a greater amount of substantive assurance.

E.2.3. While guidelines should not replace the use of professional judgment, the following may be useful for determining the amount of assurance that is usually achievable from each category of analytical methods:

Type of Analytical Procedure	Assurance	Resulting Risk
Scanning/reviews for reasonableness	0%	100%
Comparative/exploratory analysis	Up to 30%	70% or more
Predictive analysis	Up to 50%	50% or more
Statistical analysis	Up to 70%	30% or more
Overall verification methods	Up to 90%	10% or more

E.2.4. The reason for the “up to” and “or more” is because there are numerous other factors that affect the amount of assurance that can be obtained from a particular procedure. These other factors are discussed in the rest of this section.

Threshold Amount Used to Determine Significant Fluctuations

E.2.5. If the auditor sets a low threshold amount he/she will have more fluctuations to follow up than if the auditor selected a high threshold amount. As a result, the lower the threshold amount, the higher the assurance that can be achieved.

E.2.6. In setting the amount to be used for identifying significant fluctuations, the auditor should consider the planned precision determined for the audit. The threshold amount to be used for identifying significant fluctuations should be directly related to this planned precision amount.

- E.2.7. With a statistical analysis software package, the planned precision and the desired level of assurance are keyed in and the software package automatically calculates the amount to be used. For other types of analytical methods, the auditor must set the threshold amount subjectively using his/her professional judgment.
- E.2.8. Items comprising an account balance can be analysed using a number of different data profiles. For example, when analysing payroll expenditures for the federal government, the auditor could analyse the expenditures:
- For the government as a whole;
 - By ministry, department, and/or agency, etc;
 - By division or by staff classification;
 - By major object, minor object or detailed object; and/or
 - For the year as a whole or for each month.
- E.2.9. Given the different groupings, it is not possible to specify a blanket threshold amount that would be applicable to all analytical methods. However, guidelines can be used for general categories. While these guidelines should not replace the use of professional judgment, the following may be useful for determining the maximum threshold amount that should be used to determine a significant fluctuation. All are percentages of planned precision.

Level of Data Aggregation	Annual Data	Monthly Data
Entity-wide data (e.g., payroll related expenses for the entity as a whole)	50%	20%
Disaggregated by one level (e.g., payroll expenditures for each ministry, department or agency, or by minor object as opposed to major object)	15%	5%
Disaggregated by two levels (e.g., payroll expenditures for each division or staff classification within each ministry, department or agency)	5%	2%

Quality of the Relationship

- E.2.10. The quality of an analytical procedure is only as good as the quality of the underlying relationship upon which it is built. In seeking to identify the quality of a relationship, the factors described in the following paragraphs should be considered.
- E.2.11. *Simplicity of the relationship.* The fewer the factors that could cause changes in an account over time, the easier it should be to estimate the current year's balance and follow up significant fluctuations. As more factors are added, it becomes increasingly difficult to design an analytical procedure that will adequately capture each factor's impact on the account.

E.2.12. *Plausibility of the relationship.* A plausible relationship is one that the auditor may reasonably expect to exist based on an understanding of the business and the accounting methods. For example, an increase in pay rates would be a plausible explanation for an increase in payroll expenditures. On the other hand, an increase in the number of suppliers being used may not have any impact at all of the total amount for capital expenditures.

E.2.13. *Relevance of the relationship.* A relevant relationship is one that addresses the specific financial audit objective(s) and/or related compliance with authority objective(s) in a meaningful way. For example, identifying a relationship that would obtain assurance as to the ownership of assets is usually not possible.

E.2.14. *Consistency of the relationship.* A consistent relationship is one that is stable over time. This characteristic addresses how well the past predicts the future.

Quality of the Data

E.2.15. There are four major factors that affect the quality of the data used in the analysis, as follows:

- a) Extent to which the auditor can expect the data to be complete and accurate;
- b) Independence of the data;
- c) Level of data aggregation; and
- d) Measurement frequency and number of periods of data used.

E.2.16. Each is discussed below.

E.2.17. *Extent to which the auditor can expect the data to be complete and accurate.* Analytical methods should be performed using data that the auditor can reasonably expect to be complete and accurate.

E.2.18. The ways in which the auditor obtains assurance as to the completeness and accuracy of the data depend on whether the data used for the analytical methods is produced by the entity itself (internally produced data), or obtained from external sources.

E.2.19. In order to obtain evidence as to the completeness and accuracy of data produced by the entity itself, the auditor usually needs to test the system that produced the data. The extent of reliance on analytical methods using internally produced data is, therefore, directly related to the auditor's reliance on the internal control structure.

E.2.20. The cost-effectiveness of performing the necessary supporting tests of controls on internally produced data will normally affect the cost-effectiveness of performing the analytical methods themselves. As a result, the auditor should assess the cost-effectiveness of obtaining assurance from testing the internal controls at the same time as assessing the cost-effectiveness of obtaining assurance from the analytical methods.

- E.2.21. For data obtained outside the entity, the nature of the source should be assessed to determine whether the data can be considered pertinent, complete and accurate.
- E.2.22. *Independence of the data.* For data to be independent, each item being used in the analysis should come from a source that is different than the source of the amount being analysed. This ensures a stronger test, as it is unlikely that errors will occur in both sets of data simultaneously.
- E.2.23. If the items are not coming from an independent source, the auditor would need to verify the completeness and accuracy of the items being used in the analysis.
- E.2.24. The most independent internal sources are records maintained by different people. Examples would include shipping records, production records, personnel records and similar records that are not part of the basic accounting records.
- E.2.25. If external data are available and used in the analysis, it would ordinarily satisfy the independence criteria. However, care must still be exercised in determining whether the data are relevant. For example, industry statistics are often several years out of date.
- E.2.26. *Level of data aggregation.* In general, the less aggregated the data, the better the analysis that will result, and the greater the amount of assurance that can be obtained. This is because the less aggregated the data, the less chance there is that errors in one specific account will be hidden by fluctuations in other accounts.
- E.2.27. For example, the auditor may decide to simply compare revenues by major object (direct taxes and indirect taxes) to the equivalent amounts for the previous year. A better test would be to do the comparison at the minor object level – taxes on income, wealth tax, property tax, etc. And, even better, the auditor could decide to do the comparison at the detailed object level – various categories for taxes from companies, taxes from registered firms, taxes from individuals, etc.
- E.2.28. *Measurement frequency and number of periods of data used.* Generally, the greater the number of data observations used in the analysis, the stronger the evidence provided through the analytical procedure. The more frequently one can observe a particular relationship, the more one can be assured of the consistency of the relationship.
- E.2.29. For example:
- a) Monthly observations generally provide more useful information (and assurance) than annual observations; and
 - b) Using several years' data in the analysis generally provides more assurance than only using the most recent year's data.

Summary

- E.2.30. While the category of analytical methods can have a significant impact on the amount of assurance that can be derived from the procedure, there are numerous other factors that need to be considered.
- E.2.31. The Standard Audit Working Papers Kit contains an Analytical Methods Assessment Form. This form summarises all of the factors discussed above and can be used to assess the amount of assurance that the auditor can derive from a particular analytical procedure.
- E.2.32. The following points should be noted when using the form:
- a) After considering all the factors outlined above (and summarised on the form), the auditor uses his/her professional judgment to determine the possible degree of assurance.
 - b) In some cases, one or more of the factors may significantly influence the amount of assurance that may be taken. For example, if the relationship is not considered plausible, then no assurance is warranted from the analytical procedure, and it should not be performed.
 - c) For each of the five types of analytical methods, a possible range of assurance is specified. The lower limit of each assurance range is set at nil, indicating that it is possible that the lack of one or more factors may render the analytical procedure unreliable.

3. The Process for Performing Analytical Methods

- E.3.1. To help ensure effective analytical methods, each analytical procedure application should follow three stages, consisting of 13 steps, described below.
- E.3.2. To assist staff in applying this process, an Analytical Methods Design Checklist is included in the Standard Audit Working Papers Kit.

Stage 1 – Designing the Procedure

- E.3.3. This work is normally started during the general audit planning phase, with the details worked out in the detailed activity and resource planning stage.
- E.3.4. Steps 1 to 6 often need to be performed at essentially the same time.
- E.3.5. *Step 1 – Define the accounting amount to be analysed.* This step primarily involves determining:
- a) The component (asset, liability, revenue or expenditure, etc.) to be audited;
 - b) The level of data aggregation (analysing the component for the entity as a whole, by ministry, department or agency, by division, etc.); and
 - c) The measurement frequency (monthly, quarterly, annually, etc.).
- E.3.6. Frequency will be a trade-off between the cost of gathering the data and performing the analysis, and the desired level of assurance.

- E.3.7. *Step 2 – Consider the objectives for the analytical methods.* This step will primarily involve a consideration of the specific financial audit objectives, related compliance with authority objectives and error conditions for which the procedure is to provide assurance.
- E.3.8. *Step 3 – Determine the analytical procedure to be used.* The auditor must decide on the appropriate analytical procedure to use given the specific financial audit objectives, related compliance with authority objectives and errors conditions. This decision will depend on the degree of assurance desired.
- E.3.9. *Step 4 – Define a significant difference.* This is one of the most important steps in the process. It affects the subsequent amount of audit work that has to be performed to obtain assurance from the analytical procedure. It may therefore have a significant impact on the amount of the required audit work.
- E.3.10. As discussed above, the threshold point above which a fluctuation is considered significant should usually be set as a percentage of planned precision.
- E.3.11. It is particularly important that this step be performed before actually identifying significant fluctuations to help ensure a rational and consistent identification of fluctuations to be investigated.
- E.3.12. *Step 5 – Specify the degree of assurance to be obtained from applying the analytical procedure.* This step requires the auditor to use his/her professional judgment in weighting the many factors outlined above, and summarised in the Analytical Methods Assurance Form in the Standard Audit Working Papers Kit.
- E.3.13. *Step 6 – Decide between computer or non-computer analysis of the data.* This step requires the auditor to consider the use of CAATs to identify, accumulate and/or analyse the data being used.
- E.3.14. *Step 7 – Obtain audit management review and approval.* Given the impact of analytical methods as a major potential source of audit assurance, it is important that the planned use of analytical methods be well documented and approved by the Deputy Auditor General (Senior) or responsible Deputy Auditor General prior to its actual application.
- E.3.15. This step should be done automatically as part of the approval of the audit programmes developed during the detailed planning phase.

Stage 2 – Performing the Procedure

- E.3.16. These steps are completed during the fieldwork phase.
- E.3.17. The Standard Audit Working Papers Kit includes “Analytical Methods Forms” that can be used to assist in performing these steps.

- E.3.18. *Step 8 – Ensure audit control is maintained.* This step requires the auditor to document how he/she maintained control over the data being used for the analytical procedure.
- E.3.19. This step is particularly important when entity personnel have provided the data. The auditor should conduct various tests to determine the number of records, file totals, etc., and compare these with reports produced by the operating system.
- E.3.20. Also, the auditor should ensure that the files examined are for the period under examination. A test should be performed to see if any transactions included in the data took place outside the period under examination.
- E.3.21. *Step 9 – Make the comparisons.* This is a mechanical procedure. The auditor performs the analysis planned in the previous steps. Care must be exercised to ensure that the person performing the comparison understands all of the previous steps.
- E.3.22. *Step 10 – Identify significant fluctuations.* Using the pre-determined threshold point (see step 4), the auditor identifies all fluctuations in excess of the threshold amount.
- E.3.23. Sometimes the data need to be manipulated before the auditor can easily detect the significant fluctuations. CAATs can be used to re-order the data in a way that it makes it easier for the auditor to identify the fluctuations.
- E.3.24. *Step 11 – Investigate significant fluctuations.* The significant fluctuations identified by the previous step may be caused by:
- a) Circumstances that the auditor knew about beforehand but had intentionally not taken into account when designing the analytical procedure. For example, the auditor could have used comparative analysis instead of predictive analysis, the relationship may have been too complex to take into account, or the auditor may have lacked adequate information.
 - b) Circumstances unknown to the auditor when designing the analytical procedure. It is these unknown fluctuations that usually are of particular concern.
- E.3.25. The auditor should begin his/her investigation of the cause of the significant fluctuation(s) by discussing them with entity officials. However, explanations received from the officials should not be accepted at face value. Each “explanation” received should be supported by corroborative evidence provided through other audit methods.
- E.3.26. For example, entity officials may explain an increase in utility costs by stating that there has been a significant increase in utility rates. The auditor could then check the accuracy of this assertion.
- E.3.27. Explanations of some fluctuations given by management may not be substantiated by the auditor through enquiry and/or analysis. In these circumstances, relevant tests of details may be required to substantiate the cause of the fluctuation. In all cases, the working papers should provide

evidence that the auditor has adequately investigated all significant fluctuations.

- E.3.28. For example, management may justify an increase in tax revenue from companies by stating that the average net income of all companies in Pakistan has increased. This assertion may not be verifiable, or may only be verifiable at great cost. The auditor may decide to reduce his/her planned reliance on analytical methods and replace it with more substantive tests of details of tax receipts from corporations.
- E.3.29. A key question is the extent to which the auditor should be required to explain the significant fluctuation. To illustrate, let's assume that the auditor decided that all fluctuations greater than Rs. 350,000 would be significant, and the auditor has an unexplained difference of Rs. 350,100 – just Rs. 100 over the threshold amount.
- E.3.30. It is not reasonable to expect the auditor to obtain an explanation for the entire Rs. 350,100. At the same time, if the auditor was simply required to obtain enough of an explanation to reduce the unexplained difference to just under Rs. 350,000, the auditor would only need to explain Rs 100 out of the Rs. 350,100.
- E.3.31. While professional judgment is again necessary, a useful guideline is that the auditor should obtain an adequate explanation to reduce the unexplained fluctuation to one half of the threshold amount that has been used to determine a significant fluctuation. In our case, this would be Rs. 175,000. Therefore, the auditor would need to explain Rs. 175,100 of the difference.

Stage 3 – Evaluating the Results Of the Procedure

- E.3.32. This step is performed at the evaluation phase.
- E.3.33. *Step 12 – Form the conclusion.* At this stage of the analytical procedure process, one of the four following situations will generally exist:
- a) There are no significant fluctuations, and there is no conflicting audit evidence that indicates that there should be a significant fluctuation;
 - b) All the significant fluctuations will have been investigated and adequate explanations obtained, substantiated and documented;
 - c) Explanations have been provided, but cannot be cost-effectively substantiated; and
 - d) Entity officials (and the auditor) cannot adequately explain some of the significant fluctuations.
- E.3.34. There are no significant fluctuations, and there is no conflicting audit evidence that indicates that there should be a significant fluctuation. It is possible that the auditor's other methods will indicate that there should be a significant fluctuation in his/her analytical methods. For example, the auditor could find material errors in a substantive test of details sample. Such errors would normally also result in significant fluctuations when the auditor compares the current year's balance to the previous year's balance, etc.

- E.3.35. Assuming that there is no conflicting audit evidence, even though the auditor will not have performed any work in Step 11, he/she will have obtained the amount of assurance desired from the analytical procedure.
- E.3.36. All the significant fluctuations will have been investigated and adequate explanations obtained, substantiated and documented. As in the first case, the auditor will have obtained the amount of assurance desired from the analytical procedure.
- E.3.37. *Explanations have been provided, but cannot be cost-effectively substantiated.* In this case, while entity officials may have provided explanations for all significant fluctuations, the auditor cannot obtain the audit evidence required to substantiate the explanations, or can only substantiate the explanations at great cost. In cases such as these, the auditor is normally required to take no assurance from the analytical procedure, and normally needs to perform additional appropriate tests of details. Assuming that these tests do not provide audit evidence that conflicts with the explanations provided, the auditor will have obtained sufficient assurance. Where the tests indicate that the explanations provided may not be correct, the auditor should take the steps noted below.
- E.3.38. *Entity officials (and the auditor) cannot adequately explain some of the significant fluctuations.* This situation should be rare since all practical efforts should be made to obtain satisfactory explanations for all significant fluctuations. In the rare instances where satisfactory explanations cannot be obtained, additional appropriate tests of details should normally be performed. (As above, the reason for the “normally” is because the auditor may have other options).
- E.3.39. In these cases, however, it is not sufficient to simply drop the analytical procedure and extend the detailed testing to make up for the assurance that was not obtained via the analytical procedure. To do this would be to ignore audit evidence that indicates a potential problem. Instead, the auditor should reassess inherent risk as high, take no assurance from the analytical procedure, and reconsider the extent of his/her planned reliance on the internal control structure. This will result in extensive substantive tests of details being performed. These methods will either identify material errors or indicate that material error does not exist and that sufficient assurance has been obtained.
- E.3.40. The results from applying the analytical procedure should be considered along with, and in conjunction with, the results of the auditor’s other methods in determining the amount that should be carried forward to the Summary of Unadjusted Differences.
- E.3.41. *Step 13 – Obtain audit management review and approval.* This last step in the analytical procedure process requires a more senior level person to review the documentation and approve the assurance taken.

APPENDIX F

1. Interviewing

Interviewing Skills

- F.1.1. Interviews with entity representatives are a major source of information during planning and execution phases of the audit. Accordingly, the auditor needs strong interviewing skills. These skills include preparing for the interview, conducting the interview, and writing up the interview notes.
- F.1.2. There are different ways of conducting the interview. In some situations, the auditor can adhere to predefined questions; at other times, the interviewer has to explore an area of questioning without any prepared set of questions (the unstructured interview). In most cases, the interview consists of a mix of prepared questions and responsive questions.
- F.1.3. It is difficult for one person to conduct an interview and at the same time accurately record the details of interview. Therefore it is generally more effective to assign more than one auditor to the interview. Where this is possible, they should agree who leads the discussions and who is responsible for producing the audit notes afterwards.
- F.1.4. Finally, the auditor must remember that the image of the auditor and DAGP, and the cooperation he or she will receive, depends to a large extent on the way the auditor conducts the interviews that are part of the audit activities.

2. Uses of the Interview

- F.2.1. The interview forms a major part of the audit conduct, especially in value-for-money auditing.
- F.2.2. The interview is conducted in the following situations:
- a) initiating the audit;
 - b) obtaining an understanding of the business of the entity;
 - c) determining the significant audit issues;
 - d) obtaining leads on where to find audit evidence;
 - e) obtaining explanations;
 - f) obtaining audit evidence;
 - g) communicating audit findings;
 - h) exploring appropriate recommendations; and
 - i) briefing management in support of the audit report.
- F.2.3. Although not the strongest form of evidence, the interview is often the main source of information for organising and directing audit effort. Also, although not an interview in the strictest sense, the conduct of briefing meetings requires similar skills.

- F.2.4. **Initiating the audit.** In introducing the proposed audit, the auditor needs to explain how the audit was selected, what areas the auditor proposes to cover and how the auditor intends to conduct the audit. The auditor must be prepared to explain the proposed work and answer a diversity of other questions, such as how long the audit will take, how much time will be required from the entity's staff during this period, or why particular aspects of the operations are going to be examined. The auditor should make entity management and staff comfortable with the upcoming audit and feel free to ask any questions they might have. This exchange of information should establish the basis of a "surprise-free¹" audit process throughout all stages of the audit.
- F.2.5. **Obtaining an understanding.** The first set of interviews should be used to obtain an understanding of the entity's business. At the beginning, the auditor should seek the basic materials that will provide this information. Later interviews should be used to get explanations about the material provided. The more the auditor reads about the organisation, the less the managers' and staff's time is taken up answering questions.
- F.2.6. **Deciding what to examine.** Initial interview discussions help the auditor determine what should be examined. It can be useful to ask management what they consider should be looked at. Also, the auditor may have identified serious potential weaknesses. Discussion with management can provide explanations for these apparent weaknesses. If the auditor is satisfied with the explanations, some issues may get dropped. In summary, interviews can be a valuable input to the process of determining significant audit issues.
- F.2.7. **Identifying availability of evidence.** It is almost impossible for the auditor to find and examine all possible information about an operation. Also, the auditor does not have the time to seek out all information. Efficient audits require the judicious selection of information.
- F.2.8. The interview is the best means of determining:
- a) sources of information that describe the operations (objectives, organisation, resources, activities, systems and procedures, outputs, outcomes);
 - b) where to obtain the information; and
 - c) how to collect the information.
- F.2.9. In addition, the managers and staff are often prepared to:
- a) suggest examples to investigate (both well run activities/projects and problem areas);
 - b) direct the auditor to particular studies and reports (on performance, organisational reviews, future strategies); and
 - c) provide copies of correspondence supporting the statements being made in the interview.
- F.2.10. Of course the auditor should independently check out the information provided. Although most managers and staff are well meaning and truthful, occasionally the auditor may be fed unreliable, incomplete or

¹ i.e., providing feedback during the audit process.

intentionally misleading information. Exploratory interviews must be supplemented with direct investigation by the auditor, such as file reviews, analysis of data and checking corroborating sources within, or external to, the organisation.

F.2.11. **Obtaining explanations.** When the auditor conducts a file review, or examines lists of transactions with accompanying documents, or performs analysis on a set of data, various questions are generated. Sometimes, these questions take the form of a written “audit query”. Alternatively, these questions can be the basis of a series of interviews with management and staff to obtain additional information, such as explanations of what was found.

F.2.12. **Source of evidence.** Interviews are a source of audit evidence. This is discussed in more detail below.

F.2.13. **Providing feedback.** Interviews are part of a two way communications process. As well as collecting information, the auditor provides feedback to management on what he/she is finding and concluding.

F.2.14. The auditor needs to maintain an open approach while avoiding premature statements on conclusions where there is still insufficient evidence. Often the auditor is asked for feedback when conducting an interview to collect evidence. As long as the conclusions are clearly identified as preliminary, the auditor can use the discussion on what has been found to date as a means of testing whether the position is shared by management; obtaining feedback and additional evidence; and preparing management to accept the results being obtained from the audit.

F.2.15. At the completion of the audit work in a particular area, the auditor should brief management on the main findings and conclusions. At the same time, the auditor should take the opportunity to explore appropriate recommendations.

F.2.16. In delivering the draft report, the auditor should either brief the management at the time of delivering the report or, alternatively, the report can be delivered a few days prior to an arranged meeting to discuss it. Normally the auditor should not send a final report to management without first discussing the report and asking management for a timely response, say within two weeks. If there is strong resistance to the report it is best to discuss it close to the time the report is delivered rather than allowing time for a formal reply to be composed. The auditor can counter strong objections with agreement to examine further evidence or to change the wording prior to any formal response. Although technically these briefing meetings are not interviews, many of the same skills are required to deliver the messages, respond to comments and request more information.

3. Process of Conducting the Interview

- F.3.1. There is much more to interviewing than asking questions and obtaining answers.
- F.3.2. The process of conducting interviews includes the following steps:
- a) Planning and scheduling;
 - b) Conducting the interview (from opening to closing);
 - c) Applying interviewing techniques; and
 - d) Documenting and reviewing the evidence (providing evidence, summarising the results and reviewing).

Planning and Scheduling the Interview

- F.3.3. **Scheduling interviews.** Careful planning of the interviews can reduce the overall time of the audit substantially. Often it is difficult to arrange meetings with senior managers. The scheduling of meetings should begin well in advance of the time that the interviews are to be conducted. There is no assurance that a manager will be available at short notice.
- F.3.4. Reasons for unavailability might be tight deadlines, conferences, visits outside of the office as well as the scheduling of vacation time.
- F.3.5. Accordingly, appointments should be set up well in advance. When making the appointment, the auditor should outline topics to be covered and how long the interview will take. Sometimes, an outline of the questions will be requested. Depending on the nature of the audit, the questions may be sent in advance. Where it is not desirable to send detailed questions, the auditor can send an outline of the areas to be covered in the interview.
- F.3.6. Wherever possible, at the commencement of the audit, the audit team should meet with the senior manager responsible for the audit areas, rather than an acting manager. Even if this meeting is brief and just a courtesy call, it should be scheduled prior to any major audit work. Similarly, the audit report should be delivered when the senior manager is available to read the report. If possible, an acting manager should not receive the report in the absence of the senior manager.
- F.3.7. Sometimes, the manager of the areas to be audited will request that the auditors meet with the whole management team at the start. This is an excellent way of launching the audit. The auditors, however, must be prepared to answer questions at this meeting. This meeting is a good opportunity to set up a schedule of interviews.
- F.3.8. **Planning the interviews.** The audit programme should have identified the initial set of interviews. The auditor needs to identify which entity managers are responsible for which areas of audit investigation. It is useful to have some overlap in the areas covered because actual activities may not be completely consistent with the official responsibilities. Also, some areas may be impacted on by others and discussions can lead to discovering interface problems. The initial set of interviews will lead to

additional interviews to schedule. Thus the plan of interviews has to be continually updated as the audit progresses.

- F.3.9. **Preparing the interview.** The first step in preparing the interview is to determine the objective(s) of the interview. If the objectives of the interview are not clear, the auditor is likely to conduct a poor interview and appear confused. This could expose the auditor to being accused of wasting the manager's time. Other issues can arise during the audit that are outside the original objectives. This is acceptable. However, the auditor should establish the minimum set of information to collect from the interview, and should ensure it is covered before the interview terminates.
- F.3.10. The auditor should prepare an interview agenda. This can be quite broad but a pre-defined structure for the interview makes the interview more efficient and the auditor is more likely to cover all required areas. The person to be interviewed may ask for an agenda prior to the interview. The agenda is a good way of starting the interview after the initial social exchanges. The agenda helps to keep the proceedings more organised.
- F.3.11. In most cases, the auditor should prepare and organise a list of questions. At the early stage of the audit, interviews are often less structured and therefore only a few broad questions may need to be prepared before the interview. At later stages of the audit, the auditor needs to confirm precisely what exists and does not exist and so the questions are generally more specific.
- F.3.12. Sometimes, the team consists of auditors with different responsibilities: one person may be auditing HR issues while another is looking at computer systems. The budget of the audit may not permit all team members to visit all sites. In this case, each team member with a particular audit area of responsibility should produce a detailed set of all inclusive and very specific questions for other team members to ask when visiting each site.
- F.3.13. **Preparing for the interview.** The auditor should ensure that he/she has sufficient background knowledge prior to conducting the interview. Also, the auditor should not take the time of management to obtain basic information that can be obtained elsewhere. The manager will have much more respect of the auditor if the auditor already has a sound understanding of the areas of audit.
- F.3.14. The auditor should have a good background understanding of the business, and the technical details of the operations, prior to conducting the interview. For example, if conducting an audit on heavy equipment, the auditor should get to know the equipment: the different models of equipment that are used in the operations, and their load capacities, as well as other technical details. The interview will proceed much more smoothly than if the auditor has to interrupt the speaker every few minutes to ask for an explanation of the different equipment model numbers or, even worse, is lost in the detail. In some of the very technical areas, it is

useful to have a technical person on the audit team who can apply his/her experience in judging procedures and performance.

F.3.15. Even with a fully structured set of questions, the interview may not necessarily proceed along the original plan. The answers may indicate that some of the questions are inappropriate or may lead to new avenues of enquiry. As a result, there may be insufficient time to cover all the questions. Consequently, the auditor should be prepared before the interview with an interview strategy. The auditor should decide what, at a minimum, needs to be covered in the interview. A few good answers are much more valuable than all questions answered incompletely or superficially.

Conducting the Interview

F.3.16. In situations where the information is sensitive, or there is a concern that the interviewee might wish to deny the evidence collected during the interview, there is an advantage to have more than one auditor present.

F.3.17. The interview has three stages:

- a) Introduction;
- b) Main body; and
- c) Wind down.

F.3.18. **Introduction.** The beginning of the interview is very important. It sets the tone for the rest of the interview and also can establish a rapport that will last throughout the audit.

F.3.19. Often people are nervous about being audited. To overcome this, the auditor should put the interviewee at ease during the introduction. The auditor should provide an explanation about the audit, informing the interviewee what areas are being proposed for audit and what the auditor expects to look at. Ask them if they agree with the coverage or whether there are any areas that they suggest should be included or excluded and why. Ask them if there are any particular issues that they would like the audit to address. Give them a list of criteria, either in a hard copy form or go through it to the level of detail that the person wants. Enquire if they have any questions.

F.3.20. **Review audit agenda.** Before commencing with the audit questions, the auditor should outline the interview coverage. This helps the interviewee to know where the discussions will be going and also allows him/her to decide whether any discussions can be postponed until a later part of the interview. Also, establish how much time the person has for the interview.

F.3.21. **Confirm confidentiality.** The interviewee should be informed that the interviews are treated in confidence. Particular comments will not be attributed to an individual. However, the auditor should avoid saying anything is off the record: if the information subsequently becomes known, it could jeopardise the auditor's image of integrity and reflect badly on the audit organisation. Sometimes, the interviewee will ask that

no notes be taken on a particular point. The auditor may comply with this request at his or her discretion.

- F.3.22. **Picking up signals.** Throughout the interview, the auditor must consider whether the answers provided seem reasonable, reliable and complete. Body language, brief asides and special phrasing of the answer can provide considerable insight to underlying reality that the answer is not directly providing. When the auditor picks this up, he/she can ask for an elaboration at that point or, alternatively, can return to it at a later stage of the interview. Interviewing skills come into play here. It is a matter of judgement as to when to request more information, depending on whether the interviewee seems relaxed and wishing to elaborate or whether responses are more likely to be provided later in the interview. In some cases, the auditor may decide to leave in-depth questioning until a future time.
- F.3.23. Hesitancy in answering questions is caused by many factors. There may be conflict between:
- a) A desire to be truthful and also to have malpractices corrected; and
 - b) A loyalty to the organisation/colleagues and fear of possible repercussions
- F.3.24. The interviewee may not trust the auditor sufficiently at the beginning. Sometimes the information is provided by a hint, suggesting, for example, that the auditor should consider other projects than those in the sample.
- F.3.25. **Collecting opinions.** Often managers and staff provide opinions. These normally do not constitute evidence. The auditor should request elaboration and explanation of these statements; ask for examples that illustrate, and support, the opinion.
- F.3.26. Interview evidence is not usually a strong form of evidence. So, wherever possible, the auditor should request supporting evidence (such as memos, reports, documents, print-outs, and other collaborating evidence).
- F.3.27. Usually, answers provided in an interview are from memory, unless the respondent has spent some time researching in preparation for the interview and has material on hand to support the answers. Consequently, oral statements may not always be accurate. The auditor should check the validity of statements by consulting other sources. For example, the manager may state that there have been major delays. The auditor should ask for the specific cases and go back to documentation to calculate the actual delays. It is common for claims to be exaggerated.
- F.3.28. **Dealing with conflict and lack of cooperation.** Sometimes the auditor experiences a lack of cooperation. Although the auditor has in most cases the power and authority to demand information, this authority should only be used in extreme cases. It is better to acquire the information through cooperation.
- F.3.29. If there is a lack of cooperation, the auditor should attempt to determine the reason for it. There can be many reasons. For example, the interviewee may:
- a) have something serious to hide;

- b) feel threatened by the auditor or the audit process, and may want to challenge the authority of the auditor;
- c) be very busy and not consider the audit a priority (in which case the role of the auditor may not have been made clear within the entity);
- d) may not want to admit that there is a weakness and may hope that the auditor will drop the matter if confronted with a lack of cooperation; or
- e) may have been offended by the auditor or may have taken a dislike to the individual.

F.3.30. Depending on the reason for the lack of cooperation, there are different ways of handling it. If the lack of cooperation is over a minor point the auditor should not press for an answer. The auditor can always return later if the information is critical to the audit.

F.3.31. In general, it is better to return to the issue at a later date, rather than allowing a conflict to develop. Give the interviewee time to think about the position he/she has taken. If the information is important, and after trying to discover the reason and not getting a clear answer, the auditor, as a last resort, can either state the intention to consult his/her Competent Authority or state the intention of going to the official contact for the conduct of the audit (usually the senior manager in charge of the area under audit, or sometimes a designated contact for the auditors).

F.3.32. **Open, low-key approach.** The auditor should remain relaxed and comfortable throughout the interview. Do not rush to cover all questions. If the auditor is running out of time, the interviewee should be asked whether he/she would prefer to continue beyond the original scheduled time or arrange another date to complete the interview.

F.3.33. An honest approach is best. If the auditor is asked a question and does not know the answer, or if some of the statements are not clear, the auditor should be prepared to admit ignorance or ask for clarification.

F.3.34. If the auditor has made a good effort to learn about the entity, there is no problem in acknowledging a lack of specific knowledge. If more information is required, the auditor should ask for a source for obtaining it. If the auditor is asked a question for which they do not have the answer, he/she should ask for some time to obtain the information.

F.3.35. Where actual management practice is not consistent with normally accepted practice (such as accounting standards, good management practice, government contracting procedures, etc.) the auditor should not assume that it is wrong and immediately take a critical position. First, get the management view and find out why the particular practice is in place. Enquire why there is a difference between what the auditor would expect and what is being done.

F.3.36. There may be good reasons for the difference and, if not, the manager may well agree with the auditor that that there should be changes.

F.3.37. **Taking notes.** The output of the interview is the information collected. Therefore, the auditor must be able to produce sound, representative and

accurate notes of the interview. Certain note-taking practises are effective in this regard, as follows:

- a) Pre-prepared questions reduce the amount of notes required; whereas, improvised questions require the auditor take notes of both the question and the answer.
- b) The interviewer cannot normally take complete notes during the interview so as soon as possible after the completion of the interview the auditor should go through the notes and add points that were left out during the interview.
- c) The auditor should use **key words** to help recollection after the interview.
- d) The auditor should also develop the skill to recognise where a verbatim quotation is significant and take notes accordingly.

F.3.38. **Wind down.** Towards the end of the interview, the auditor should check how much time is left and how much further material needs to be covered. There are some choices: speed up the process to get answers quickly to all remaining questions; ask if the interview could be extended; or ask to reschedule the interview to complete all areas.

F.3.39. It is sometimes worth summarising the key points from the interview, although time constraints may not permit much summary discussion. At the end of the interview, the auditor should review what material has been requested.

F.3.40. Not only should the interviewee note what material has been requested but the auditor should note these also. The auditor must make sure that he/she returns to collect the material subsequently.

F.3.41. The auditor should always enquire, at the end of the interview, whether the interviewee has any questions. Make it clear that the interviewee can get back to the auditor at any time if there are any questions. The auditor should add that if there is anything about the audit that they are troubled by, to feel free to contact him/her for clarification.

F.3.42. In turn, the auditor should ask permission to get back with further questions. Where the auditor is on a site visit, he/she can follow up with further questions by phone. Usually a subsequent phone call is welcomed as it allows the managers or staff to know how the audit is proceeding.

4. Applying Interviewing Techniques

F.4.1. There are different methods of conducting interviews. The auditor should be comfortable applying different methods according to the needs of the audit process.

F.4.2. **Structured / unstructured interviews.** The interview can take a structured or an unstructured form or some combination of these. The unstructured interview is also referred to as an exploratory interview. The auditor enters the interview with only a very broad outline of what information is to be collected. The approach may take a form of requests rather than specific questions. For example, the auditor could start by saying “Please tell me what challenges your area faces.” Often, without being asked, the

interviewee suggests that the interview start with him/her providing the auditor with an explanation of what the work is all about. In these situations, the auditor must be a good listener. An interruption to ask for more detail on a particular point can disrupt the flow of information. Detailed questions can wait until later – let the interviewee describe the business. Interruptions should be kept to a minimum. Only if the information gets too irrelevant to the area of audit should the auditor redirect the discussion. The interviewee should be encouraged with appropriate interjections to indicate that the auditor is following and appreciates the points being made.

- F.4.3. Structured interviews require a logical framework for the conduct of the interview together with specific detailed questions. Structured interviews are necessary if the auditor is doing a “survey” of opinions, or has specific findings to confirm precisely. Opinions are not normally in themselves evidence. If the auditor can report, however, that “83% of those interviewed found that their roles and responsibilities were not clear”, then this is a strong piece of evidence to support the auditor’s analysis of the statements on roles and responsibilities. Very specific questions can force a precise answer.
- F.4.4. Normally, interviews during the early stage of the audit tend to be unstructured. At the later stages of the audit, where the auditor wants to obtain explanations and wants to confirm specific audit findings, a structured interview is much more appropriate. Also, experienced auditors work well with unstructured interviews whereas junior auditors should develop, or be provided with, detailed questions prior to conducting an interview. Structured interviews make it a lot easier to take notes, because all that has to be recorded are the answers.
- F.4.5. **Biased / unbiased questions.** Auditors must be careful in the way they phrase questions and must be aware of whether their questions are biased or unbiased. Generally, questions should be unbiased, although in some situations where they want to confirm an understanding the question is directed (and in that sense could be described as biased). An unbiased question is one that is neutral as to the expected answer. It does not “lead” the response or suggest a more appropriate answer. It provides a full range of possible answers rather than restricts the possible answers.
- F.4.6. Examples of biased questions are:
- a) Would you say that generally error rates are low?
 - b) Would you say that there should be very detailed controls?
 - c) Do you agree that the findings are correct?
- F.4.7. Examples of unbiased questions are:
- a) Do you know what were the error rates last month? If no figures are available, would you judge that the error rates were lower, the same, or higher than those in the previous month?
 - b) In your opinion, do you think that there should be very detailed controls, some controls, or no controls?

c) Do you agree, or disagree with these findings?

- F.4.8. **Focus.** Responses can range from evasion of the question to long drawn out explanations with unrelated details. The auditor needs to develop the skills to help focus the responses to provide meaningful and brief replies. Sometimes the respondents get side tracked. The auditor needs to judge whether useful information is being provided or whether this is a waste of time. At the early stages of the audit, these lengthy asides can provide very valuable information. The auditor needs to have ways of bringing the discussions back on the main line of questioning. For example, the auditor can make polite suggestions that these points can be raised at a later stage of the interview.
- F.4.9. There can be conflicting objectives within an interview. Sometimes the interviewees are most interested in imparting their perspective, whereas the auditor is most interested in getting answers to the questions along their particular framework of investigation. Unless these different perspectives are recognised, there can be a breakdown in communication.
- F.4.10. The way something is said can be more important than what is being said. The auditor should develop an interviewing style that causes minimum resentment to what the auditor needs to communicate. If the auditor phrases an observation in the form of a question rather than as a statement, it is more likely to be accepted. For example, instead of commenting that “the transaction is not in compliance with regulations” he/she might inquire “Would you agree that the transaction was not carried out according to the regulations? If so, why was that?”
- F.4.11. Sometimes the auditor needs to establish a trail of logic rather than go directly to the issue. Each fact is established piece by piece until the overall conclusion is irrefutable. For example, if the auditor suspects that sales income from a processing plant is being understated, he/she can ask what is the capacity of the plant, whether it is operated efficiently, and for how many hours per day and how many days per year. The auditor can then multiply the total production figure, so derived, for the year by the unit price to get the total expected sales income for the year, and ask the interviewee to explain the shortfall.
- F.4.12. Knowledge of many of the answers before the interview gives the auditor an advantage. When, for example, it is obvious that the auditor knows there is a problem, respondents are often much more likely to provide the truthful answers than if they think that they might be able to bluff an answer.
- F.4.13. **Tape recording.** Although not common, a tape recorder can be used for interviews. The interviewees should be asked if they mind the use of the tape recorder. Although there may be some hesitation at the start, normally there are no problems with its use. The interviewee can always ask that the recorder be stopped at any point. The advantage of the tape recorder is that an accurate and detailed record of the interview is produced.

F.4.14. **Telephone interviews.** A useful means of carrying out the collection of audit evidence is the telephone. Although it may not be used very often in place of a site visit, it is common to use the phone for follow-up collection of missing evidence that did not get collected during the visit. Now, with the availability of e-mail, files and reports can be sent in response to a telephone call. Also, a tape recorder can be used for telephone calls. Of course, the auditor must inform the interviewee of the intention to use the tape recorder and obtain his/her permission to use it.

5. Documenting and Reviewing the Evidence

- F.5.1. The auditor must maintain good interview notes, because they:
- need to be relied upon for evidence;
 - indicate professional working habits; and because they
 - are a source of information that can be referred to throughout the conduct of the audit.
- F.5.2. Although interview evidence is not normally considered a strong form of evidence, it is nevertheless a valuable source of evidence.
- F.5.3. One reason why interview notes are not considered strong evidence because, unless validated by the person interviewed, they can be denied at a later date. The interviewee can always claim that the auditor misquoted what was said. Furthermore, if they are to remain confidential, they cannot be divulged as evidence in the normal process of clearing findings. The auditor must always take care to not **divulge the source of information**. It is not appropriate to request the interviewee to sign a copy of the notes (but it is a good practice to obtain written confirmation of what was discussed at a meeting held to discuss findings – see paragraph 12.102 below).
- F.5.4. The only time interview notes should be available outside the audit office would be if there was an independent third party or review of the working papers.
- F.5.5. Each interview should be clearly documented (either typed or clearly written²) and include:
- The audit title;
 - Who was present (interviewees / auditors);
 - Positions within the entity and titles;
 - Telephone numbers (and where applicable address – room number, building);
 - Date of interview;
 - All key points obtained (clear replies to specific questions, additional comments that are relevant, quotes verbatim where highly significant);
 - Summary of main points (not necessary but useful) and any follow up questions resulting from the interview;
 - List of documents obtained or promised (particularly if any documents are provided on a loan basis); and

² Normally the notes written during the interview are not sufficiently clear or extensive to constitute appropriate notes. The interview needs to be written up in full as soon after the interview as possible.

- i) Items remaining for follow up from auditor or respondent.
- F.5.6. The auditor should return to the interview notes later in the audit. The notes may include comments or references that did not mean much at the time but which, after collecting additional evidence, may become more meaningful and may provide additional leads.
- F.5.7. A strong source of evidence is minutes of exit meetings. Here the observations collected during a visit are provided verbally to senior entity management of the area. Minutes of the meeting (with the observations and the responses to the observations) can be sent to the manager for confirmation. This information does not divulge the source of the observations yet, at the same time, the formal acknowledgement constitutes strong evidence.
- F.5.8. When the auditor prepares the audit report, or briefing material, it is useful to list observations/findings and go through the interview notes and attach relevant comments from all the interviews under each heading. This process of analysis demonstrates where the verbal evidence is consistent (and in that sense strong) and where there may be differences. The differences can indicate potential problem areas that need further investigation or may simply reflect different perspectives according to where the interviewees are located within the entity.

APPENDIX G

External Confirmations

1. Introduction

G.1.1. Paragraph A14 to A25 of Audit Evidence ISA 500 (International Standard on Auditing) describe seven audit procedure which may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. External Confirmations is an integral part of these seven procedures. The objective of this appendix is to provide assistance to auditor in designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

G.1.2. P4 of ISSAI 1505 (International Standard of Supreme Audit Institutions 1505) states that corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from evidence within the accounting records or from representations made by management. Paragraph 6 (a) of the ISA 505 defines an external confirmation as “audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.”

G.1.3. In addition to assertions related to the audit of financial statements, public sector auditors may find confirmations useful in obtaining evidence related to additional audit objectives stipulated by their audit mandate or arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. For example, external confirmations can be used to obtain evidence about:

- The presence or absence in agreements or arrangements with third parties of legislated or other terms and conditions such as guarantees of performance or funding;
- The commitment of expenditures that have not yet been authorized by the legislature;
- The continued eligibility of individuals in receipt of pensions, income assistance, annuities or other ongoing payments; or
- The presence of “side deals” with suppliers for the return of goods for credit in order to use funding that would have otherwise lapsed in a subsequent fiscal period.

G.2. Basic concepts and definitions

G.2.1. External confirmation – Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

- G.2.2. **Positive confirmation request** – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
- G.2.3. A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party’s agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of “blank” confirmation request may result in lower response rates because additional effort is required of the confirming parties.
- G.2.4. **Negative confirmation request** – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- G.2.5. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present: (Ref: Para. A23)
- a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
 - b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
 - c) A very low exception rate is expected; and
 - d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.
- G.2.6. **Non-response** – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

G.2.7. Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity’s records, and information provided by the confirming party.

Authority of the Entity

G.2.8. The confirming party must have the permission of the entity to release the information. To obtain this permission the auditor asks the entity to sign an authority letter to the confirming parties authorising them to release any information the auditors may require directly to them.

G.3. External Confirmation Procedures

G.3.1. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- a) Determining the information to be confirmed or requested;
- b) Selecting the appropriate confirming party;
- c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- d) Sending the requests, including follow-up requests when applicable, to the confirming party.

Designing Confirmation Requests

G.3.2. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

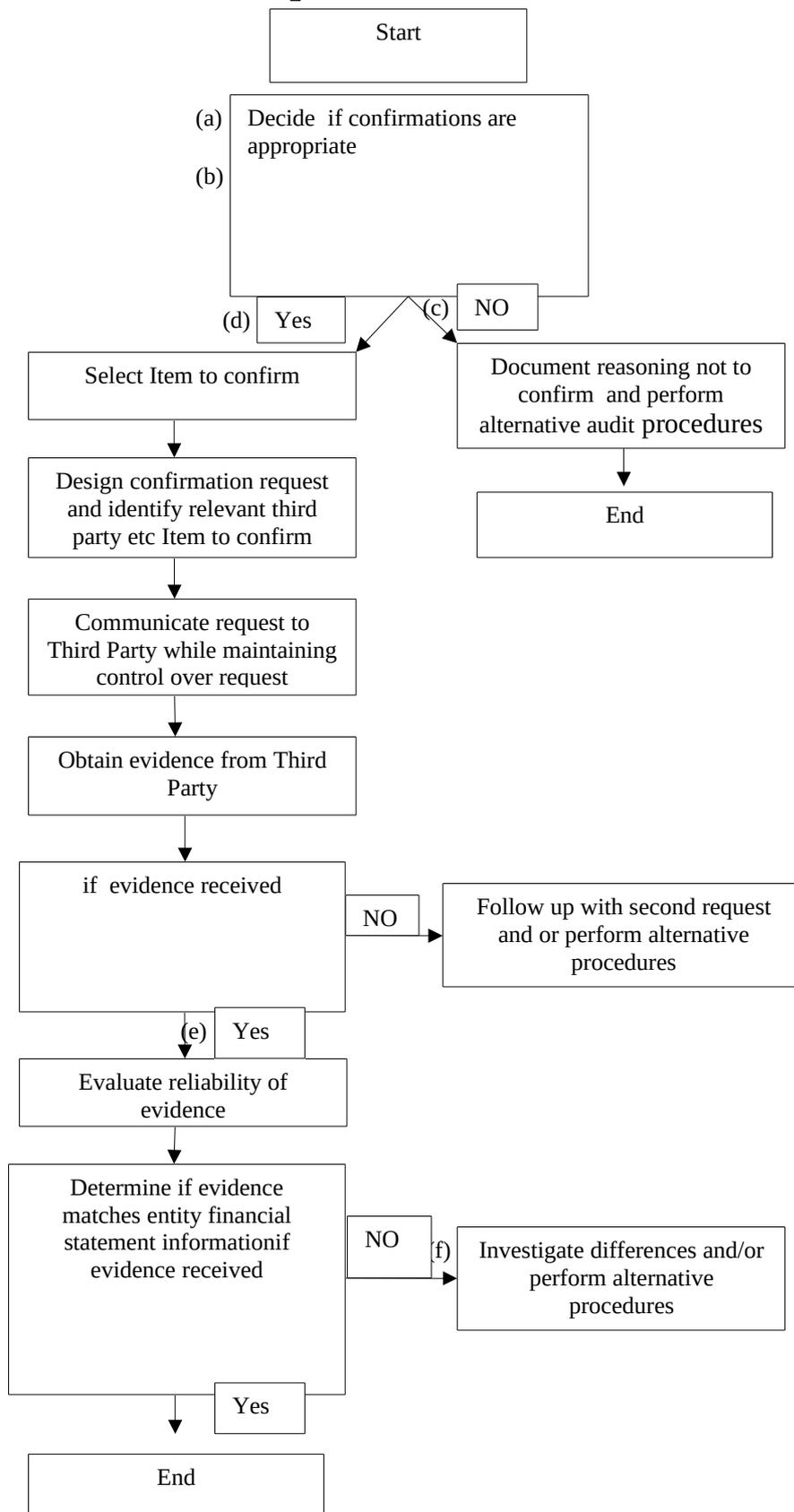
G.3.3. Factors to consider when designing confirmation requests include:

G.3.4. The assertions being addressed.

- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.
- The method of communication (for example, in paper form, or by electronic or other medium).
- Management’s authorization or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management’s authorization.

- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

Audit Confirmation Steps



Follow-Up on Confirmation Requests

G.3.5. The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Management's Refusal to Allow the Auditor to Send a Confirmation Request

G.3.6. If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- a) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

G.4. Results of the External Confirmation

Reliability of Responses to Confirmation Requests

G.4.1. ISA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include that it:

- Was received by the auditor indirectly; or
- Appeared not to come from the originally intended confirming party.

G.4.2. If a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that:

- The response may not be from the proper source;
- A respondent may not be authorized to respond; and
- The integrity of the transmission may have been compromised.

G.4.3. On its own, an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor. However, upon obtaining an oral response to a confirmation request, the auditor may, depending on the circumstances,

request the confirming party to respond in writing directly to the auditor. If no such response is received, in accordance with paragraph 12, the auditor seeks other audit evidence to support the information in the oral response.

- G.4.4. A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence.

Unreliable Responses

- G.4.5. When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly. For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with ISA 240.

Non-response

- G.4.6. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence,

Exception

- G.4.7. Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by ISA 240 to evaluate whether such misstatement is indicative of fraud. Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

- G.4.8. Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

G.5. Specimen of External Confirmations

Bank Confirmation

- G.5.1. As bank is the most liquid of all assets in general the auditor seeks direct receipt of a confirmation from every bank or other financial institution with which the entity does business.

Instructions for completion

- a) The standard letter must be sent in duplicate.
- b) The confirmation request should be typed on letter head of the Audit office.
- c) If any additional information is required, a separate letter duly authorised by the entity, must be sent, preferably with the standard request.
- d) A stamped, addressed envelope (in the name of Audit office) should be enclosed for reply.
- e) Correct mentioning of the period or date under consideration of the Audit.
- f) The name of all entities covered by the request.
- g) Details of other information (Reference to serial 9 of the letter).
- h) This standard letter is intended for use where an audit is being carried out. If it is used in other circumstances, “audit” should be deleted.
- i) The request should, wherever possible, be timely despatched to bank along with entity’s authority letter. (appropriate time may be given to entity for completion of the reply).
- j) The request must be signed by a senior official and posted by a member of AUDIT OFFICE, NOT BY THE ENTITY or his staff.

ENTITY AUTHORITY LETTER FOR BANK CONFIRMATION

The Manager

Date

Bank Name

Dear Sir,

Bank Confirmation Request

Entity Name

We would appreciate if you could provide for audit purposes the information requested in the attached form(s):

- Bank Confirmation - Audit Request (General)

To facilitate the timely completion of the audit, it would be appreciated if the forms were completed and returned by (Insert date).

Please mail the original of the completed form(s) direct to our auditors as named in the forms and the duplicate to us in the stamped, addressed envelopes enclosed for this purpose.

Any charge for providing this information is to be debited to _____ Account.

Yours faithfully

Authorised Signatory/Signatories

Entity Name

BANK CONFIRMATION LETTER

Date :

To,

Dear Sir / Madam,

ENTITY NAME: _____
REQUEST FOR BANK REPORT FOR AUDIT PURPOSES

FOR THE YEAR ENDED _____

In accordance with your above-named customer's instructions given in authority letter , please send DIRECT to us at the above address, as auditors of your customer, the following information relating to their affairs at your branch as at the close of business on _____ and, in the case of items 2, 4 and 9 during the period since _____. For each item, please state any factors which may limit the completeness of your reply; if there is nothing to report, state 'NONE'.

It would be particularly helpful if your reply could be given on this letter in the space provided (supported by an additional schedule stamped and signed by the bank where space is insufficient).

It is understood that any replies given are in strict confidence, for the purpose of audit and are being provided without any contractual obligation.

Information requested	Reply
Bank accounts (Please refer notes i & ii)	
1. Full titles of all accounts (whether in rupees or in any other currency) together with the account numbers and balances thereon, including Nil balances :	
(a) Whether your customer's name is the sole name in the title;	
(b) Whether your	

Information requested	Reply
customer's name is joined with that of other parties;	
(c) Whether the account is in a trade name.	
Notes	
(i) Where the amount is subject to any restriction (e.g., a garnish order, attachment or arrestment) or exchange control considerations (e.g., blocked account) this information should be stated.	
(ii) Where the authority upon which you are providing this information does not cover any amounts held jointly with other parties, please refer to your customer in order to obtain the requisite authority of the other parties. If this authority is not forthcoming please indicate.	
2. Full titles and dates of closure of all accounts closed during the period.	
3. The separate amounts accrued but not charged or credited at the above date, of :	
(a) mark-up	
(b) Interest	
(c) provisional charges (including commitment fees);	
4. The amount of mark-up and interest (indicating each separately) charged during the period if not specified separately in the customer's statement of account.	
5. Particulars (i.e. date, type of document and accounts covered) of any written acknowledgement of set-off, either by specific letter of set-off, or incorporated in some	

Information requested	Reply
other document, or security.	
6. Details of :	
(a) Short term running finances, overdrafts, cash credits facilities and loans specifying for each agreed limit and in the case of term loans, date of repayment or review.	
(b) Details of participation term certificates, musharika arrangement, term finance certificates, lease financing, debentures, long term running finances utilised under mark-up arrangements or instruments and loans repayable on demand specifying dates of review and agreed facilities in respect of each of the above facility.	
(c) Rates of mark-up, profit, return and interest in respect of each facility.	
(d) In case of lending under mark-up arrangements please indicate the amount of the purchase and resale price together with the amount/rate of prompt payment rebate and period within which the mark-up and resale price is payable by your customer.	
7. (a) Customer's Assets held as SECURITY: Please give	
(i) details of any security formally charged to the bank, including the date and type of charge, (e.g., pledge, hypothecation, mortgage etc.)	
(ii) particulars of any undertaking to assign to the bank any assets. If a security is limited to any borrowing/credit facility or if there is a prior, equal or subordinate charge, please indicate.	

Information requested	Reply
(b) Investments, bills of exchange, documents of title or other assets held but not charged. Please give details.	
<u>Contingent Liabilities</u>	
8. All contingent liabilities, viz :	
(a) Total of bills discounted for your customer, with recourse;	
(b) Details of any guarantees, bonds or indemnities given to you by the customer in favour of third parties;	
(c) Details of any guarantees, bonds or indemnities given by you, on your customer's behalf, stating where there is recourse to your customer and/or to its holding, parent or any other entity within the group;	
(d) Total of acceptances;	
(e) Particulars of outstanding forward exchange contracts; (e.g. rates, dates, rupees and foreign currency amounts etc.)	
(f) Total of outstanding liabilities under documentary credits;	
(g) Other – please give details.	
<u>9. Other Information</u>	
A list of other banks, or branches of your bank, where you are aware that a relationship has been established during the period.	

Yours
faithfully

For and on
behalf of
Audit office

.

Information requested	Reply
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(a) * DISCLOSURE AUTHORISED	(Authorized signatory)
(b) (CUSTOMER'S NAME)	Date _____ : _____

*Signed in accordance with the terms and conditions for the conduct of the customer's bank account.

Lawyer Confirmation Letter

ISA 501: *Audit Evidence regarding specific financial statement account balances and disclosures* (para 10) states: “When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when the auditor believes that other litigation or claims may exist the auditor shallseek direct communication with the entity’s legal counsel through a letter of general inquiry or specific inquiry, prepared by management and sent by the auditor, requesting the entity’s legal counsel to communicate directly with the auditor”.

Instructions for Completion

- a) The letter should be typed on entity’s letter head.
- b) If any additional information is required, a separate letter, duly authorised by the entity, must be sent, preferably with the standard request.
- c) A stamped, addressed envelope should be enclosed for reply.
- d) Correct mentioning of the period or date under consideration of the Audit.
- e) The name of all entities covered by the request.
- f) This standard letter is intended for use where an audit is being carried out. If it is used in other circumstances, “audit” should be deleted.
- g) The request should, wherever possible, be timely despatched. (Appropriate time may be given for completion of the reply).
- h) The request must be posted by a member of Audit Office, NOT BY THE ENTITY or his staff.

LAWYER CONFIRMATION LETTER

(Letterhead of Entity)

(Date)

(Name and Address of Lawyer)

Dear ...

In connection with the preparation and audit of the financial report of the entity (and the following subsidiaries and/or divisions) for the reporting period ended (date) we request that you provide, at our cost, the following information,

- 1 Confirmation that you are acting for the entity (and the above-named subsidiaries and/or divisions) in relation to the matters mentioned below and that the directors' description and estimates of the amounts of the financial settlement (including costs and disbursements) which might arise in relation to those matters are in your opinion reasonable.

Name of Entity	Concerned Description of (including status)	Official Matter current	Concerned Estimate of Settlement (inclusive of costs and disbursements)	Officials' the Financial
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- 2 Should you disagree with any of the information included in 1 above, please comment on the nature of your disagreement.

- 3 In addition to the above, a list of open files that you maintain in relation to the entity (and the above mentioned subsidiaries and/or divisions).

- 4 In relation to the matters identified under 2 and 3 above, we authorise you to discuss these matters with our auditor (name and address), if requested, and at our cost.

It is understood that:

- (a) the entity (and the above-named subsidiaries and/or divisions) may have used other lawyers in certain matters;
- (b) the information sought relates only to information relating to legal matters referred to your firm (including branches or subsidiaries) which were current at any time during the above-mentioned reporting period, or have arisen since the end of the reporting period and up to the date of your response;
- (c) unless separately requested in writing, you are not responsible for keeping the auditors advised of any changes after the date of your reply;
- (d) you are only required to respond on matters referred to you as lawyers for the entity (and the above-mentioned subsidiaries and/or divisions), not on those within your knowledge solely because of the holding of any office as director, secretary or otherwise of the entity (and the above-mentioned subsidiaries and/or divisions) by a consultant, partner or employee of your firm; and
- (e) your reply is sought solely for the information of, and assistance to, this entity in connection with the audit of, and report with respect to,

the financial report of the entity (and the above-mentioned subsidiaries and/or divisions) and will not be quoted or otherwise referred to in any financial report or related documents of the entity (and the above-mentioned subsidiaries and/or divisions) nor will it be furnished to any governmental agency or other person, subject to specific legislative requirements, without the prior written consent of your firm.

Your prompt assistance in this matter will be appreciated. If you are unable to confirm or provide the information requested above, please advise us and our auditor the reasons for any limitation or impediment to fulfilling this request.

Would you please forward a signed copy of your reply directly to our auditors, (name) at (address), by (date).

Yours faithfully,

(Signature of Entity)

Balance Confirmation Letter

Instructions for Completion

- a) The standard letter must be sent in duplicate.
- b) The letter should be typed on entity's letter head.
- c) If any additional information is required, a separate letter, duly authorised by the entity, must be sent, preferably with the standard request.
- d) A stamped, addressed envelope should be enclosed for reply.
- e) Correct mentioning of the period or date under consideration of the Audit.
- f) The name of all entities covered by the request.
- g) Details of other information (Reference to the letter.).
- h) This standard letter is intended for use where an audit is being carried out. If it is used in other circumstances, "audit" should be deleted.
- i) The request should, wherever possible, be timely despatched to entity (appropriate time may be given to entity for completion of the reply).
- j) The request must be posted by a member of Audit Office, NOT BY THE ENTITY or his staff.

BALANCE CONFIRMATION LETTER

(TO BE TYPED ON ENTITY'S LETTERHEAD)

Date:

To:

Dear Madam / Sir

ENTITY NAME: _____

FOR THE YEAR / PERIOD ENDED: _____

Our auditors, (Name of Audit office), are conducting an audit. In connection therewith, they desire to confirm the balance due to/from us on your account as at

_____.

Please state in the space below whether or not this is in agreement with your records as at the above date. Please furnish the information you may have that will assist our auditors in reconciling the differences, if any. After signing, stamping and dating your reply, please mail or fax the same directly to our auditors.

A stamped, addressed envelope is enclosed for your convenience.

Very truly yours

Disclosure Authorised

For and on behalf of

To:
 Audit Office.
 Ref:

Date:

Dear Sirs

ENTITY NAME: _____ **(the entity)**

FOR THE YEAR / PERIOD ENDED: _____

(Amounts in Rupees)

PARTICULARS		AS PER RECORDS OF THE ENTITY	AS PER OUR RECORDS	DIFFERENC E
Balance	Payable to the ENTITY			
	Receivable from the ENTITY			
Security deposit	Paid to the ENTITY			
	Received from the ENTITY			
Advance	Paid to the ENTITY			
	Received from the ENTITY			
Other (please specify)				

Yours sincerely

(Name & Designation)

(Entity Name and Seal)

Details of discrepancies, if any: