

IDI e-Learning course on 'Implementing Compliance Audit ISSAIs'

# ISSAI IMPLEMENTATION HANDBOOK COMPLIANCE AUDIT

Draft version 1.0





# Table of Contents

<b>About the Handbook</b>	<b>4</b>
<b>Chapter 1: Introduction and Basic Elements of Compliance Auditing</b>	<b>6</b>
1.1 Introduction	7
1.2 Elements of Compliance Audit	8
1.3 What Does the Auditor Look for in Different Audits?	10
1.4 Different Ways of Conducting a Compliance Audit	10
1.5 How ISSAIs Help to Conduct Quality Compliance Audit	12
1.6 Principles of Compliance auditing	13
1.7 Compliance Audit Process	16
1.8 Conclusion	17
<b>Chapter 2: Main concepts of compliance audit</b>	<b>18</b>
2.1 Introduction	19
2.2 Definition of audit and compliance audit	19
2.3 Subject matter and subject matter information	19
2.4 Authorities and criteria	21
2.5 The three parties	22
2.6 Assurance	23
2.7 Attestation engagements and direct reporting	24
2.8 Assertions and audit	27
2.9 Professional scepticism and professional judgment	28
2.10 Conclusion	30
<b>Chapter 3: Planning and Designing a Compliance Audit</b>	<b>31</b>
3.1 Introduction	32
3.2 Initial considerations for planning	32
3.3 Planning process	35
3.4 Determining materiality at planning stage	44
3.5 Audit strategy and audit plan	47
3.6 Conclusion	48
<b>Chapter 4: Gathering Audit Evidence</b>	<b>49</b>
4.1 Introduction	50
4.2 Audit Evidence	50
4.3 Evidence Gathering Techniques	53
4.4 Consideration of Non-compliance that may indicate Fraud and Unlawful Acts	57
4.5 Conclusion	58
<b>Chapter 5: Evaluating Evidence and Forming Conclusion</b>	<b>59</b>
5.1 Introduction	60
5.2 Evaluating of evidence and forming conclusions	60
5.3 Conclusion	62
<b>Chapter 6: Documentation and Communication</b>	<b>63</b>
6.1 Introduction	64
6.2 Documentation	64
6.3 Communication	67
6.4 Conclusion	69



<b>Chapter 7: Reporting a compliance audit</b>	<b>70</b>
7.1 Introduction	71
7.2 Reporting a compliance audit	71
7.3 Forms of a compliance audit	72
7.4 Contents of a compliance audit	72
7.5 Conclusions/opinions in compliance audit	75
7.6 Example of a short form compliance audit report	80
7.7 Audit follow up	81
7.8 Conclusion	82
<b>Chapter 8: Implementation Strategies for compliance audit ISSAIs</b>	<b>83</b>
8.1 Introduction	84
8.2 Process for formulating ISSAI Implementation Strategy	88
8.3 Formulating an action plan	98
8.4 Commitment of the leadership in implementing the action plan	99
8.5 Guidance on preparing Action Plan	99
8.6 Conclusion	100

### List of Tables

Table 2.1: Levels of assurance and types of audit in compliance auditing
Table 4.1: Evidence gathering techniques
Table 8.1: iCAT of SAI X (step 1) on Level 4 ISSAI requirements with status "Met"
Table 8.2: iCAT of SAI X (step 1) on Level 4 ISSAI requirements with status "Not Met/partially met"
Table 8.3: SWOT Analysis of SAI X
Table 8.4: Example & Format of preparing action plan

### List of Figures

Figure 1.1: Authorities related to the specific constitutional Arrangement of the SAI
Figure 1.2: Authorities are the sources of audit criteria
Figure 1.3: The three parties to the audit
Figure 1.4: The General Principles of Compliance auditing
Figure 1.5: Professional Judgment and Skepticism
Figure 1.6: Compliance audit process
Figure 3.1: Interrelationship between subject matter, scope and criteria
Figure 4.1: Decision making process
Figure 8.1: Compliance audit ISSAI implementation decision process
Figure 8.2 Compliance Audit ISSAI Implementation Strategy Framework
Figure 8.3: Four main domains under Level 2 ISSAIs
Figure 8.4: Factors determining selection of ISSAI implementation strategic options

### List of References

ISSAI 100
ISSAI 400
ISSAI 4000
ISSAI 4100
ISSAI 4200
ISSAI 1000-1999
International Standards on Assurance Engagements (ISAE) 3000 (Revised).



# About the Handbook

## 1.1 Introduction

The 3i Programme Phase 1 facilitates implementation of International Standards of Supreme Audit Institutions (ISSAIs) by SAIs of developing countries, with a comprehensive capacity building programme for level 2 ISSAIs (Prerequisites for the Functioning of Supreme Audit Institutions) and level 4 financial audit, compliance audit and performance audit ISSAIs.

In the process of implementing ISSAI 400/4100/4200[1], this handbook on compliance audit is a part of the phase 1 of the 3i programme.

## 1.2 Objectives

This handbook has been written in order to facilitate implementing compliance auditing ISSAIs at level 3 and level 4 in SAIs of developing countries. In this respect the handbook aims to achieve two goals:

1. To explain the nature of compliance audit in public sector and guide through strategic considerations in implementing the compliance audit standards in SAIs.
2. To provide guidance and illustrations on the process, tools and working papers that could be used in conducting a compliance audit based on the ISSAIs.

The handbook is **not intended** to be a compliance audit manual. Therefore the handbook does not substitute audit policy documents, strategies and manuals. Each SAI should set out to describe its own compliance audit methodology taking into account: its mandate, resources, user needs and regulatory environment.

This handbook aims to explain the concepts of compliance audit by linking them to the practice in the field. The users will be able to recognize the elements and concepts elaborated in the handbook with their audit practices. They will also be able to appreciate that it is about the alignment of existing audit practice with the requirements of the standards that will lead to ISSAI compliant compliance audit.

The users of the handbook should consider the following two points. Firstly, the explanations provided in the handbook are only one way of interpreting the compliance audit standards. Secondly, compliance audit standards represent a work in progress, and the whole compliance audit process is yet to be explained by further standards. The interpretations

provided in the handbook represent a foregoing attempt at elaborating the compliance audit process based on the ISSAI 400: Fundamental principles of compliance auditing and the ISSAIs 4000-4200.

## 1.3 Audience

The handbook targets SAIs who have decided to start the implementation of ISSAIs at level 3 and level 4, as well as SAIs who are already on journey to implement ISSAIs and wish to continue improving their compliance audit process based on the ISSAIs.

Within a SAI the handbook targets both the senior level staff (management) of compliance audit as well as the practitioners of compliance audit (auditors and methodology specialists).

## 1.4 Approach

The handbook uses a case study covering all aspect of compliance audit process (planning, gathering evidence, evaluating evidence, forming conclusions, reporting) to illustrate the concepts described in the chapters of the handbook. In the chapters respective ISSAIs related to the audit process are described as well as how this can be used in the audit demonstrated in the case study.

## 1.5 Content

The handbook is divided into eight chapters:

- Chapter 1: Introduction and basis elements of compliance audit
- Chapter 2: Main concepts of compliance auditing
- Chapter 3: Planning and designing compliance audit
- Chapter 4: Gathering audit evidence
- Chapter 5: Evaluating evidence and forming conclusion
- Chapter 6: Documentation and Communication
- Chapter 7: Reporting
- Chapter 8: ISSAI Implementation Strategy for compliance auditing

[1] *General Auditing Guidelines on Compliance Audit, IS-SAIs 4000-4200*

*Fundamental principles of Compliance Auditing, ISSAI 400*



## 1.6 Link between this Handbook and the compliance audit iCAT

To assist SAIs in integrating ISSAIs in their compliance auditing process the Handbook provides a step-by-step process, which may require each SAI to adopt varied strategies and action plans in accordance with their mandate, user needs, national legislation, regulations etc.

The first step for the SAI is to take a comprehensive look at its mandate, users' need and environment. If a SAI decides that it would like to refer to ISSAIs at level 4 then the first step for the SAI would be to ascertain ISSAI requirements and assess the status of the SAI vis-a-vis the compliance audit standard requirements. As a next step the SAI identifies the causes or reasons for non-compliance and the SAI's needs in order to fulfil the requirements.

The ISSAI Compliance Assessment Tool (iCAT) developed under the 3i Programme helps the SAIs with the exercises of mapping its current audit practice with the compliance audit guidelines i.e. the Level 4 ISSAIs. The handbook chapter 8 shows how to move from identifying the gaps of current practices to the implementation process by determining the priority implementation issues, moving on to building a strategy and action plan and overcoming some of the difficulties that SAIs in the starting position might face.



## **Chapter 1:**

# **Introduction and Basic Elements of Compliance Auditing**



## 1.1 INTRODUCTION

The purpose of this introductory chapter of the compliance audit ISSAI Implementation Handbook is to help the readers to become familiar with the basics of compliance audits so that they can graduate to advanced treatment of the concepts in the following chapters. This chapter briefly explains (a) compliance audit, its elements, its principles and importance in the public sector; (b) the intent and purpose of the ISSAIs on compliance audits as how ISSAIs help to conduct quality compliance audit; (c) ways in which SAs can consider adopting the ISSAIs on compliance audit (d) differences between compliance audit and other types of audits and how they can be combined in practice and (e) the compliance audit process. The concepts described in this chapter are elaborated in the subsequent chapters with illustrations.

### 1.1.1 Compliance Audit in a Public Sector Context

In defining what Compliance Auditing is, we need to consider the definition of public sector auditing as the definition of Compliance auditing builds on from it.

Public-sector auditing can be described as a systematic process of objectively obtaining and evaluating evidence to determine whether information or actual conditions conform to established criteria[1]. The definition of compliance audit builds on this definition with a specific focus on assessing compliance with criteria derived from authorities.

Compliance audit is an independent assessment of whether a given subject matter is in compliance with applicable authorities identified as criteria. As auditors, we assess whether activities, financial transactions, and information are, in all material respect, in compliance with the authorities which govern the audited entity[2]. Auditors in compliance audit look for material deviations or departure from established criteria which could be based on laws and regulations, principles of sound financial management, or propriety.

As auditors, we need to understand the context of compliance auditing. The concepts and establishment

of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent - or at least render more difficult - such breaches[3].

Public sector audit is essential for public sector administration, because the management of scarce public funds is placed into public sector officials' care. The usage of these funds is regulated by principles, rules and standards, which all together constitute the authorities. The officials are expected to act in the best interest of the public, by spending the funds for the intended purposes, and in line with the authorities.

It is the responsibility of public sector bodies and their appointed officials to be *transparent* about their actions and *accountable* to citizens for the funds with which they are entrusted, and to exercise *good governance* over those funds[4]. Whether and how public sector managers fulfil their responsibilities is not a matter of absolute trust. Compliance audit plays an important role in ensuring that the principles of transparency, accountability and good governance are actually met.

Compliance auditing promotes transparency by providing reliable reports as to whether public funds have been utilized in line with the applicable authorities. It promotes accountability by reporting deviations from and violations of authorities. This information makes it possible to take corrective action, and to hold public officials accountable for their activities. Compliance audit promotes good governance by identifying weaknesses and deviations from laws and regulations and also by assessing the propriety of officials.

[1] ISSAI 100.18.

[2] ISSAI 400.12

[3] ISSAI 4100, Section 1.

[4] ISSAI 400.16.





Compliance auditing may be concerned with regularity (adherence to formal criteria such as relevant laws, regulations and agreements) or with propriety (observance of the general principles governing sound financial management and the conduct of public officials). While regularity is the main focus of compliance auditing, propriety may also be pertinent given the public-sector context, in which there are certain expectations concerning financial management and the conduct of officials. Depending on the mandate of the SAI and the nature of laws and regulations in the public sector context of the SAI, the audit scope may therefore include aspects of propriety.

## 1.2 ELEMENTS OF COMPLIANCE AUDIT

ISSAI 100 described the elements of public-sector auditing. All public-sector audits have the same basic elements: the auditor, the responsible party, intended users i.e. the three parties to the audit, criteria for assessing the subject matter and the resulting subject matter information. Public-sector audit can be categorised as two different types of audit engagement: attestation engagements and direct reporting engagements these are described in the later chapters. The additional aspects of the elements relevant to compliance auditing, which should be identified by the auditor before commencing the audit are described in this section:

### 1.2.1 Authorities and criteria

Authorities are relevant acts or resolutions of the legislature or other statutory instruments, directions and guidance issued by the public sector bodies with powers provided for in statute, with which the audited entity is expected to comply. Authorities may include laws, policies, rules, regulations, and other instruments that people/organizations, for whom the authorities have been framed, must follow in order to be compliant. These elements are sometimes collectively referred to as legislative authorities or just authorities. This should not be confused with authorities in the sense of bodies or persons exercising power or

command such as law enforcement authorities or regulatory authorities.

For example, governments in many countries have laws to provide income support to individuals meeting certain eligibility requirements. These laws serve as authorities in case if a compliance audit of Income Support Programmes.

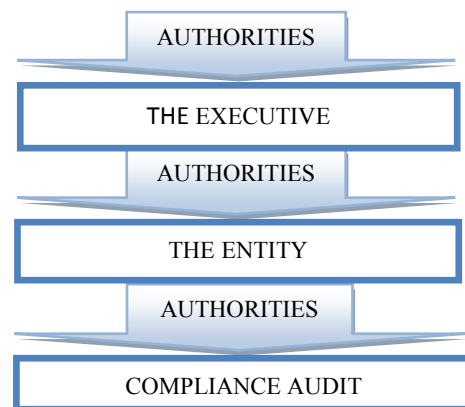


Figure 1.1: Authorities related to the specific constitutional Arrangement of the SAI

Criteria are the benchmarks used to evaluate or measure the subject matter consistently and reasonably. Authorities are the sources of criteria. Criteria may be derived from laws, policies, rules, regulations, and other instruments and used in assessing compliance or non-compliance.

For example, in the case of the income support programme mentioned above, one eligibility condition could be that - only those earning less than \$800/month and having four people to support will be paid \$500/month as income support.

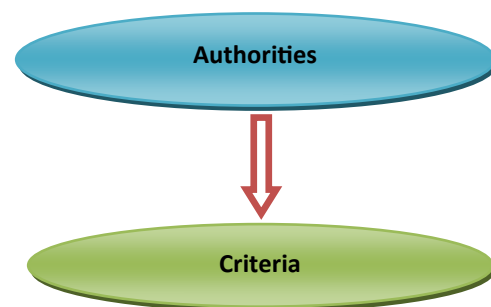


Figure 1.2: Authorities are the sources of audit criteria





## 1.2.2 Subject matter

Subject matter refers to the information, condition or activity that is measured or evaluated against certain criteria. It can be activities, financial transactions, or information.

For example, in the context of income support programme, the subject matter could be:

- a. Activity which is the actual income support programme itself and its operations, or
- b. The financial transactions of the programme, or
- c. Information such as financial statement, annual reports and accounts of the income support programme that management makes available for auditors.

## 1.2.3 Three parties

Compliance auditing is based on a three party relationship, where an auditor aims to obtain sufficient, appropriate audit evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the measurement or evaluation of a subject matter against criteria. In all compliance audits we have:

A responsible party (usually government agency) which gets funds for specified activities

The intended users (parliament) that allocates fund to government agencies and expects that funds will be used as per relevant authorities and appropriate propriety considerations, and

SAIs that conduct audit on behalf of the parliament and provide assurance as to whether or not fund have been used as per criteria.

In the case of our example, the Income Support Programme Agency is the responsible party whereas the intended user is the parliament.

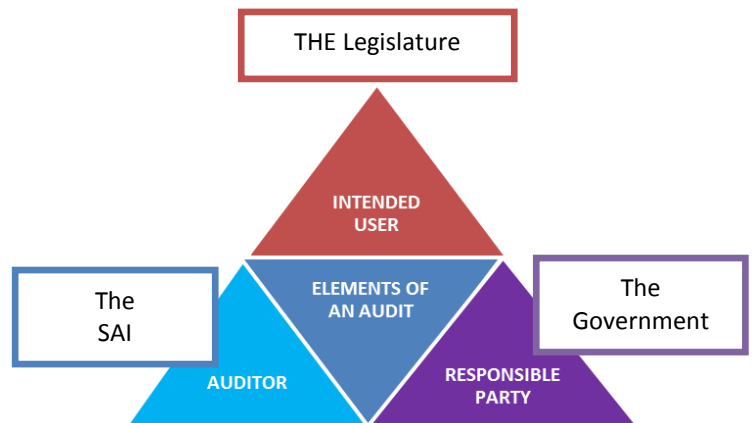


Figure 1.3: The three parties to the audit

## 1.2.4 Assurance

Intended users wish to be confident about the reliability and relevance of information provided to them for decision making. Audits should therefore provide information to the users based on sufficient and appropriate evidence. Thus, auditors need to perform procedures to reduce or manage the risk of reaching inappropriate conclusions and provide credible information to the intended users so that the latter could make informed decision, otherwise these could mislead intended users thus making valueless decisions. For example, the intended user (parliament) authorises government to collect and use taxes with the aim of providing basic services. Parliament wants to know that the responsible party (respective government agency) has used the funds allocated to it as per applicable authorities (laws, regulations etc.). The Parliament wants a third party to provide this assurance to them. SAIs all over the world are best placed to provide that assurance based on their work.

In the example case of the income support programme, the SAI can provide assurance that the money allocated to the income support agency has been spent as per applicable authorities. The level of assurance that can be provided to the intended user should be communicated in a transparent way. However, due to inherent limitations, audits can never provide absolute assurance. In audit, assurance can be either reasonable or limited. Also, reasonable assurance is high but not absolute. These elements of assurance are explained in detail in next chapter on main concepts of compliance auditing.



## 1.3 WHAT DOES THE AUDITOR LOOK FOR IN DIFFERENT AUDITS?

SAs usually carry out three types of audits namely financial audit, compliance audit and performance audit. Definition and context of compliance audit has already been given above. It is important to understand financial audit and performance audit and how they are different from compliance audit and what particularly the audit look for in the different audits.

### Financial Audit

Financial audit is determining whether an entity's financial information is presented in accordance with the applicable financial reporting and regulatory framework[5].

While doing financial audit auditors look for misstatement and errors that can have material impact on the information presented in the financial statement. The material misstatement or error is something that would force individuals with average understanding of the subject matter to change their views on the assertions made in the financial statements.

### Performance Audit

Performance audit is an independent, objective and reliable examination of whether the government undertakings, systems, operations, programmes, activities or organizations are operating in accordance with the principles of economy, efficiency and effectiveness and whether there is room for improvements[6].

Auditors here review any subject matter from the perspectives of economy, efficiency and effectiveness. Is the government is using resources economically while handling a subject matter? Is the ratio of inputs to output is optimal in government operations covered in audit? Is the government entity able to deliver the intended result and impact?

## Compliance Audit

Compliance audit is an independent assessment of whether a given subject matter is in compliance with applicable authorities identified as criteria. This is done by assessing whether activities, financial transactions and information are in all material respect, in compliance with the authorities which govern the audited entity[7].

So, what is the auditor looking for in compliance audit? It is, whether, the subject matter is in compliance with the authorities propriety?

## 1.4 DIFFERENT WAYS TO CONDUCTING COMPLIANCE AUDIT

In practice many SAs do their annual audit that includes different types of audit or as combination of financial, compliance or performance audits. As such compliance audit can also be combined with financial and performance audit. ISSAI 100 states that SAs may conduct combined audits incorporating financial, performance and/or compliance aspects. The following are the probable different ways compliance audit can be conducted:

### 1.4.1 Compliance Audit as Stand alone Activity

Some SAs conduct compliance audit as standalone engagement. This means that the compliance audit is done on its own and it is not done in conjunction with financial auditing or performance auditing. The ISSAIs provide that Compliance auditing conducted separately may be planned, performed and reported separately from audit of financial statements and from performance audits. It may be conducted on a regular or ad-hoc basis, as distinct and clearly defined audits each related to a specific subject matter[8].

[5] ISSAI 100.22

[6] ISSAI 300.9

[7] ISSAI 400.12

[8] ISSAI 400.25



The ISSAI 4100 explain key considerations applicable when SAIs conduct compliance audits as standalone engagement which will be explained in detail in the following chapters.

### **1.4.2 Compliance Audit coupled with other types of audits**

Compliance Auditing can be conducted not only separately but also in combination with other types of audits. For example, compliance audit can be done coupled with the audit of financial statement or with performance audit. Different SAIs may be using different approaches in carrying out combined audits. It may be relevant to see how the ISSAIs look at combining compliance audit with the other two types of audit.

#### ***Compliance auditing in relation with the audit of financial statements***

Many SAIs follow a practice of combining their audit of financial statement with giving assurance on compliance issues within one audit process. Compliance auditing is much broader than financial auditing and enables the auditor to have a wider scope. The legislature, as an element of public democratic process, establishes the priorities for public-sector income and expenditure and for the calculation and attribution of expenditure and income. The underlying premises of legislative bodies, and the decisions they take, are the source of the authorities governing cash flow in the public sector. Compliance with those authorities constitutes a broader perspective alongside the audit of financial statements in budgetary execution.

Combining financial and compliance audits enables the auditor to obtain assurance not only about whether the financial statements are free from material misstatement but additionally to obtain assurance about whether activities, financial transactions and information comply, in all material respects, with the authorities/or laws which govern the audited entity.

Laws and regulations are important both in compliance auditing and in the audit of financial statement.

Conducting the audit of financial statements, only those laws and regulations with a direct and material effect on the financial statement are relevant. In compliance auditing, any laws and regulations relevant to the subject matter may be applied<sup>[9]</sup>.

ISSAI 4200 provides for the auditor to consider all the matters that are included in the public sector combined audit. It is important that this standard is read and understood in conjunction with the financial audit ISSAIs 1000-2999. The ISSAI 4200, when applied together with the Financial Audit Guidelines, provide public sector auditors with a comprehensive set of guidance for audits of financial statements in the public sector.

#### ***Compliance auditing in combination with performance auditing***

When compliance auditing is part of a performance audit, compliance is seen as one of the aspects of economy, efficiency and effectiveness<sup>[10]</sup>. In combined audits of this kind, auditors should use their professional judgment in deciding whether performance or compliance is the primary focus of the audit and determine audit scope and criteria accordingly.

The following are some of the differences between performance auditing and compliance auditing which would help us understand more in deciding the primary focus of an audit:

- In a performance audit, a non compliance may be a cause of, an explanation for, or a consequence of, the state of the activities being subject to the performance audit whereas in a compliance audit, the auditor assesses the degree to which the audited entity (through its officials) follows rules, laws and regulation, policy, established codes, or agreed upon terms which govern a public sector entity.

<sup>[9]</sup> ISSAI 400.23

<sup>[10]</sup> ISSAI 400.26



- In performance auditing, auditors look at whether or not the audited entity is operating economically, efficiently, and effectively. These parameters are integral to the definition of performance audits. The underlying concept is that if an audited entity uses resources economically, generates more value for the input it uses, and creates intended impact. In performance auditing, the larger focus is on delivering results, though economy and efficiency aspects are also relevant. Performance criteria are usually based on economy, efficiency, and effectiveness considerations accordingly.
- In compliance auditing, auditors are looking for instance of non-compliance with relevant authorities as defined above (e.g. applicable laws, policies, rules, regulations, procedures, terms of contract or agreement) that can have material impact on the audited entity achieving its objectives.

## 1.5 HOW ISSAIS HELP TO CONDUCT COMPLIANCE AUDIT

In the above backdrop, it is not difficult to see that compliance auditing is not something new to the audit sphere. However, we may see significant variation in practice as how different SAIs carry out compliance audits. The International Standards of Supreme Audit Institution (ISSAIs) on compliance auditing<sup>[11]</sup> are broad principles, standards, and guidelines that provide a common frame of reference for SAIs and facilitate convergence toward common professional standards and practices of compliance audit. They are based on the historical practices of SAIs. Many SAIs have taken significant steps toward adopting these ISSAIs. Some of the ways in which the ISSAIs may help SAIs in improving the quality of their work are explained below:

- **As a basis for the development of standards**

Some SAIs may be conducting compliance audits as per their mandate but they may not have any governing auditing framework to support their work. These SAIs can review the ISSAIs and develop standards and guidelines accordingly for compliance audits. The SAIs would need to consider the ISSAI 400: The

Fundamental Principles of Compliance Audit while carrying out this work.

It is important for SAIs to note that references should only be made to the Fundamental Principles of Compliance Auditing in audit reports if the standards they have developed fully comply with all relevant principles of compliance auditing. The ISSAIs are flexible in that they emphasize need for SAIs to consider their respective mandate, laws, and regulations when adopting the ISSAIs. Thus, these principles do not override the existing mandates, laws, and regulations that govern SAI audit practices.

- **As a basis for the adoption of consistent national standards**

Some SAIs may already have auditing standards to perform compliance audits. The ISSAIs provide a frame of reference for these SAIs. The SAIs can analyse their existing practices vis-à-vis the ISSAIs, identify gaps, and modify their governing auditing framework to suite their peculiar circumstances in the light of the ISSAIs. As time goes on, the SAIs can continue to improve on their national auditing framework to eventually become compliant with the ISSAIs in the long run.

- **As a basis for adoption of the Compliance Auditing Guidelines as authoritative standards**

Another option for SAIs could be to consider adopting the ISSAIs on compliance audit guidelines (ISSAIs 4000-4200) as their governing auditing framework. In some SAI environments, this might not be possible because of administrative structures or laws or regulations that don't lend support in this direction. It is also important to note that SAIs may have different approaches to achieving these principles and these approaches may be included in a SAI's policies, manuals etc. ISSAI 4000 series is undergoing a review and will be fully developed as authoritative standards by 2016. However, this may not hinder SAIs from referring to it for guidance with its current stage which may also warrant an SAI's management's consideration in such case.

<sup>[11]</sup> ISSAI 400.4



Some SAIs conduct compliance audit coupled with financial audit or performance audit in line with their respective mandates. In such cases, the ISSAIs relevant to each type of audit as adopted by SAIs should be complied with and references should also be made accordingly.

## 1.6 PRINCIPLES OF COMPLIANCE AUDITING

ISSAI 400 describes the principles of compliance auditing. These principles are fundamental to the conduct of a compliance audit. As the nature of the audit is iterative and cumulative the auditor should consider these principles prior to commencement of any audit and also at more than one point during the audit process i.e. planning and designing, gathering and evaluating evidence and reporting.

The fundamental principles are grouped by principles related to SAI's organizational requirements, which are the General Principles[12]. And the principles related to specific steps in the audit process e.g. planning, conducting and reporting.

The following General Principles of compliance audit are briefly described in this chapter as they will be further explained in detail in the upcoming chapters of this handbook. As the figure 1.4 illustrates auditor should exercise professional judgment and skepticism throughout the engagement while considering the other elements of the general principles. These elements are to be there at a SAI level to ensure proper compliance audit that complies with the standards.

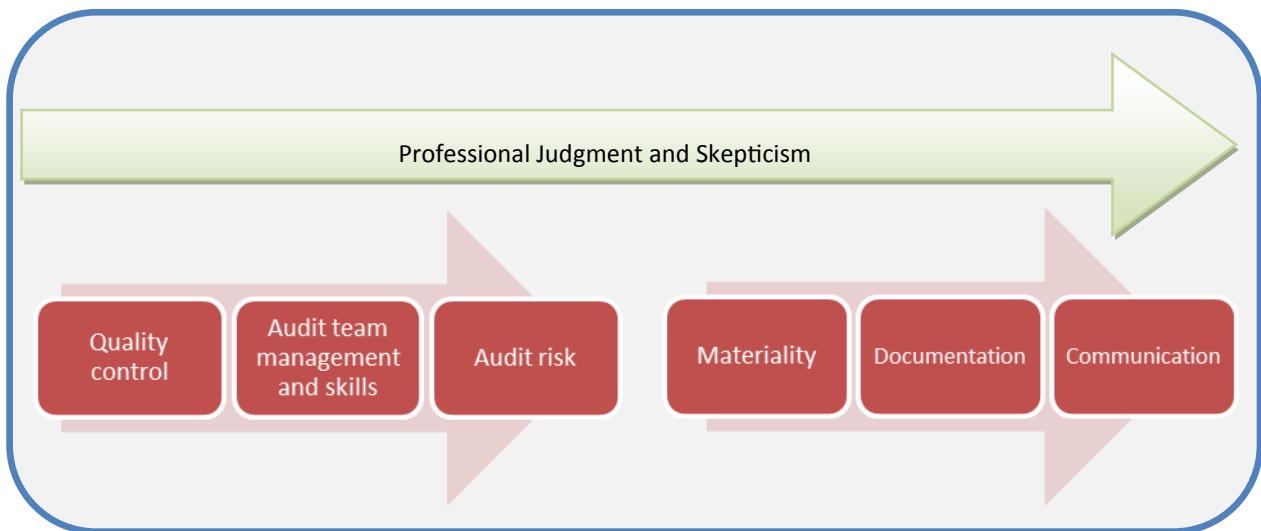


Figure 1.4: The General Principles of Compliance auditing

[12] ISSAI 400.4



## Professional judgment and skepticism

Professional judgment is the application of relevant training, knowledge and experience, within the context provided by auditing standards, so that informed decisions can be made about the courses of action that are appropriate given the circumstances of the audit [13]. It is how an auditor views different contexts or situations from different angles or perspectives based on professional experience and knowledge.

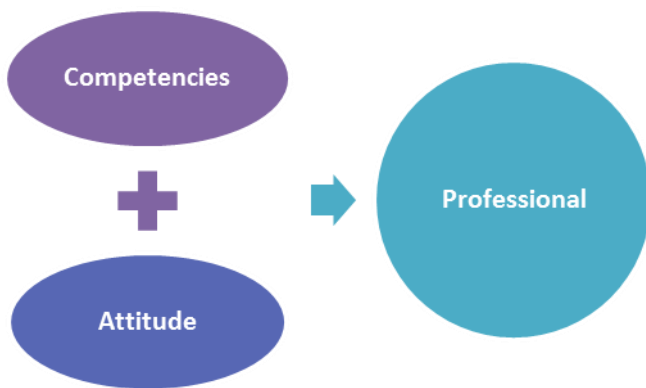


Figure 1.5: Professional Judgment and Skepticism

Professional skepticism refers to maintaining professional distance and an alert and questioning attitude in assessing the sufficiency and appropriateness of evidence obtained throughout the audit. For example, an auditor doesn't have to believe what is given as he/she will maintain a questioning mind until he/she has obtained some assurance that the said is proven correct.

## Quality Control

This refers to processes in place whereby the overall quality of a compliance audit is reviewed to ensure that the audit was in compliance with applicable governing standards and that the audit report; conclusion or opinion issued is appropriate in the circumstances. Some SAIs already have established quality control units for this purpose. Audit reports are issued only after SAIs has done this assessment. Additional guidance on quality control is given in ISSAI 40: Quality Control for SAIs.

## Audit team management and skills

The audit team should collectively possess the knowledge, skills and expertise necessary to successfully complete the audit. This includes an understanding and practical experience of the type of audit being undertaken, familiarity with the applicable standards and authorities, an understanding of the audited entity's operations and the ability and experience to exercise professional judgement. Common to all audits is the need to recruit personnel with suitable qualifications, offer staff development and training, prepare manuals and other written guidance and instructions concerning the conduct of audits, and assign sufficient audit resources. Auditors should maintain their professional competence through ongoing professional development[14].

## Audit Risk

Audit risk is the risk of the auditor that the auditor's report, conclusion or opinion may be inappropriate. A compliance audit should be performed to reduce the audit risk to an acceptable low level in the circumstances of the audit. The different components of audit risk include inherent Risk, control Risk, and detection risk.

## Materiality

A matter can be judged material if knowledge of it would be likely to influence the decisions of the intended users. For example, a non-compliance with the terms and condition of a donor-funded project would be considered material if that non-compliance could lead to the donor discontinuing funding for the project or imposing more stringent controls as pre-condition for continued funding.

Materiality may relate to an individual item or to a group of items taken together. Materiality is often considered in terms of value, but it also has other quantitative as well as qualitative aspects. The

[13] ISSAI 400.43

[14] ISSAI 400.45





inherent characteristics of an item or group of items may render a matter material by its very nature. A matter may also be material because of the context in which it occurs.

## Documentation and Communication

Sufficient audit documentation is important within all steps of the compliance audit. This is to ensure that all steps taken and decisions made during an audit are properly justified and documented in such way that, if an experienced auditor who doesn't have any prior knowledge or connection with the previous audit review, the audit documentation will be able to understand the audit conducted. Further detailed information on this is included in Chapter 5 of the Handbook regarding Documentation and Communication in relation to compliance auditing.

Communication takes place at all audit stages; before the audit starts, during initial planning, during the gathering and evaluating evidence, and at the reporting phase. It is essential that the audited entity together

with the SAI are kept informed of all matters relating to the audit. This is key to developing a constructive working relationship between the auditor and the entity and also within the audit team. This would help keep all parties informed of the audit progress and would really assist in resolving any matters that may obstruct the audit and could cause delays to the audit.

Communication should include obtaining information relevant to the audit and providing management and those charged with governance with timely observations and findings throughout the engagement. Any significant difficulties encountered during the audit, as well as instances of material non-compliance, should be communicated to the appropriate level of management or those charged with governance<sup>[15]</sup>. This would assist in rectifying any deviations and any other findings the auditor may come up with immediately or at an earlier stage, rather than later where the impact of the finding could be substantially material and may be difficult to resolve. The auditor may also have a responsibility to communicate audit-related matters to other users, such as legislative and oversight bodies.

[15] ISSAI 400.49



## 1.7 COMPLIANCE AUDIT PROCESS

The diagram below depicts the steps of a compliance audit process.

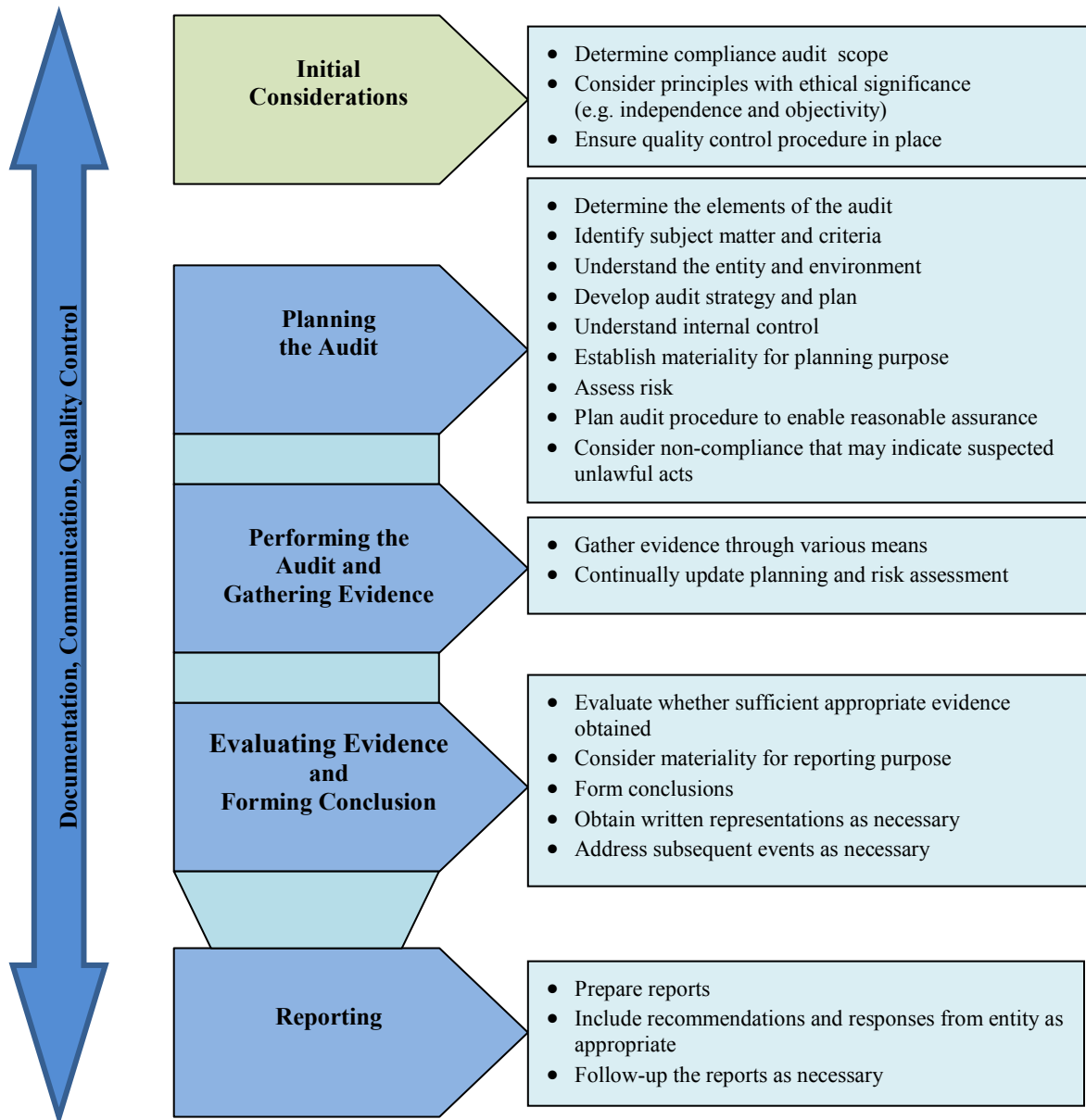


Figure 1.6: Compliance audit process



## **i. Initial Considerations and Planning the Audit**

In the initial consideration phase auditors determine the objective and scope, consider the principles of ethical significance i.e. independence and objectivity of the auditor and ensure that quality control procedure is in place.

In planning phase auditor look into the relationship between subject matter, criteria, and scope of compliance audit. Auditors are guided by professional judgment and the need of intended users while doing this exercise. Once they decide on the subject matter, criteria, and scope of a compliance audit, they work out audit the strategy and audit plan. They understand the internal control, establish materiality, assess risks of the entity and plan audit procedure as part of the designing of compliance audit.

## **ii. Performing the Audit and Gathering Evidence**

In this phase, auditors primarily gather and document evidence to form a conclusion or opinion as to whether the subject matter, in all material respects, complies with established criteria. In some cases, auditors may have to change the scope of a compliance audit when they come across audit evidence suggesting need for that change. For instance, while gathering evidence, auditors find something that is indicative of fraud, they may have to modify their procedures. They will need to document why they change their audit plan.

## **iii. Evaluating the Evidence and Forming Conclusions**

At the end of the audit auditors examine evidence for sufficiency and appropriateness with a view to forming a conclusion or opinion as to whether or not the subject matter is in compliance with the established criteria. At this stage auditor consider materiality for reporting purpose.

## **iv. Reporting**

The conclusion or opinion is presented in the form of report to the intended user. Here the auditor include the recommendations and responses from the entity.

This Handbook provides additional information on the elements of compliance audit in following chapters. It also has separate chapters on the steps of the compliance audit process. Further to note that, As shown in the Figure 1.6 documentation, communicating and quality control are crosscutting and significant requirements of the ISSAIs has to be considered at all stages of the audit.

## **1.8 CONCLUSION**

For many SAIs, compliance audit is their core activity. It is distinct from other types of audits in that it focuses on ascertaining whether audited entities or defined subject matters are complying with applicable laws, rules, regulation, procedures, and terms of contracts/agreements. It can be done as standalone activity or coupled with financial and performance audits. The ISSAIs provide an opportunity for SAIs to reassess their current compliance audit practices and modify in as much as their mandate, laws, and other regulations allow this change. In the next chapter we will describe in detail the main concepts of compliance audit. Following the concepts chapter the compliance audit phases i.e. planning and designing audit, gathering evidence, evaluating evidence and forming conclusions, and reporting will be explained.



## **Chapter 2:**

# **Main Concepts of Compliance Auditing**



## 2.1 INTRODUCTION

This chapter builds on the basic understanding of compliance audit, provided in the first chapter. The chapter focuses on the assurance concept by explaining the similarities and differences between different levels of assurance SAIs provide to intended users; reasonable assurance and limited assurance.

## 2.2 DEFINITION OF AUDIT AND COMPLIANCE AUDIT

As defined in Chapter 1, “public-sector auditing can be described as a systematic process of objectively obtaining and evaluating evidence to determine whether information or actual conditions conform to established criteria”[1]. The definition of compliance audit builds on this definition with a specific focus on criteria derived from authorities (for a definition of criteria, see section 2.4).

Compliance auditing is the independent assessment of whether a given subject matter is in compliance with applicable authorities identified as criteria. Compliance audits are carried out by assessing whether activities, financial transactions and information comply, in all material respects, with the authorities, which govern the audited entity[2].

Standards also define the related parties in compliance audit, and the relationship between them:

Compliance auditing is based on a three party relationship in which *the auditor* aims to obtain sufficient appropriate audit evidence in order to express a conclusion designed to enhance the degree of confidence of *the intended users*, other than *the responsible party*, about the measurement or evaluation of a subject matter against criteria[3].

Based on the definitions above, this chapter will examine the following concepts:

- Subject matter and subject matter information
- Authorities and criteria
- Audit risk
- Materiality

- The three party relationship
  - the auditor
  - the responsible party
  - the intended users
- Assurance
  - reasonable assurance engagements
  - limited assurance engagements
- Attestation engagements and direct reporting
- Professional judgment and professional scepticism

## 2.3 SUBJECT MATTER AND SUBJECT MATTER INFORMATION

The standards state that; “...in the context of compliance auditing, the responsibility of the auditor includes determining whether information related to a particular subject matter is in compliance, in all material respects, with relevant criteria such as relevant laws, regulations, directives, terms of contracts and agreements, etc.”[4]

The *subject matter* depends on the mandate of the SAI, the relevant authorities and the scope of the audit. Because of this, the content and scope of compliance audit subject matter can vary widely. It can take many forms and have different characteristics depending on the audit objective and audit scope[5]. E.g. subject matter can refer to the information, condition or activity that is measured or evaluated against certain criteria.

*Subject matter information* refers to the outcome of evaluating or measuring the subject matter against the criteria.

[1] ISSAI 100.18.

[2] ISSAI 400.12.

[3] ISSAI 400.35.

[4] ISSAI 4100.4, 4200.4

[5] ISSAI 100.28 and ISSAI 400.33



**Example 1:** Subject matter: Financial performance and use of appropriated funds of a government entity. Subject matter information: Financial information such as financial statements.

**Example 2:** Subject matter: Expenditures related to training activities of a government entity. Subject matter information: Financial information and reports on training activities.

Compliance audit is about evaluating the subject matter or subject matter information against relevant criteria. More information about the distinction between these two is provided in Section 2.9 on attestation engagements and direct reporting.

## Identifying the subject matter

The definition of subject matter in compliance audit standards is flexible. This flexibility responds to the diverse needs of SAIs which may view the concept differently, and allows them to focus their resources where it matters most.

For example, in some SAIs, the subject matter of a compliance audit consists of an entity (or the subject matter information is taken as the “accounts” of an entity), without defining a more specific scope. Looking at the definition, it is possible to take an “entity” as the subject matter. In this case, the scope of the audit will cover all activities of the entity and all authorities governing them. Nevertheless, providing a conclusion on such a wide scope of audit would be very challenging.

For this reason, standards recognize the relationship between the subject matter and scope of compliance audits. The definition provided above states “The subject matter depends on the mandate of the SAI, the relevant authorities and *the scope of the audit.*” This means that when auditors plan a compliance audit, they usually start with a larger subject matter, such as the entity, but as they narrow down the audit scope during the audit planning process, they may modify the subject matter and scope of the audit to have a more focused audit, which will make the results more meaningful for users.

For example, auditors may start their audit planning considering “Ministry of Health” as the subject matter

and eventually scope down to auditing “the provision of clean drinking water”:

**Example:** Scoping for compliance audit of a Clean Drinking Water Initiative

SAI Pakistan included the health sector in its audit plan of 2013 because the sector received significant government and donors’ funding in the past few years. What prompted focus on this area was a decline in key health indicators despite considerable investments, as well as media reports criticizing improper handling of public health issues by the government.

Auditors first thought of covering service delivery mechanisms from primary to the tertiary healthcare institutions. The country had an elaborate legal framework including constitutional provisions and other policies and procedures to provide healthcare services to all citizens. However, during planning process, the auditors discovered that many indicators were linked to the consumption of unsafe drinking water. These were indicators such as child mortality rate, maternal health, proportion of under-five children with malnutrition, which were declining. Further, the auditors noted that a major fraction of government and donors funding that ended up in the health sector was used in creating facilities for clean drinking water for the poor and vulnerable people in the country. Thus, the auditors decided to narrow down the scope of audit to the provision of clean drinking water only.

The auditors’ review for planning process also indicated that appropriate benchmarks/criteria were also available for this engagement.

In some countries the subject matter of compliance audits may be indicated in the relevant laws, and in others, it can be determined by using risk assessment and professional judgment. For example, in some SAIs, auditable entities have been classified into high, medium or low risk entities. SAIs will conduct compliance audit of high risk entities every year, while medium to low risk entities will be audited once every three years. SAIs should work out a way to determine subject matter for compliance audit considering their particular circumstances and the flexibility available in the ISSAI framework.





## 2.4 AUTHORITIES AND CRITERIA

Authorities are the most fundamental element of compliance auditing, since the structure and content of authorities furnish the audit criteria and therefore form the basis of how the audit is to proceed under a specific constitutional arrangement. Authorities may include rules, laws and regulations, budgetary resolutions, policy, established codes, agreed terms or the general principles governing sound public-sector financial management and the conduct of public officials[6].

The extent of the auditor's work on obtaining a sufficient understanding of the legal and regulatory framework will depend on the nature and complexity of the laws and regulations. However, the auditor only needs to understand the parts of the legislation that are relevant to the particular audit task. In all cases, the audited entity retains the responsibility for ensuring compliance with applicable laws and regulations.

### Conflicting authorities

Because of the variety of possible authorities, they may have mutually conflicting provisions and be subject to differing interpretations. In addition, subordinate authorities may not be consistent with the requirements or limits of the enabling legislation, and there may be legislative gaps. As a result, to assess compliance with authorities in the public sector it is necessary to have sufficient knowledge of the structure and content of the authorities themselves[7].

If the auditor identifies conflicting authorities, it is important to consider the hierarchy of the authorities; the higher level of authority will prevail over subordinate authorities. For example, if something has been defined in the law about a subject matter, the internal regulations of an entity has to be in line with this law. If they aren't, auditors should point out the contradiction and, if their mandate allows, recommend a change in subordinate regulation.

Similarly, in cases when auditors are in doubt about the correct interpretation of an authority, they should review background information to understand the intention and premises of law before using the authority as benchmark. When faced with such situation, auditors may bring this to the attention of

their seniors so that the appropriate course of action can be followed during the audit.

### Criteria

Criteria are the benchmarks derived from authorities, which are used to evaluate the subject matter consistently and reasonably. Criteria can be specific or more general, and may be drawn from various sources, including laws, regulations, standards, sound principles and best practices.

In performing compliance audits, the criteria may differ greatly from audit to audit. Standards state that "the criteria may be included in the report itself, or the report may make reference to the criteria if they are contained in an assertion from management or otherwise available from a readily accessible and reliable source." [8] Whichever of these options are chosen, it is important to clearly identify the criteria in the compliance audit report, so that the users of the report can understand the basis for public sector auditors' work and conclusions.

Criteria should be made available to the intended users to enable them to understand how the subject matter has been evaluated or measured. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding.

The ISSAIs frequently stress the need for applying suitable criteria when assessing regularity and propriety aspects of an entity. The reason is that the quality of audit opinion and conclusion in compliance audits largely depends on how auditors establish and apply audit criteria in their work. Auditors are expected to carry out proper risk assessment to determine which compliance requirements are likely to be violated and, based on that, design and perform procedures to detect such instances. Auditors use professional judgment in determining and applying criteria.

Two types of criteria are required in compliance standards as per the ISSAI framework (a) those based on established authorities and (b) the others that capture propriety aspects.

[6] ISSAI 400.28 and 29.

[7] ISSAI 400.30.

[8] ISSAI 4100.145, 4200.152.



## Propriety

Propriety is defined as “observance of the general principles governing sound financial management and the conduct of public officials”[9]. The use of propriety as a basis for the audit may be common in some SAIs but there are others that don’t have the relevant authorities and mandate to assess propriety. Some SAIs use this approach in “management audits” conducted at the request of legislative body.

If an SAI has the mandate, auditors are also required to consider propriety aspects in compliance audits. Usually, this requires auditors to ascertain that the audited entity has followed the principles of sound financial management and its officials have acted transparently and equitably in making critical decisions for the entity. Auditors establish the scope of their compliance audit and audit criteria on the basis of this review.

Criteria based on established authorities are relatively easy to develop and apply, since auditors, while understanding the working of an audited entity, look into these authorities. They know which authorities are significant and use them as benchmarks accordingly. However, establishing suitable criteria for propriety is challenging as these criteria may be less formal and may require considering public expectations regarding the actions and behaviour of government officials. This all depends on whether aspects of propriety have been described by the authorities. If not, the auditor may have to derive criteria from generally accepted principles or national or international best practice. In some cases these may be un-codified, implicit or based on overriding principles of law.

It is important to understand that when auditors are questioning propriety, they will be questioning the professional judgement of the public officials. Propriety issues can be subjective and therefore the conclusions of the auditor can be difficult to defend. Therefore if criteria have not been defined by authorities, it is important to identify criteria which carry the qualities described in the standards. Criteria must be “relevant, reliable, complete, objective, understandable, comparable, acceptable and available.”[10]

## 2.5 THE THREE PARTIES

Understanding public sector audit requires understanding the parties involved. To put into simple words;

- The auditor refers to the SAI.
- The intended users are the individuals, organizations or classes for whom the auditor prepares the audit report. In many countries, the legislative or the body which creates the legislation would be considered as the main intended user. However, according to the standards, it can also be oversight bodies, those charged with governance or the general public. [11]
- The responsible party refers to the public officials (and therefore to the government entity being audited) which are responsible for the subject matter.

In order to understand the three parties, it is important to consider the relationship between them. We need to look into what each party expects from the others, and how these expectations are met.

Although there are different models, usually the legislature empowers the government to perform specific duties, by providing funds with the budget and establishing a legal framework to govern the spending of these funds. The executive branch of government (the public officials) is responsible for the management of public funds. In theory, public officials’ exercise of authority is under the control of the legislature. However, in practice, establishing this control depends on receiving information about how the entities are fulfilling their mandate. The legislature needs information about the entities and their activities for decision making purposes.

Understanding the intended users is crucial, since they will be the ones receiving the audit reports. An SAI has to be aware of the information needs of the users and how they utilize the information they receive.

[9] ISSAI 400.13.

[10] ISSAI 400.31.

[11] ISSAI 100.25.



## The role of information in understanding the three parties

The relationship between the three parties in the public sector can be explained by the principal–agent model. When one person (the principal) agrees with or hires another person (the agent) to perform tasks on his behalf, a relationship is established. The principal will then delegate the necessary authority and resources to the agent to conduct the tasks. Now the principal needs to ensure that the agent is performing the tasks and using the resources according to the agreement. However, there is an imbalance in this relationship; although the principal holds the power, it is very difficult to monitor the decisions and performance of the agent. The principal cannot just rely on the good intention of the agent, since the agent is likely to have a different agenda and priorities than the principal. The principal needs information to monitor the agent, but all information about the activities is in the hands of the agent, or is produced by the agent.

In the public sector there are many layers of principal–agent relationships, such as; the principal is the public and the agent is the Parliament; the Parliament is the principal and the agent is the government; the government is the principal and the agent is the minister...

This model is very useful to explain the role of audit. Auditors play a crucial role to balance the information asymmetry between the principal and agent. SAI reports provide an independent assessment of the activities of agents, so that they can be held accountable by principals.

## 2.6 ASSURANCE

Compliance audit standards state that compliance auditing may cover a wide range of subject matters and can be performed to provide either *reasonable* or *limited assurance*, using several types of criteria, evidence gathering procedures and reporting formats. Compliance audits may be *attestation* or *direct reporting engagements*, or both at once[12]. This section describes the concept of assurance.

Standards state that, the intended users will wish to be confident about the reliability and relevance of the

information which they use as the basis for making decisions. Audits therefore provide information based on sufficient and appropriate evidence, and auditors should perform procedures to reduce or manage the risk of reaching inappropriate conclusions[13].

Each audit conducted by the SAI is an assurance engagement. This assurance can either be provided through opinions and conclusions which explicitly convey the level of assurance, or it can be provided in other forms[14]. This handbook will only describe opinions and conclusions conveying reasonable and limited assurance in accordance with the ISSAIs on compliance auditing.

Now let's examine the concept of assurance more closely:

Public officials are responsible for running public entities in compliance with the authorities governing their activities and for achieving a level of performance which is expected of them. If, for some reason, the entity fails to comply with authorities, then it means its officials will be held accountable. For example, if a government entity provides information to the Parliament about its failures to comply with authorities, or about its poor performance, this could lead to the replacement of the top officials of that entity.

Under such circumstances, a responsible party might be motivated to provide false or insufficient information to the users. Due to similar reasons, users demand an independent third party assessment of the information. There can also be other cases, where the responsible party does not provide information to the users, and users demand an independent assessment of the actual conditions. Both cases refer to the "assurance" provided by the SAI.

Audit is defined as "a systematic process of objectively obtaining and evaluating evidence to determine whether information or actual conditions conform to established criteria"[15]. The compliance auditor will check whether the information provided by the government entities, or actual conditions in these entities comply with authorities (the relevant

[12] ISSAI 400.15.

[13] ISSAI 100.31.

[14] ISSAI 100.32.

[15] ISSAI 100.18.



laws and regulations, etc.). Following the audit, the SAI will prepare a report for the users, which includes a conclusion on the subject matter. Thus the auditor will be providing an assurance, which reduces the risk of using the specific information. In the standards, this is referred as “enhancing the degree of confidence of the intended users”.

An auditor performs procedures to reduce or manage the risk of providing incorrect conclusions, recognising that, owing to the inherent limitations in all audits, no audit can ever provide absolute assurance of the condition of the subject matter. This should be communicated in a transparent way. In most cases, a compliance audit will not cover all elements of the subject matter but will rely on a degree of qualitative or quantitative sampling[16].

## Assurance in compliance audit and financial audit

It is important to differentiate the usage of “assurance” in compliance audit from its usage in financial audit. According to financial audit standards, the work conducted by an auditor is referred to as an audit only if it provides “reasonable assurance”. If the work provides “limited assurance”, it is referred to as a “review”, instead of an audit. However, compliance audit has a broader scope in methodology and covers both limited and reasonable assurance. Further on, limited assurance has a broader scope than a review [17].

## Reasonable and limited assurance

Compliance auditing carried out by obtaining assurance can enhance the credibility of information provided by the auditor or another party. In compliance auditing there are two levels of assurance: reasonable assurance, conveying that, in the auditor's opinion, the subject matter is or is not in compliance, in all material respects, with the stated criteria; and limited assurance, conveying that nothing has come to the auditor's attention to cause him/her to believe that the subject matter is not compliant with the criteria. Reasonable or limited assurance can be provided both for direct reporting and attestation engagements in compliance auditing[18].

The terms “reasonable” and “limited” are specifically chosen, because even if the auditor is meticulous in his

work, there is always a chance that he may not identify instances of non-compliances, and therefore reach a wrong conclusion. It is not possible to provide an absolute (hundred per cent) assurance.

Levels of assurance will be examined further in planning the audit, since the decision to provide a limited or reasonable assurance will have a strong impact on the design of the audit.

## 2.7 ATTESTATION ENGAGEMENT AND DIRECT REPORTING

This section describes two types of audits, based on standards. Although the terms and definitions used to describe these engagements are familiar for financial auditors, they may be new for compliance auditors. It is crucial to note that concepts have been given a broader meaning related to the public sector context of compliance auditing. The concepts will be described in detail in the following sections.

Public sector audits can be categorised as two different types of audit engagements: attestation engagements and direct reporting engagements[19]:

- In *attestation engagements* the responsible party measures the subject matter against the criteria and presents the subject matter information, on which the auditor then gathers sufficient and appropriate audit evidence to provide a reasonable basis for expressing a conclusion.

[16] ISSAI 400.40.

[17] Although ISSAI 4100.16 stated that “limited assurance work is not considered an audit, but rather a review-level engagement”, the new ISSAI 400 now supersedes this statement by stipulating that compliance audit provides either reasonable or limited assurance (para.15 and 41).

[18] ISSAI 400.41.

[19] ISSAI 100.24.



- In *direct reporting engagements* it is the auditor who measures or evaluates the subject matter against the criteria. The auditor selects the subject matter and criteria, taking into consideration risk and materiality. The outcome of measuring the subject matter against the criteria is presented in the audit report in the form of findings, conclusions, recommendations or an opinion. The audit of the subject matter may also provide new information, analysis or insights[20]. The conclusion may also be expressed as a more elaborate answer to specific audit questions[21].

Compliance audits may be attestation or direct reporting engagements, or both at once. The difference lies in who is preparing the information; the responsible party or the auditor.

The subject matter of a compliance audit is defined by the scope of the audit. It may be activities, financial transactions or information. For attestation

engagements on compliance, it is more relevant to focus on the subject matter information, which may be a statement of compliance in accordance with an established and standardised reporting framework [22].

The difference between the two types of audit is linked to subject matter and subject matter information, and refers to the definition of audit. "Public-sector auditing can be described as a systematic process of objectively obtaining and evaluating evidence to determine whether *information* or *actual conditions* conform to established criteria"[23]. We can broadly say that if the audit is based on evaluating information (subject matter information), it is an attestation engagement; if it is based on evaluating actual conditions (subject matter), it is a direct reporting engagement.

Let's show this with an example which builds on the same subject matter and scope, in different environments:

**Scenario 1:**

**Responsible party:** National Tax Office (NTO) of Platonia

**Subject matter of audit:** Tax revenues of Value Added Tax (VAT)

**Subject matter information:** Financial information related to VAT revenues

**Criteria:** VAT law and other laws and regulations governing collection of taxes

**User:** Parliament

**Scenario 2:**

**Responsible party:** National Tax Office (NTO) of Kasboria

**Subject matter of audit:** Tax revenues of Value Added Tax (VAT)

**Subject matter information:** Financial information related to VAT revenues

**Criteria:** VAT law and other laws and regulations governing collection of taxes

**User:** Parliament

[20] ISSAI 100.29.

[21] ISSAI 400.59.

[22] ISSAI 100.30.

[23] ISSAI 100.18.





Now let's look at who creates the subject matter information, and how this influences the audit. There are two possible scenarios, which lead either to an attestation engagement, or to a direct reporting engagement.

## Attestation engagements

### Scenario 1:

National Tax Office of Platonia presented a report to the Parliament regarding tax collection. In this scenario subject matter information has been produced by the responsible party and presented to the users in the form of a report (this information could also be in the format of a statement, statistics, etc.). When officials were producing the subject matter information, they were obliged to follow relevant legislation and other laws and regulations governing these taxes.

Standards make reference to producing subject matter information as "evaluation of subject matter against criteria". In this situation, National Tax Office has already provided the subject matter information (evaluation) to the Parliament, in the form of a report. With their report, the officials of the responsible party are making explicit or implicit claims (assertions) that the information (evaluation) on the VAT revenue (subject matter) is true and fair in the light of the laws and regulations (criteria).

The auditor's role in this scenario is to express a conclusion (attestation) on whether the assertion made by the responsible party about the evaluation it provided is correct or not; whether the officials have indeed followed the laws and regulations as they have claimed (explicitly or implicitly). This conclusion enhances the confidence of the Parliament about the report (subject matter information) they received.

This form of audit, where the auditor gives an opinion on the subject matter information instead of on the subject matter, is called an "attestation engagement".

## Direct reporting engagements

### Scenario 2:

National Tax Office (NTO) of Kasboria doesn't publish reports on tax collection. Some statistics are provided in its website, but these are usually outdated and not detailed. NTO is a part of the general budget system, and due to the financial management framework, doesn't produce a separate set of financial statements. Due to the way final accounts are prepared, it isn't possible to isolate tax revenues collected by NTO from tax revenues from other sources. Recently, the Parliament of Kasboria has been discussing a reform initiative which aims to improve tax collection from VAT. The SAI management decided to prepare an audit report on VAT revenues and submit it to the Parliament.

In the scenario given above, no subject matter information (and therefore no assertions) has been made available by the responsible party, despite the need for this information. Therefore the SAI decided to provide the information to the users. The audit will directly evaluate the VAT revenues (subject matter) based on criteria, and provide a conclusion. Therefore, the subject matter information will be prepared by the SAI and submitted to the Parliament in the form of an audit report.

This form of audit is called "direct reporting". In a direct reporting engagement, the audit is conducted directly on the subject matter, rather than on the subject matter information.





## Compliance audits which are both attestation engagement and direct reporting

Standards state that compliance audits can also be both attestation and direct reporting engagements. To explain this better, we can provide an example, which builds on Scenario 1.

### Scenario 3:

The SAI of Platonia decided to prepare a report, which will assess the information provided by National Tax Office to the Parliament, regarding tax collection (Scenario 1). However, during the audit, auditors discovered that NTO's report didn't include information on tax exemptions. In fact, the accounting regulations didn't require exemptions to be calculated or recorded. Therefore, it wasn't possible to identify the actual cost of granting a VAT exemption. The SAI decided to include this issue in its report.

In this scenario, the first part of the work is attestation engagement, since the audit provides an assurance about the accuracy of the information provided to the Parliament. The second part of the work is direct reporting, since the audit is conducted directly on the subject matter. In the first part the audit is conducted on subject matter information, and in the second part it is directly on the subject matter.

## Levels of assurance and types of audit

To understand the wide scope of compliance audit, it is necessary to understand the link between assurance levels and types of audit. The following table will help to understand how these concepts work together in practice.

		Engagement type	
		Direct reporting	Attestation engagement
Assurance level	Reasonable assurance		
	Limited assurance		

Table 1: Levels of assurance and types of audit in compliance auditing

Each audit conducted by the SAI will fall into one of the four cells shown in the table. However, it is important to point out that there can be overlaps, too. For example, a compliance audit can incorporate both attestation and direct reporting aspects.

## 2.8 ASSERTION AND AUDIT

Assertion is described in the standards, as a representation, explicit or implicit, that is embodied in the activities, financial transactions and information pertaining to the audited entity, used by the auditor in considering different types of potential deviations. In the context of compliance audit, the compliance assertion would mean that the entity, including responsible public sector officials, is acting in accordance with applicable authorities (and for audits of propriety - relevant public expectations). Assertions may be embodied in subject matter information presented by the audited entity or stated explicitly in a management representation letter[24].

This means that when a government entity provides information about its activities, there are certain assumptions which can be made about this information. For example; the information provided is accurate (accuracy assertion); it is complete

[24] 4100.26, 4200.32.



(completeness assertion); and most importantly, it complies with relevant laws and regulations (compliance assertion). In fact, in many cases, these assumptions are inseparable qualities of the information provided. These qualities are referred to as assertions.

When the subject matter information is prepared by the responsible party and made available to the users, compliance audit evaluates this information by comparing it with authorities, testing the accuracy of the compliance assertion. This is attestation engagement.

#### Example:

When issuing financial statements, management of the entity makes implicit financial reporting assertions that having prepared those financial statements in accordance with the applicable financial reporting framework, such as International Public Sector Accounting Standards (IPSAS) or generally accepted government accounting standards in the particular country, the financial statements are prepared in accordance with the applicable framework, assets exist, and are owned by the entity and properly valued, etc. Similarly, management may make implicit assertions related to compliance with authorities [25].

On the other hand, standards state that, in many public sector audits, there are no specific assertions or statements of compliance that the audited entity makes available to users. Rather, the subject matter information is embedded in the auditor's report – either in the form of data/information or as an explicit statement in the form of an opinion[26]. This refers to direct reporting.

#### Example:

In compliance audits performed as a separate audit task or together with performance audits, the assertion could be a statement of compliance with laws or regulations, a statement of compliance with the terms of a contract, or a statement as to the effectiveness of a specific process or system. An example of an implicit assertion may be when key performance indicators are subject to audit and they are presented on the inherent assumption that there has been no undisclosed noncompliance in achieving the levels of performance as set out in the key performance indicators[27].

As well as being assumptions, or claims made by the management, assertions also represent what the auditors are looking for in their audit. For this reason, some SAIs refer to assertions as “overall audit objectives”.

## 2.9 PROFESSIONAL SCEPTICISM AND PROFESSIONAL JUDGEMENT

Auditors should plan and conduct the audit with professional scepticism and exercise professional judgement throughout the audit. The auditor's attitude should be characterised by professional scepticism and professional judgement, which are to be applied when forming decisions about the appropriate course of action. Auditors should exercise due care to ensure that their professional behaviour is appropriate[28].

Professional Scepticism and Professional Judgment both are required to conduct the compliance audit properly. Both are two separate requirements and are not one and the same and are different in their meaning and also in their application. But both complement each other in auditor's work.

Specific requirements for maintaining professional judgement and scepticism in compliance auditing are the ability to analyse the structure and content of public authorities as a basis for identifying suitable criteria or gaps in legislation, in the event that laws and regulations are entirely or partially lacking, and to



apply audit concepts in the approach to known and unknown subject matter.

## Professional Judgment

Professional judgment is a process used to reach a well-reasoned conclusion that is based on the relevant facts and circumstances available at the time of the conclusion. Auditors must apply professional judgment at all stages of the compliance audit process. Professional judgment involves the identification, without bias, of reasonable alternatives; therefore, careful and objective consideration of information that may seem contradictory to a conclusion is key to its application.

A fundamental part of the process is the involvement of individuals with sufficient knowledge and experience. When conducting compliance audits it is important to have the ability to understand and analyse the structure and content of public authorities, the public needs, gaps in legislation, to apply professional audit concepts in the approach to known and unknown subject matter.

Professional judgment is a skill that auditor acquires overtime and only after acquiring such skill he can apply professional judgment. Auditor acquires this skill by obtaining relevant training and experience. That is why application of professional judgment also means application of the training, skill and experience of the auditor. And only such auditor is expected to have acquired professional judgment whose training, knowledge and experience has enabled him/her to gain such competency level that allows him/her to achieve a reasonable judgment in the given circumstance. In short professional judgment is circumstantial based and not every auditor is expected to be competent for every assignment.

Knowledgeable, experienced, and objective persons can reach different conclusions in applying professional standards despite similar facts and circumstances. This does not necessarily mean that one conclusion is right and the other is wrong. Appropriate questioning to understand the procedures performed and basis for conclusions reached is to be expected. Documentation of professional judgments is important and demonstrates that a sound process was followed and helps the development of a well-reasoned conclusion. When professional judgment is challenged,

documentation shows the analysis of the facts, circumstances, and alternatives considered as well as the basis for the conclusions reached.

## Professional Scepticism

Professional scepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Auditors ask the questions which will be helpful for knowing the consequences. They measure every side effect of the information which they obtain by their questioning attitude or mind. They also ask the questions which will help them to make critical assessment with a strong set of evidences. Critical assessment does not mean doubting the correctness of the information at first place. Auditor places doubt on any information when contradictory or conflicting information is obtained.

An attitude of professional scepticism is applied by the auditor to be alert of such conditions, circumstances and information which may be indicative of existence of material non-compliance and to critically assess the audit evidence.

When exercising professional scepticism, auditors keep an open and reasonably questioning mind without being overly suspicious. Auditors don't assume that management is dishonest, and they don't assume that it's honest. Auditors always keep it in the back of their mind that fraud can exist and they should not be satisfied with less than persuasive evidence because of a belief that management is honest.

Professional scepticism includes being alert to for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.



Maintaining professional scepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalizing when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

## 2.10 CONCLUSION

This module has provided information on the basic concepts of compliance audit, with a specific focus on the assurance concept. Compliance auditing carried out by obtaining assurance can enhance the credibility of information provided by the auditor or another party. In compliance auditing there are two levels of assurance: reasonable and limited. The decision to provide a limited or reasonable assurance has a strong impact on the design of the audit, which will be examined further in the following module which focuses on planning.



## **Chapter 3:**

# **Planning and Designing**



## 3.1 INTRODUCTION

In Chapter-2 we have discussed about the main concepts of compliance auditing. In this chapter, we will review initial considerations and steps in preparing compliance audit plan. Standards state that auditor should 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. Auditors planning the audit need to be knowledgeable of the compliance requirements applicable to the subject matter to be audited. Accordingly we first, look into initial considerations for planning a compliance audit at SAI level. This follows detailed review of audit planning process including risk assessment and materiality.

## 3.2 INITIAL CONSIDERATIONS FOR PLANNING

Before reviewing specific steps in audit process, it is important to look at initial considerations relevant to audit planning at the SAI or institutional level. While identifying the scope and subject matter of an audit, SAIs need to consider the level of assurance to be provided in an audit. SAIs need to make informed decisions on whether to conduct a reasonable or limited assurance audit on a subject matter. Factors that may guide the decision on which level of assurance is appropriate in the surrounding circumstances of audit are explained below.

### 3.2.1 Determining the level of assurance to be provided

The level of assurance to be provided in an audit needs to be considered when the scope and subject matter of an audit is being identified. Conducting a limited or reasonable assurance audit is a strategic decision which needs to be made at the entity level by the SAI, after considering:

- Needs of the intended user
- State of internal control environment and system of the audited entity
- Availability of and access to information
- Existing competencies of the auditors
- Availability of resources

Although some of these factors may take precedence, all relevant factors should be considered in reaching a decision. The list given above is not exhaustive. SAIs may consider other factors while making decision on the level of assurance to be provided in an audit.

Because the scope and subject matter of compliance audit is very flexible, changing the scope of the audit could theoretically have an influence on the level of assurance provided. For example, if the scope of an audit is narrowed down to consist only of the actual number of transactions which will be tested, the auditor will be able to provide nearly 100% assurance. If the scope of this audit is made slightly wider, this will enable the auditor to easily provide reasonable assurance. However, these decisions have to be made on a rational basis. This example is provided only to highlight that the identification of the scope and subject matter of the audit have a key role in identifying the level of assurance to be provided.

#### *Needs of intended user*

User needs are the most important factor to consider in determining the level of assurance to be provided by the audit. An SAI has to assess the needs of the intended users to determine which type of conclusion is more appropriate. This requires an understanding of the decisions made by the users, and the type of information they use for their decision making purposes.

It can be said that if the decision making process of the users require sophisticated information on the subject matter and its functioning, a reasonable assurance audit would be more appropriate. This assurance level provides an insight into the systems of the subject matter and their reliability. However, if the users are interested in findings, and don't request for an insight on the systems and controls, then a limited assurance audit would be more suitable.

Different SAIs may take different approaches in an audit planning. Some may be making a longer term strategic audit plan while others may be making annual audit plans. Also, some other SAIs may be using a hybrid system involving both longer term and annual planning. These variations in planning don't restrict SAIs to follow a consistent approach in conducting individual audits. While planning a





compliance audit at macro level, SAIs may consider the following factors:

- Significant funding by donors linked to compliance with provisions of contracts/agreements;
- Instances of non-compliances by entity;
- Findings/recommendations made by parties other than SAIs;
- Risk assessment performed in connection with financial or performance audits indicating areas where risk of non-compliance is higher;
- Public interest or expectation (for example, suspected fraud, mismanagement, information reported in the media), etc.

Another factor to consider in planning the compliance audit can be the urgency of the need for information on a particular subject matter by the intended users. If there is an immediate need or request of users for audit results, conducting a limited assurance audit would be more feasible.

### ***Availability of information***

Although access to information is a fundamental aspect of an audit and SAIs usually has strong powers to ensure necessary access, an SAI still can face situations where information available for the audit is limited; some information may not even exist. Or the auditor may not have sufficient access to existing information. Due to the specific nature of public sector audit, in such cases, the SAI may not be in a position to decline from conducting the audit. However, this factor would have an impact on the level of assurance to be provided.

This is especially important regarding outsourced services. Now-a-days more and more public entities outsource their services. And this can be more common about services pertaining to information systems. In such a case, the auditor needs full access to the entity providing the services, in order to conduct the audit. In some instances this would require the SAI to audit the service provider. However, many SAIs don't have the mandate to do such audits, which severely limits the audit and its effectiveness.

Reasonable assurance audits require the auditor to have access to the systems and processes utilized by the subject matter (e.g. internal controls of an entity), and therefore necessitate more information, compared to a limited assurance audit. Therefore limitations on

information would likely lead to a limited assurance audit.

### ***Existing competencies of the audit teams***

Standards state that “the individuals in the audit team should collectively possess the knowledge, skills and expertise necessary to successfully complete the audit[1]. An SAI needs to consider what competencies already exist, when the decision on the scope of audit and level of assurance to be provided are made. If necessary competencies are not available within the audit team, then the SAI should consider options such as changing the audit team’s composition or hiring an expert.

Although the basic audit skills would be the same, reasonable and limited assurance audits are likely to require auditors to have differing competencies.

In a reasonable assurance audit, the auditor is likely to use a systematic approach to reach to an overall conclusion about the subject matter. For example, this could be done by identifying a sample of transactions, which are representative of the total population, and extrapolating the results of sampling to the whole population. In order to reach an overall conclusion, in a reasonable assurance audit, the auditor is also likely to evaluate the systems and processes of the subject matter, for example, conduct an internal controls assessment. For this approach to be taken, the audit team would need the necessary competencies, relevant in the circumstances, to conduct the audit.

In limited assurance audits, the aim of the audit is to obtain a level of assurance meaningful to the intended users based on a limited nature, timing and extent of audit procedures.

[1] ISSAI 400.45.



#### Illustration:

The SAI of Kasboria decided to conduct a limited assurance audit on the National Tax Office. As previous audits of the National Tax Office highlighted significant internal control weaknesses, the audit was going to focus on details of transactions, and not on systems and controls. The audit team decided not to use statistical sampling, since they didn't have the experience of extrapolating the sampling results, to arrive at an overall conclusion. Due to this reason, one of the team members who specializes on statistical sampling was reassigned to another audit team.

#### Availability of other resources

Reasonable assurance audits usually require more time and resources, compared to a limited assurance audit conducted on the same subject matter with the same scope. Therefore an SAI with limited resources would be more inclined to conduct a limited assurance audit. However, this should be considered carefully by giving precedence to user needs, and by considering other factors such as materiality and risk.

### 3.2.2 Consideration of Audit risk and its Impact on Assurance

Auditors should manage the risks of providing a report that is inappropriate in the circumstances of the audit. The audit risk is the risk that the audit report – or more specifically the auditor's conclusion or opinion will be inappropriate in the circumstances of the audit. Consideration of audit risk is relevant in both attestation and direct audits. The auditor should consider three different dimensions of audit risk – inherent risk, control risk and detection risk – in relation to the subject matter and the reporting format, i.e. whether the subject matter is quantitative or qualitative and whether the audit report is to include an opinion or a conclusion[2].

Auditors need to consider audit risk throughout the audit process. And audit should be conducted in such a way that it would manage, or reduce the audit risk to an acceptably low level. The relative significance of the dimensions of audit risk depends on the nature of the subject matter, whether the audit is to provide reasonable or limited assurance.

The option of providing reasonable or limited assurance gives the SAI flexibility to in responding to audit risk. When the SAI provides a report about a subject matter, there is always a risk that the conclusion or opinion made in the report is inappropriate. For example, the auditor's conclusion may say that the subject matter is in compliance with the criteria, but there might be significant non-compliances which were not detected. This is the audit risk. All audit procedures are designed to reduce audit risk to an acceptably low level. To achieve this the auditor performs procedures to reduce or manage the risk of reaching inappropriate conclusions, recognising that an audit can never provide absolute certainty of the condition of the subject matter[3].

The main difference between providing reasonable and limited assurance is the way audit risk and related audit concepts are treated. When the objective is to provide reasonable assurance, the auditor should reduce audit risk to an acceptably low level given the circumstances of the audit[4]. In a reasonable assurance audit, the auditor's conclusion will provide an overall assurance on the subject matter. Since it is not practical to audit all relevant transactions and subject matter the auditor will provide this assurance by testing a portion of transactions through sampling. This means that the auditor will also be providing assurance about items which the auditor hasn't tested. In this case, if a systematic approach is not used, there is a high risk that the auditor's conclusion will be wrong. To reduce this *risk*, the auditor is likely to systematically analyze the subject matter (such as the internal controls of an entity), and identify a sample (of transactions, etc.) which will be representative of the total population. For the sampling to be correct, the auditor should consider the risk of not identifying significant non-compliances. To be able to do this, the auditor first needs to identify what issues are significant for a particular audit. This is done by determining the *materiality*.

[2] ISSAI 400.46.

[3] ISSAI 100.40.

[4] ISSAI 100.40.



The audit may also aim to provide limited assurance, in which case the acceptable risk that criteria are not complied with is greater than in a reasonable assurance audit. A limited assurance audit provides a level of assurance that, in the auditor's professional judgment, will be meaningful to the intended users<sup>[5]</sup>.

The procedures used in a limited assurance audit can vary widely and incorporate the same procedures used for a reasonable assurance audit. However, the way the concepts of audit risk and audit evidence are treated will be significantly different. In conducting a limited assurance audit, the approach used may not be as systematic as it would be in a reasonable assurance audit. The audit will be designed to identify significant non-compliances with the available resources and methods, as much as possible. At the end of the audit, there might still be non-compliances in the items which haven't been tested by the auditor. But with this kind of limited conclusion, the auditor will be reducing the risk of providing a wrong conclusion.

Different from a reasonable assurance audit, at the end, the auditor will not say anything about the items the auditor hasn't tested; the conclusion will not cover them. The aim of the audit is not to identify all significant instances of non-compliance. Because of this nature of a limited assurance audit, the audit risk is also considered differently, because the auditor will accept a higher level of uncertainty in the conclusions on the subject matter.

Now that we have re-emphasized the need for understanding the linkages between subject matter, criteria, and scope, and also discussed the audit risk and related assurance issues, we apply these concepts to the compliance audit planning process in the following section.

### 3.3 PLANNING PROCESS

In general, the compliance audit planning has two aspects. First, auditors develop an overall strategy for the scope, emphasis, timing and conduct of the audit. And two, auditors, based on that strategy, prepare an audit plan that shows detailed approach and specific steps for the nature, timing and extent of procedures to be performed, and the reasons for selecting them.

Adequate planning helps to devote appropriate attention to important areas of the audit, identify potential problems on a timely basis and properly organize and manage the audit to respond to users' need efficiently and effectively. Adequate planning also assists the auditor to properly assign work to the team members, and facilitates the direction, supervision, and the review of their work. Further, it assists, where applicable, the coordination of work done by auditors and experts, if required. The nature and extent of planning activities will vary with the circumstances of the audit, for example, the complexity of the underlying subject matter and criteria. Examples of some of the main matters that may be considered in planning include:

- The characteristics of the audit that define its scope, including the characteristics of the underlying subject matter and the criteria.
- The expected timing and the nature of the communications required.
- Whether knowledge gained on other audits performed by the auditor for the responsible party is relevant.
- The audit process.
- The auditor's understanding of the responsible party and their environment, including the risks that the subject matter may not be in compliance with the criteria.
- Control environment and internal control of the entity.
- Identification of intended users and their information needs, and consideration of materiality and the components of audit risk.
- The extent to which the risk of fraud is relevant to the audit.
- The nature, timing and extent of resources necessary to perform the audit, such as personnel and expertise requirements, including the nature and extent of experts' involvement.
- The impact of the internal audit function on the audit.

The auditor may decide to discuss elements of planning with the responsible party to facilitate the conduct and management of the audit, for example, to coordinate some of the planned procedures with the work of the responsible party's personnel. Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's

<sup>[5]</sup> ISSAI 100.40.



responsibility. When discussing matters included in the overall audit strategy or audit plan, it is important, not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed procedures with the responsible party may compromise the effectiveness of the audit by making the procedures too predictable.

In smaller or less complex audit audits, the entire audit may be conducted by a very small audit team. With a smaller team, co-ordination and communication between team members is easier. Establishing the overall audit strategy in such cases need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, including the underlying subject matter and criteria, and the size of the audit team.

The auditors should also establish legal elements for their work by understanding the mandate of the SAI, the responsibilities of public sector auditors, and the constitutional status and responsibilities of the audited entity as well as the expectations of the intended users. This understanding provides public sector auditors with a frame of reference to be used in applying professional judgment throughout the entire audit process.

### 3.3.1 Determining Subject Matter, Criteria and Scope in planning a compliance audit

Determination of subject matter and criteria is one of the first steps to be carried out in planning and performing compliance audit.

In some situations the scope and nature of the compliance audit do not follow directly from the audit mandate or relevant legislation of the SAI and, instead, it is based on the public sector auditor's professional judgment. In such situations it is important to inform the audited entity of the scope and nature of the audit in writing[6].

As mentioned in the preceding paragraphs, the concepts of subject matter, criteria and scope are interrelated. Auditors need to appreciate that these

concepts influence each other as illustrated in figure 3.1 below.

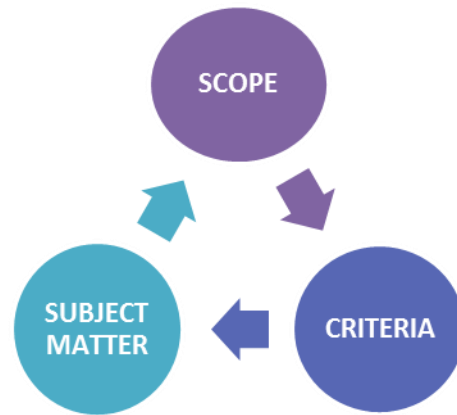


Figure 3.1: Interrelationship between subject matter, scope and criteria

Auditors need to exercise professional judgment while reviewing the relationship depicted in the figure above. The objective of this review is to properly identify the scope of a compliance audit for planning purpose. It may be relevant to recall the example given in Chapter-1 in which auditors narrowed down the scope of audit from the Ministry of Health to the Clean Drinking Water Project. It is important here to note that the scope of a compliance audit may change while conducting audit if the auditors identify material information that makes it necessary to reconsider scope accordingly.

Invariably, SAIs have the obligation and interest in producing high quality audit reports. They need to zero in on the subject matter and criteria discreetly so that meaningful report can be produced to meet the expectation of the intended users. Thus, SAIs always try to find:

- a. Significant aspects of a subject matter; and
- b. Whether suitable criteria are available for measurement of the subject matter

[6] ISSAI 4100.12



Some examples of subject matter are mentioned below as reference:

- Financial performance:
  - ◊ use of appropriated funds (budget execution)
  - ◊ revenue collection, e.g. council taxes, application of fines and penalties
  - ◊ use of grants and loans
- Procurement
- Expenditures
- Service delivery – medical, education, etc.
- Public complaints
- Heritage protection
- Propriety of auditee officials/decision making
- Health and safety
- Environmental protection
- Internal control framework
- Payments of social benefits, pensions
- Physical characteristics, zoning density, access to government buildings etc.

### 3.3.2 Understanding the Entity

Understanding the audited entity is crucial for compliance audit as it might be used to determine the subject matter and the criteria, audit materiality and assessment of risk of non-compliance at all levels. The auditor should, therefore, need to examine following factors in understanding the audited entity in light of relevant authorities. In some cases compliance audit can cover more than one entity and in such cases auditors should obtain understanding all entities which activities will be audited by determined scope. For example, some SAIs conduct compliance audit on proper utilization of a fund which is used by more than one entity. To achieve these, the auditor may need to consider the following aspects of the audited entity:

Strategies, operations and good governance of the entity: understand and evaluate whether:

- the fundamental goals and objectives and measure to implement as outlined in the strategic plan of the audited entity are aligned to the mandatory coverage and standards required;
- the goals specified in the strategic action plans and programmes are linked to the results;
- activities and operations are directed towards attainment of the goals and objectives of audited

entity which should in turn respond to all compliance requirements of the entity;

- legal acts applied to the operations of the audited entity and other authorities like administrative policies, internal procedures and instructions/orders do not contradict the normative legal acts;

Auditors may use following sources of information to develop a proper understanding of the nature of the audited entity, including:

- Laws and regulations;
- Budgetary legislation/approved budget;
- Code of ethic, code of conduct;
- Internal policies, strategic plans, operational plans, procedures manuals;
- Contracts;
- Grant agreements;
- Media reports;
- Annual Report; attestation and direct reporting audits, and internal or external monitoring that directly relate to the objectives of the compliance audit.
- Meeting minutes (Board of Directors, management minutes);
- Internal Audit Reports;
- Knowledge from previous audits;
- National statistics;
- Visiting the entity website
- Reviewing the logs of inbox and sent Items.

A thorough understanding of the audited entity as outlined in the laws, policies, or standards. It helps auditors recognize when a deviation has occurred, and evaluate evidence obtained through audit tests.

### 3.3.3 Understanding the control environment and internal control system

Auditors' understanding of the audited entity and subject matter would not be complete unless internal controls of the audited entity are thoroughly studied. Control environment sets the tone of an organization influencing the control consciousness of its people. The audited entity establishes internal controls with





the aim of achieving fulfillment with compliance requirements in its operations. Auditors need to understand about:

- a. what these controls are,
- b. whether the controls are adequate and can detect, prevent, and correct instances of non-compliance and most importantly,
- c. whether the controls are working as intended.

In the context of compliance audits, an internal control system is composed of policies, structure, procedures, processes, tasks and other tangible and intangible factors that help the audited entity to respond appropriately to risks of non-compliance with the compliance requirements. An effective system should safeguard the audited entity’s assets, facilitate internal and external reporting and help the audited entity to comply with relevant legislation.

The auditor needs to have a considerable insight into the internal functioning of the subject matter through assessment of control environment and internal controls of the audited entity.

**Assessing control environment:**

In general, the auditors examine whether the management has created and maintained a culture of honesty and ethical behaviour and the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment. Auditors can carry out control assessment by gathering and analysing following information of the entity[7]:

- Policies and procedures including a code of conduct are clearly written and communicated;
- Duties are properly segregated between performance, review, and record keeping of tasks;
- Organizational arrangement (board/committee) is in place for reviewing audits/communication of auditors. Proceedings of the board/committee are properly documented/followed up;
- Management has responded positively to the audit findings/recommendation in the past;
- Are responsibilities of key officials/managers clearly defined;
- Key managers/officials have adequate knowledge and experience to discharge their responsibilities;

- Staff is properly educated/trained about compliance requirements and has the responsibility to point out instances of non-compliance to management;
- Management supports adequate information and reporting system;
- Computer and program controls include data entry controls e.g. edit checks, exception reporting, access controls, reviews of input and output data; and
- Information which can be analysed, which depends on the subject matter. For example, if the subject matter relates to asset, that assets are secured and physically counted periodically and compared with recorded amounts.

**Illustration: Internal Controls at National Tax Office (NTO) Platonía**

The NTO has developed and implemented a Policy and Procedures Manual (PPM) that indicates, among other things, what will be done, how it will be done, who will do it, and how performance of the employees will be measured. The PPM includes all applicable laws, rules, and regulations relevant to the collection of VAT and other taxes that the NTO has the mandate to collect. To ensure that the policies and procedures are properly implemented, the NTO has established a Risk Management Unit (RMU) that reports to the head of the NTO. The RMU conducts periodic reviews to assess, among other things, that:

- a. Registration of businessmen for VAT with the NTO is complete
- b. VAT returns are being filed properly, and
- c. VAT refunds are properly worked out and made to the tax payers.

Based on its periodic assessment, the RMU makes changes in policies and procedures i.e. controls and implements new initiatives to minimize the risk that the NTO would be in non-compliance with applicable compliance requirements.

[7] The text given for control assessment and risk management is based on the guidance provided by the General Accountability Office, USA for Internal Control Assessment for auditors. It has been adapted to fit in the requirements as mandated in the ISSAIs. Additional details on how internal controls assessment can be carried out may be seen on the website. The <http://www.gao.gov/special.pubs/ai00021p.pdf>





The particular type of controls evaluated depends on the subject matter, and the nature and scope of the particular compliance audit. In evaluating internal control, public sector auditors assess the risk that the control structure may not prevent or detect material non-compliance. The internal control system in an entity may also include controls designed to correct identified instances of non-compliance. In these cases auditors need to obtain an understanding of internal control relevant to the audit objective, and test controls on which they expect to rely. The result of the internal controls assessment will help the auditors determine the confidence level and hence, the extent of the audit procedures to perform.

### 3.3.4 Risk Assessment of the Subject Matter/Audited Entity

The key criteria used to measure the significance of a potential audit area are the risk tolerances contained in the approved risk strategies of the audited entity. Risk assessment starts by analyzing how the audited entity is managing its risks. Therefore, in the light of the audit criteria, the audit scope and the characteristics of the audited entity auditors should consider both controls and risk management practices at the audited entity while doing risk assessment during planning a compliance audit.

While assessing risks to the subject matter or the entity the auditor needs to understand the inherent limitations of compliance which may include:

- judgment may be applied by management in interpreting laws and regulations;
- human errors occur;
- systems may not be properly designed or function ineffectively;
- controls may be circumvented; and evidence may be concealed or withheld
- stakeholders concerns,
- significant changes,
- potential fraud,
- waste and abuse of public resources, as well as internal controls and control environment.

Auditors should identify what risk comes from the law, regulations, risky transactions, activities etc. Then auditors evaluate if the entity has a control system, procedures to manage these risks, or not. If the auditor

finds that no significant risk comes from the nature of law and regularities, then the issue of control mechanism and control risk comes.

Considering the above factors, auditors' risk assessment, that the audited entity would not comply with applicable compliance requirements, *starts with identifying risk with law and regulations, then review of internal controls* and how risk of non-compliance is managed by the entity itself. This includes assessing the ability of audited entity to identify, measure, monitor and control the key risks that it faces in pursuing its mandates; to achieve strategic and operational goals and objectives.

*After reviewing internal controls* of the audited entity, auditors need to focus on determining the likelihood that:

- a. non-compliance with significant compliance requirements may occur, and that
- b. the impact of non-compliance on the audited entity vis-à-vis its organizational objectives.

In most cases, auditors deal with a universe of rules and regulations under which the subject matters operates and, therefore, it is critical that they focus on identifying non-compliance with applicable laws, rules, regulations and procedures that are material in the context of their compliance audit.

Auditors should be alert to the fact that non-compliance may occur because of fraud or error and both aspects should be considered in risk assessment during all stages of audit cycle. This will enable the auditor to determine the nature, timing and the extent of the audit procedures associated with the potential audit universe. Further, it helps in identifying priority audit areas to respond to need of the audited entity and other intended users of the audit report.



## Performing Risk Assessment Procedures

Obtaining an understanding of the entity, the applicable compliance requirements, and the entity's internal control over compliance establishes a frame of reference within which the auditor plans the compliance audit. Within this frame of reference the auditor exercises professional judgment about assessing risks of material non-compliance and responding to those risks throughout the compliance audit.

The nature and extent of the risk assessment procedures the auditor performs may vary from entity to entity and are influenced by factors such as:

- The newness and complexity of the applicable compliance requirements
- The auditor's knowledge of the entity's internal control over compliance with the applicable compliance requirements obtained in previous audits or other professional audits
- The nature of the applicable compliance requirements
- The services provided by the entity and how they are affected by external factors
- The level of oversight by the government

Risk assessment regarding controls requires the auditors to examine whether:

- Managers/key officials of the entity clearly understand key compliance objectives. Also, if they are able to detect instances of non-compliance and initiate process necessary to fix the underlying cause of non-compliance.
- Organizational structure provides identification of risks of non-compliance. A large and complex organization typically has a dedicated unit for risk management. It continuously examines compliance and other risks facing the entity, review controls, and recommends changes therein to ensure that the entity complies with applicable compliance requirements.
- Key managers/officials of the audited entity have been given responsibility to communicate changes. An entity operating in a dynamic environment needs to respond quickly to the changes in environment. If the entity has assigned official(s)/manager(s) to communicate information

on changes in procedures/controls across the entity, it decreases risk of non-compliance.

- Key managers/officials have a clear understanding of complex parts of its operations. When key managers/officials lack such understanding, they are not likely to implement or oversee compliance with requirements as they need to. Risk of non-compliance is likely to be higher in that situation.
- The entity management views audit findings/recommendations seriously and take appropriate corrective measures. An institutional body e.g. committee/board meets periodically to review compliance issues arising from audits.

The auditor's procedures related to understanding how management has responded to audit findings and recommendations that could have a material effect on the entity's compliance with the applicable compliance requirements, are performed to assist the auditor in understanding whether management responded appropriately to such findings. Examples of *external monitoring* include regulatory reviews, program reviews by government agencies, and reviews by oversight bodies. Examples of *internal monitoring* include reports prepared by the internal audit function and internal quality assessments.

Performing risk assessment procedures to obtain an understanding of the entity's internal control over compliance includes an evaluation of the design of controls and whether the controls have been implemented. Internal control consists of the following five interrelated components:

- the control environment,
- the entity's risk assessment,
- information and communication systems,
- control activities, and
- monitoring.



### Assessing the Risks of Material Non-compliance

In assessing the risks of material non-compliance, auditors may consider the following factors:

- The complexity of the applicable compliance requirements
- The susceptibility of the applicable compliance requirements to non-compliance
- The length of time the entity has been subject to the applicable compliance requirements
- The auditor's observations about how the entity has complied with the applicable compliance requirements in prior years
- The potential effect on the entity of non-compliance with the applicable compliance requirements
- The degree of judgment involved in adhering to the compliance requirements.

Some examples of situations in which there may be a risk of material non-compliance that is pervasive to the entity's non-compliance are:

- An entity that is experiencing financial difficulty and for which there is an increased risk that grant funds will be diverted for unauthorized purposes
- An entity that has a history of poor recordkeeping for its programs

### 3.3.5 Consideration of Risks of Fraud

As auditors, we know that fraud and corruption pose serious risks to the public sector. The potential damage of fraud and corruption extends well beyond any financial loss, as it also causes substantial negative effects on the entity's reputation and internal working environment. Several cases of fraud and corruption can also severely reduce peoples trust in the public sector as a whole. Fraud risks and assessments of materiality in relation to fraud are considered in the context of the broader scope of public sector auditing.

The following questions may be relevant to consider while performing a fraud risk assessment for an entity:

- i. Has the audited entity developed a clear overall fraud and corruption control framework? A fraud control framework is a system of co-ordinated measures put in place to prevent, detect and respond to instances of fraud.

- ii. Do policies and procedures relevant to fraud and corruption prevention and detection, complement each other and operate in an integrated and cohesive manner?
- iii. Have all relevant users been involved in contributing to and developing the overall policy regarding fraud and corruption prevention and detection?
- iv. Does the overall policy address fraud related elements such as (a) tone at the top, (b) fraud risk assessment, (c) risk based internal controls, (d) internal reporting, (e) external reporting (f) public interest disclosures (g) investigation (h) code of conduct (i) staff education and awareness and (j) client and community awareness?
- v. Do the overall policy and any related policies and procedures reflect the specific needs of the audited entity?
- vi. Is the fraud control framework reviewed on a periodic basis? When was the frameworks last reviewed?
- vii. Is there a structured approach to implementing significant review recommendations?
- viii. Have the recommendations for changes or improvements to policy and operational procedures been prioritized or implemented?
- ix. Has the entity implemented effective communication or programs to raise awareness of its fraud control frameworks?
- x. Is the frameworks easily accessible to all relevant parties?
- xi. Do the overall frameworks and its components clearly show the commitment of senior management to its principles and policies?
- xii. Is there a person/organizational unit responsible for 'ownership' and administration of the fraud and corruption control frameworks?

It is important to have a clear understanding of what fraud and corruption mean. The distinguishing factor between fraud and error is whether the underlying action that results in the non-compliance is intentional or unintentional. Fraud and corruption are intentional acts involving the use of deception - to obtain an unjust or illegal advantage. The ones responsible for a fraudulent act may be members of the management, those charged with governance, employees, or third parties.



Owing to the inherent limitations of an audit, there is an unavoidable risk that some material cases of non-compliance may not be detected, even though the audit is properly planned and performed in accordance with the ISSAIs. The potential effects of inherent limitations are particularly significant in cases of deviations as a result of fraud. The risk of not detecting a case of non-compliance resulting from fraud is higher than the risk of not detecting one resulting from error. Contrary to unintentional mistakes and errors, a fraudulent act usually involves organized schemes designed to conceal it, such as false information, forgery, hidden or lack of documentation, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false.

According to ISSAI 100 Fundamental Principles of Public-Sector Auditing, the auditor should consider and assess the risk of different types of deficiencies, deviations or misstatements that may occur. Both general and specific risks in relation to the subject matter should be considered. Paragraph 47 states specifically that auditors should identify and assess the risks of fraud relevant to the audit objectives.

The purpose of the fraud risk assessment is to:

- a. Identify inherent fraud and corruption risks of the entity,
- b. Identify and assess the entities' internal controls in place, and
- c. Assess residual risks, and to consider possible audit procedures.

Auditors should maintain an attitude of professional skepticism and be alert to fraud risks and their impact throughout the audit process.

There are three key elements normally present when someone commits fraud and corruption: 1. Opportunity, 2. Incentive/pressure, and 3. Rationalization/attitude. All these elements should be dealt with through the entity's internal controls. Hence, weak internal controls may indicate risks of fraud and corruption. Depending on their mandate, this may be an appropriate starting point for auditors, than looking for indicators of possible acts of fraud and corruption. Much can be done to prevent fraud and corruption by addressing weak internal controls.

When performing assessments specifically on fraud risks the auditor must particularly bear in mind that even though the relevant internal controls exist on paper, it is no guarantee that the controls function as intended in practice. Potential fraudsters are more focused on weaknesses of the controls than in their strengths, and therefore auditors are encouraged to "think like a thief" during the assessment and seek to find possible loopholes or methods that could lead to unjust or illegal advantage to someone inside and/or outside the entity. It is advisable to establish a risk assessment team which can provide various sorts of inputs, based on different knowledge, experiences and skills.

Fraud and corruption can take many forms. Fraud is normally characterized by some form of deliberate deception to facilitate or conceal misappropriation of assets, whereas corruption typically involves breach of trust in the performance of official duties[8]. Corruption is a type of fraud involving a public agent (bribe) that receives a benefit, bribe, or kickback (financial or intangible) in exchange for providing an undue advantage or benefit for the briber[9].

As part of the audit and following the initial fraud risk assessment, public sector auditors gather sufficient appropriate evidence related to audit topic, through the performance of suitable audit procedures. While detecting potential unlawful acts, including fraud, is normally not the main objective of performing a compliance audit, public sector auditors do include fraud risk factors in their risk assessments, and remain alert for indications of unlawful acts, including fraud, in carrying out their work.

Activities and processes in which there is intensive contact with "clients" or external relations prove to be more vulnerable to fraud and corruption because there are more opportunities and temptations. Examples of such activities are procurement for goods and services, payments like subsidies, grants, allowances etc., the role of granting or issuing licenses, permits, identification documents etc.,

[8] *Fraud and Corruption Control, Guidelines for Best Practice, Crime and Misconduct Commission, Queensland, Australia*

[9] *The Brazilian Court of Audit developed a strategy to fight fraud and corruption in national governance. The whole text of the strategy is available on the website <http://portal2.tcu.gov.br/portal/pls/portal/s/2053600.PDF>*



regulating, inspection, audits etc., and enforcement of laws and regulations. The public sector has unique duties and responsibilities to enforce laws and regulations. This includes for example investigations, prosecution and sanctioning. Clients may have considerable (financial) interest in the activities or services of the government. This implies that the temptation may exist to bribe civil servants or to manipulate government decision making in a favourable way for the client. It also creates temptations for civil servants to accept or to ask for favours.

Managing public property is also a vulnerable area. Valuable property is vulnerable to theft or loss. This includes money, goods or real estate, human capital and also information as a valuable public asset.

In performing compliance audits, if public sector auditors come across instances of non-compliance which may be indicative of unlawful acts or fraud, they exercise due professional care and caution so as not to interfere with potential future legal proceedings or investigations. Public sector auditors may consider consulting with legal counsel or appropriate regulatory authorities[10].

Furthermore, auditors may communicate their suspicions to the appropriate levels of management or to those charged with governance, and then follow up to ascertain that appropriate action has been taken. In

regard to instances of non-compliance related to fraud or serious irregularities, because of the different mandates and organisational structures that exist internationally, it is up to the SAI to determine the appropriate action to be taken[11]. Public sector auditors take action to ensure that they respond appropriately based upon the mandate of the SAI and the particular circumstances.

### 3.3.6 Determining reliance on internal controls

As explained earlier, the purpose of performing risk assessment in compliance auditing is to identify areas which are most exposed to high risk of non-compliance and allocate the scarce audit resources to audit areas that are critical to the success and sustainability of audited entities. Therefore, after assessing the risks associated with the strategic and operational activities of the audited entity auditors need to determine the appropriate response to the material risks identified which involves consideration of the perceived level of maturity of internal controls. Based on the evaluation of internal control, the auditor will be in a position to decide on the appropriate audit approach and identify the audit evidence required in conducting the audit. An illustration on risk, risk response and probable audit approach is shown below:

Audit procedures in response to inherent risk:

Inherent risk	Risk Response	Audit Approach
High	Low levels of controls	Audit response to be focused on improving internal controls through assessment of improved plans
High	Controls are asserted by the management to be adequate	Focus on obtaining assurance that controls continue to operate as designed and that there is consistency in risk management.
Low	Low level of controls that may be consciously accepted by management	Evaluate and monitor the development of risk level
Low	High level of control	Audit response to be focused on compliance issues

If the auditor identifies risks of material non-compliance the auditor should develop an overall response to such risks.

The auditor should design further audit procedures, including tests of details (which may include tests of transactions) to obtain sufficient appropriate audit evidence about the entity's compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance.

[10] ISSAI 300.

[11] ISSAI 400.





### 3.3.7 Linking identified risks to audit strategy

An important aspect of compliance audit planning is that the auditor practically considers the linkage of identified risks to the audit strategy. On the basis of the value of detection which is acceptable for auditors in the evaluation of internal controls, they can then decide on the audit strategy to follow i.e. whether it will be a control based approach or substantive test based approach. In real life auditors perform walkthroughs of identified controls in order to gain a degree of confidence on the operating effectiveness of these control. During walkthroughs, auditors exercise professional judgment in determining what could potentially go wrong and how to collect sufficient and appropriate evidence to test this assumption. The audit strategy may consist either in relying on tests of controls or in performing substantive procedures.

## 3.4 DETERMINING MATERIALITY AT PLANNING STAGE

In public sector when auditors obtain reasonable assurance they plan and perform the audit to determine whether the subject matter information, in all material respects, is in compliance with the stated criteria.

In performing compliance audits, materiality is determined for all stages of audit:

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

During the planning process, information is gathered about the entity in order to assess risk and establish materiality for designing audit procedures. Evidence gathered must then be evaluated as a basis for forming conclusions and for reporting purposes and determining materiality is significant to this evaluation.

Determining materiality is a matter of professional judgment and depends on the auditor's interpretation of the users' needs. A matter can be judged material if

knowledge of it would be likely to influence the decisions of the intended users. Materiality is often considered in terms of value, but it also has other quantitative as well as qualitative aspects. The inherent characteristics of an item or group of items may render a matter material by its very nature. A matter may also be material because of the context in which it occurs. An essential part of determining materiality within compliance is to consider whether reported cases of compliance or non-compliance could reasonably be expected to influence decisions by the intended users. Factors to be considered within this judgment are mandated requirements, public interest or expectations, specific areas of legislative focus, request and significant funding. Issues on a lower level of value, such as fraud, may also be considered material[12].

In evaluating the materiality of any non-compliance identified, matters such as the criteria, the conditions, the cause and the effect of non-compliance are also considered. This might be the case in situations where a law or regulation, or agreed-upon terms establish an unconditional requirement for compliance, for example if the constitution prohibits overspending in relation to the approved budget (ISSAI 4100.71, 72).

### 3.4.1 Professional judgments about materiality

Professional judgments about materiality are made in light of circumstances surrounding the audit, but are not affected by the level of assurance. That is, for the same intended users and purpose, materiality for a reasonable assurance audit is the same as for a limited assurance audit because materiality is based on the information need of the intended users.

In some cases the applicable criteria may discuss the concept of materiality in the context of the preparation and presentation of the subject matter information and thereby provide a frame of reference for the auditor in considering materiality for the particular audit. In cases, where the applicable criteria do not include a discussion of the concept of

[12] ISSAI 400. 47





materiality auditor may get guidance with a frame of reference to consider materiality as explained below.

Non-compliance or compliance deviations, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence relevant decisions of intended users taken on the basis of the subject matter information. As we have discussed that the auditor's consideration of materiality is a matter of professional judgment, and is affected by the auditor's perception of the common information needs of intended users as a group. In this context, it is reasonable for the auditor to assume that intended users:

- Have adequate knowledge of the underlying subject matter, and a willingness to study the subject matter information with reasonable diligence;
- Understand that the subject matter information is prepared and assured to appropriate levels of materiality, and have an understanding of any materiality concepts included in the applicable criteria;
- Understand any inherent uncertainties involved in the measuring or evaluating the underlying subject matter; and
- Make reasonable decisions on the basis of the subject matter information taken as a whole.

### 3.4.2 Determining materiality

Standards state that a matter can be judged material if knowledge of it would be likely to influence the decisions of the intended users. This judgment may relate to an individual item or to a group of items taken together.

Materiality is often considered in terms of value, but it also has other quantitative as well as qualitative aspects. The inherent characteristics of an item or group of items may render a matter material by its very nature. A matter may also be material because of the context in which it occurs<sup>[13]</sup>. Materiality is related to the whole population under the purview of audit. The auditor will design the audit procedures and sampling in such a way, that if there are non-compliances reaching the materiality level, they would be identified by the sampling. As we have mentioned the assessment of materiality requires professional judgment on the

part of the auditor and is related to the audit scope, but, some SAIs may give guidance by setting the level of materiality (threshold) to be considered in context of legality and regulatory of the transactions or in terms of value.

Determination of materiality requires auditors to understand and assess what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter, auditors considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. For instance, in the context of legality and regulatory of compliance the underlying transaction with regulations, compliance deviations are material if they would reasonably affect the decision of the users of the audit opinion.

In the practice of some SAIs, materiality is based on an assessment of the importance of audit findings, and therefore, it is more judgmental than the materiality considered in case of a reasonable assurance audit. In this type of practice, at the end of the audit, the auditor will judge whether the findings are significant enough to be included in the report, based on the specific nature of each finding. To address such issues, during the planning phase, auditors need to consider following factors in determining whether an information is material or not:

- The context in which the matter appears, for example if the matter is also subject to compliance with authorities, legislation or regulations, or if law or regulation prohibits overspending of public funds, regardless of the amounts involved;
- Public expectations and public interest, including emphasis placed on the particular matter by relevant committees in the legislature, such as a public accounts committee, including the necessity of certain disclosures;

<sup>[13]</sup> ISSAI 400.47.



- The need for legislative oversight and regulation in a particular area; and
- The need for openness and transparency, for example if there are particular disclosure requirements for frauds or other losses.

Other matters that may be considered material by their nature include:

- Fraud
- Intentional unlawful acts or non-compliance
- Incorrect or incomplete information to management, the auditor or to the legislature (concealment)
- Intentional disregard for follow-up of requests made by management, authoritative bodies or auditors
- Events and transactions made despite knowledge of the lack of legal basis to carry out the particular event or transaction

### 3.4.3 Qualitative and Quantitative factors in determining materiality

As mentioned earlier that materiality is considered in the context of qualitative factors and, when applicable, quantitative factors. In general, quantitative aspects are: size - usually in terms of value, it can be percentage, number, amount etc. and qualitative aspects are: nature and characteristics etc. In some cases qualitative aspects can influence that lower amount of non-compliance is material as well, in some cases non-compliance does not relate to value, amount or size at all. For further understanding of the qualitative materiality which is not related to quantity at all, some examples given below may be helpful:

1. The terms of a building code require annual inspections to be performed. The government agency has not performed inspections for the past five years. This non-compliance may be significant due to qualitative aspects such as safety implications. Although no particular monetary amounts are involved, the non-compliance may be material due to the potential consequences it may have on the safety of the building occupants. In the event of a disaster, there is also a risk that the non-compliance may result in significant liability claims which could have material financial implications for the government agency as well.

2. The terms of a funding agreement state that the recipient of the funds must prepare financial statements and send them to the donor organisation by a certain date. The financial statements have not been prepared and sent by this date. The non-compliance may or may not be material depending on whether or not the financial statements were subsequently prepared and sent, the extent of the delay, the reasons for the delay, any consequences that may arise as a result of the non-compliance, etc.

The relative importance of qualitative factors and quantitative factors when considering materiality in a particular audit is a matter of auditor's professional judgment. Qualitative factors may include such things as:

- The interaction between, and relative importance of, various components of the subject matter information when it is made up of multiple components, such as a report that includes numerous performance indicators.
- The wording chosen with respect to subject matter information that is expressed in narrative form.
- The nature of a non-compliance, for example, the nature of observed deviations from a control when the subject matter information is a statement that the control is effective.
- Whether a non-compliance affects compliance with law or regulation.
- Whether a non-compliance is the result of an intentional act or is unintentional.
- When the subject matter information relates to a conclusion on compliance with law or regulation, the seriousness of the consequences of non-compliance.

Quantitative factors relate to the magnitude of non-compliance relative to reported amounts for those aspects of the subject matter information are:

- Expressed numerically; or
- The number of observed deviations from a control may be a relevant quantitative factor when the subject matter information is a statement that the control is effective.



Concluding on the materiality of the non-compliance identified as a result of the procedures performed requires auditor's professional judgment. This can be further clarified through the following example:

In a compliance audit, the entity may have complied with nine provisions of the relevant law or regulation, but did not comply with one provision. Professional judgment is needed to conclude whether the entity complied with the relevant law or regulation as a whole. For example, the auditor may consider the significance of the provision with which the entity did not comply, as well as the relationship of that provision to the remaining provisions of the relevant law or regulation.

### 3.5 AUDIT STRATEGY AND AUDIT PLAN

Finalization of audit strategy and audit plan is the final step of the planning process. Planning the audit so that it will be performed effectively involves discussions with relevant members of the audit team, and developing an overall audit strategy and an audit plan. The standards emphasize the need for an audit strategy and audit plan because this helps SAIs in determining how the audit will proceed from start to end. All critical aspects of a compliance audit are examined threadbare and an understanding reached on what would be done (audit strategy) and how (audit plan). Both the audit strategy and the audit plan should be documented in writing and are updated as necessary throughout the audit. Planning also involves considerations related to the direction, supervision and review of the audit team. Auditors should therefore have a thorough understanding of the difference between the audit strategy and the plan.

The purpose of the audit strategy is to devise an effective response to the risks of non-compliance. It specifies and sets the planned extent, timing and direction of the audit and guides the development of the audit plan. The audit strategy will show how auditors would respond to and changes may be made to the scope of audit when additional information becomes available on the subject matter, criteria, or controls, thereby changing risk profile of the audited entity.

In establishing the overall audit strategy for the compliance audit, public sector auditors consider:

- The objectives, scope, subject matter, criteria and other characteristics of the compliance audit, taking into account the mandate of the SAI and the elements contained in the compliance audit definition;
- Reporting responsibilities and objectives, as well as to whom and when such reporting will take place, and in what form;
- Significant factors that may influence the direction of the audit;
- Materiality and audit risk assessment;
- Knowledge gained from previous or related audits;
- Composition and work allocation of the audit team, including any need for experts; and
- timing of the audit.

Once auditors have understood the compliance requirements applicable to a subject matter and the internal controls affecting it, auditors are able to identify the risk that something can go wrong and accordingly plan necessary audit procedures that would allow them to arrive at an appropriate conclusion or opinion considering that risks.

#### 3.5.1 Planned audit procedure

In preparing an audit plan, SAIs review, rearrange and document every step of audit process in sufficient detail. Thus, audit plans eventually work as benchmarks against which the flow of compliance audit activities is appraised.

Planning audit procedures involves designing procedures to respond to the identified risks of non-compliance. The exact nature, timing and extent of the audit procedures to be performed may vary widely from one audit to the next. Nonetheless, compliance audit procedures in general involve establishing the relevant criteria, i.e. the authorities which govern the entity, and then measuring the relevant subject matter information against such authorities. In the next chapter on performing compliance audits and gathering evidence we will discuss about the audit procedures.



The compliance audit planning document includes the description of:

- a. Identified criteria related to the scope and characteristics of the compliance audit and to the legal, regulatory or appropriations framework;
- b. The nature, timing and extent of risk assessment procedures sufficient to assess the risks of non-compliance, related to the various audit criteria;
- c. The nature, timing and extent of planned audit procedures related to the various compliance audit criteria and risk assessments.

### 3.6 CONCLUSION

In this chapter we have discussed the initial considerations for a compliance audit planning as well as the detail steps in the planning process including internal controls, risk assessment and materiality. The chapter also provides guidance on when to provide 'limited' or 'reasonable' assurance in an assurance audit. Auditors build their audit plan considering audit risk with the objective of arriving at an appropriate conclusion or opinion. Auditors also blend fraud risk assessment in their planning process as required by the standards.



## **Chapter 4:**

# **Gathering and Evaluating Audit Evidence**



## 4: GATHERING AUDIT EVIDENCE

### 4.1 INTRODUCTION

In the previous chapter we have discussed about the initial consideration of planning and the planning process. Auditors move into the audit execution phase after they have reviewed subject matter, criteria, scope, audit strategy and audit plan. Based on the audit procedures identified in the audit planning auditors gather and evaluate audit evidence as part of the audit execution. This chapter explains the key considerations for the auditors in gathering audit evidence.

### 4.2 AUDIT EVIDENCE

Audit evidence is the information used by the auditor in arriving at the conclusions on which the auditor's conclusion or opinion is based. Auditors design and apply appropriate audit procedures to obtain sufficient and appropriate audit evidence in order to form a conclusion or opinion as to whether a subject matter complies, in all material respects, with established criteria<sup>[1]</sup>. To cover the audit scope, the auditor has to decide when the audit evidence is sufficient and appropriate to give provision for the basis of conclusion or opinion.

In the planning phase, auditors review the:

- a. internal controls established by the audited entity to prevent, detect, and rectify instances of non-compliance, and
- b. whether there is an organizational unit within the audited entity for management of controls and other risks.

Based on this review auditors identify control risks and other risks and keep these in consideration while they start gathering audit evidence.

The procedures depend on the particular subject matter and criteria and auditors' professional judgment. As explained in the planning module

auditors establish a link with the audit procedures to identified risks. When the risks of noncompliance are significant and auditors plan to rely on the controls in place, such controls are required to be tested. When controls are not considered reliable, auditors plan and perform substantive procedures to respond to the identified risks. Auditors perform additional substantive procedures when there are significant risks of non-compliance. If the audit approach consists only of substantive procedures, analytical tests and tests of details are performed.<sup>[2]</sup>

The compliance auditor will often need to combine and compare evidence from different sources in order to meet the requirements for sufficiency and appropriateness of audit evidence.<sup>[3]</sup> Professional judgment needs to be exercised in considering the quantity and quality of available evidence when performing the engagement, in particular when determining the nature, timing and extent of procedures.

#### 4.2.1 Quantity and Quality of Available Evidence:

Audit evidence would be considered sufficient (quantitative) when it can persuade a knowledgeable person that the findings are reasonable. Audit evidence would be considered appropriate when it is relevant, directly linked to the criteria and subject matter and reliable.

The quantity or quality of available evidence is affected by:

- a. The characteristics of the subject matter and subject matter information. For example, less objective evidence might be expected when the subject matter information is future oriented rather than historical; and
- b. In circumstances when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the auditor's engagement, an entity's document retention policy, inadequate information systems, or a restriction imposed by the responsible party.

<sup>[1]</sup> ISSAI 4200.95

<sup>[2]</sup> ISSAI 4200.96

<sup>[3]</sup> ISSAI 400.57





#### 4.2.2 Sufficiency, Appropriateness and Reliability of Audit Evidence:

The sufficiency and appropriateness of evidence are interrelated. Sufficiency is the measure of the quantity of evidence. The quantity of evidence needed is affected by the risks of the subject matter information being non-compliant or prone to compliance deviation (i.e. the higher the risks, the more evidence is likely to be required) and also by the quality of such evidence (i.e. the higher the quality, the less may be required). Obtaining more evidence, however, may not compensate for its poor quality.

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

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

- Significance of a potential non-compliance or compliance deviation and the likelihood of its having a material effect, individually or when aggregated with other potential non-compliance, on the subject matter information.
- Effectiveness of the responsible party's responses to address the known risk of non-compliance or compliance deviation.
- Experience gained during previous audit with respect to similar potential non-compliance or compliance deviation.
- Results of procedures performed, including whether such procedures identified specific non-compliance or compliance deviation.
- Source and reliability of the available information.
- Persuasiveness of the evidence.
- Understanding of the responsible party and its environment.

The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of evidence can be made; however, such generalizations are subject to important exceptions. Even when evidence is obtained from external sources, circumstances may exist that could affect its reliability.

For example, evidence obtained from an external source may not be reliable if the source is not knowledgeable or objective. While recognizing that exceptions may exist, the following generalizations about the reliability of evidence may be useful, evidence is likely to be more reliable when:

- It is obtained from sources outside the responsible party.
- It is generated internally, when the related controls are effective.
- Obtained directly by the auditor. For example, observation of the application of a control is more reliable than evidence obtained indirectly or by inference, for example, inquiry about the application of a control.
- It exists in documentary form, whether paper, electronic, or other media. For example, a minutes of a meeting which is recorded concurrently during the meeting is generally more reliable than a subsequent oral representation of what was discussed.

More assurance is ordinarily obtained from consistent evidence obtained from different sources, or of a different nature, than from items of evidence considered individually. In addition, obtaining evidence from different sources or of a different nature may either corroborate other evidence or indicate that an individual item of evidence is not reliable. In cases, where evidence obtained from one source is inconsistent with that obtained from another, auditor needs to determine what additional procedures are needed to resolve the inconsistency.

In terms of obtaining sufficient appropriate evidence, it is generally more difficult to obtain assurance about subject matter information *covering a period* than about subject matter information *at a point in time*. In addition, conclusions provided on processes ordinarily are limited to the period covered by the engagement; auditor provides no conclusion about whether the process will continue to function in the specified manner in the future.



The scope of the audit determines where to gather audit evidence, meaning that the audit evidence can be collected from within or outside the entity, or be produced directly by the auditor. The auditor should consider using different sources in the evidence gathering process. The audit evidence may be physical, documentary, oral or analytical depending on the audit scope.

**4.2.3 Gathering of Evidence:**

Gathering of sufficient and appropriate audit evidence is a systemic and iterative process as it involves:[4]

- i. Gathering evidence by performing appropriate audit procedures.
- ii. Evaluating the evidence obtained as to its sufficiency (quantity) and appropriateness (quality)
- iii. Re-assessing risk and gathering further evidence as necessary.

As the auditor performs planned audit procedures, the audit evidence obtained may lead the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessments were based at the outset. For example the extent of deviation that the auditor detects by performing audit procedures may alter the auditor's judgment about the risk assessments and may indicate a material weakness in internal control. In such circumstances the auditor should re-evaluate the planned audit procedures based on revised considerations of assessed risks.

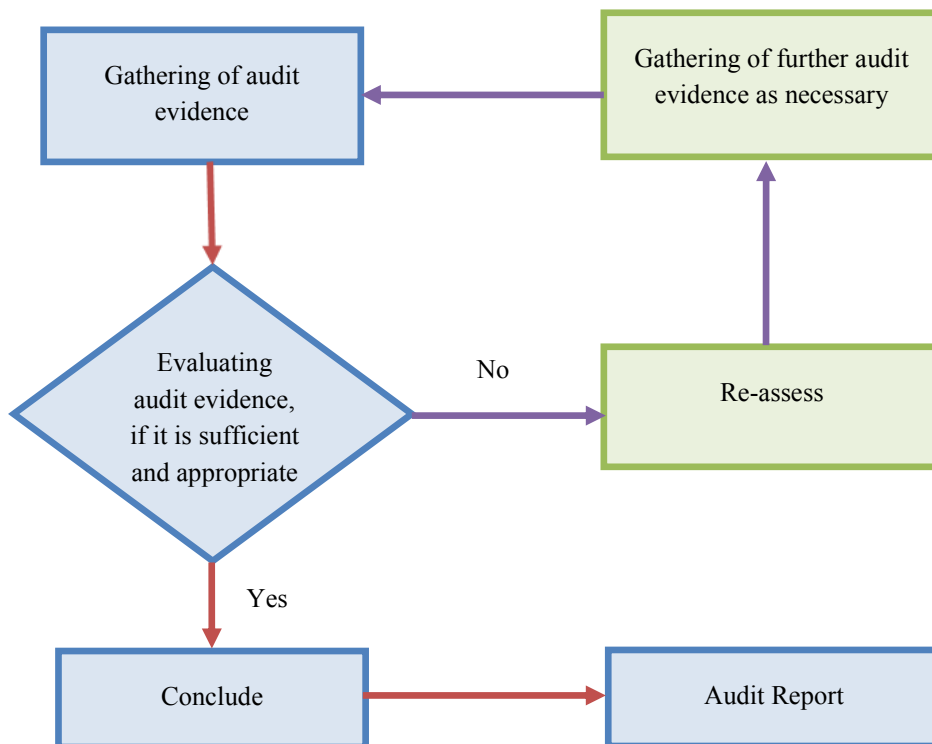


Figure 4.1: Decision making process

[4] ISSAI 4200.101, 102



## 4.3. EVIDENCE GATHERING TECHNIQUES

The effectiveness of an evidence gathering process is dependent on a realistic planning of this part of the audit process using proper evidence gathering techniques. SAIs may be using different tools for this purpose. The standards provide guidance on how to gather and evaluate audit evidence. Following are some techniques of gathering audit evidence:

### Observations

Auditors look at processes or procedures being performed. In performing compliance audit, this may include looking at how a bid tendering process is carried out, observing how benefit payments are processed or if performance of any kind is in line with laws and regulations.

### Inspection

Inspection may include:

- Examining the books and records to determine how project funds have been accounted for, and the completeness of recording.
- Comparing actual project accounting records to the terms of the project agreement.
- Review of case files/relevant documents to determine if recipients of benefits met eligibility requirements.
- Examining an asset, such as a bridge or a building, to determine if it meets the applicable building specifications.

The auditor should consider the reliability of any documents inspected and keep in mind the risk of fraud and the possibility that documents inspected may not be authentic. In cases of fraud, sometimes two different sets of books and records have been kept. The auditor may conduct additional audit procedures e.g. also inquire different persons of the entity to ascertain the source of the documents, or the controls over their preparation or maintenance.

### Inquiry

It involves seeking information from relevant persons, both within and outside the audited body, and may include:

- Formal written inquiries
- Informal oral discussions
- Interviewing and asking questions of relevant persons, including experts
- Preparing and sending questionnaires or surveys

Inquiry is generally used extensively throughout an audit and complements other audit procedures. For example, when observing processes being performed, such as the benefits payment process within a country/state, inquiries could be made of officers in regard to how relevant legislation, including changes and updates, is identified and interpreted. Results of inquiries may indicate that the processes are performed in different ways in different locations; which is a frequent cause of non-compliance.

To get a better understanding, inquiries are often made of persons outside the particular function subject to audit. For example, in addition to making inquiries of accounting personnel at a line ministry, it may also be relevant to make inquiries of ministry's legal or technical departments.

Generally, the further a person is from the subject of audit, the greater the probability that they will be objective in their response, although their experience with the audit area is likely to be in a narrow area. Those external to the audited body – such as banks, contractors, media - are more likely still to be objective. In this case, auditor needs to be mindful of potential relationships between the audited entity and personnel of the audited body.

Inquiry can be a weak form of audit evidence and it alone cannot provide sufficient appropriate evidence for audit purposes. In order to obtain sufficient appropriate evidence, inquiry should be performed together with other types of procedures. Inquiry is most effective when conducted with relevant and knowledgeable persons, i.e. persons in positions of authority who are authorized to speak or give opinions on behalf of the entity.



## Confirmation

It is a formal type of inquiry and involves obtaining a reply from a third party, independently from the audited entity, with regard to some particular information. In compliance audits, confirmation may involve obtaining feedback:

- Directly from grant beneficiaries that they have received the grants or other funds that the audited entity asserts have been paid out.
- Directly from grant beneficiaries that funds have been used for the particular purpose set out in the terms of a grant or funding agreement.
- Directly from suppliers that they have provided assets to the audited body on a certain date and free of damage.
- Receiving guidance from the legislature as to how a specific piece of legislation is meant to be interpreted.

Written confirmations may also be obtained from management in regard to oral representations made during the audit. Example of written management representations may relate to:

- Management's assertion of compliance with a relevant section of legislation, the terms of an agreement, etc.
- Management's disclosure of all instances of non-compliance of which it is aware.
- Management having provided the auditor with complete information about the subject matter.

By their very nature management representations are a weak form of assurance, but where audited entity management are privy to confidential information, this may be the only source of evidence.

## Re-performance

It can be a very important technique to use to determine if the results of the auditors work detect deviation from the entity/auditee's work. The auditor is independently carrying out the same procedures already performed by the audited entity. The data systems that are used by the entity/auditee can demand special qualifications that have to be considered before starting the re-performance. The auditor has to consider this, and assess the need to engage an expert who understands the system if needed, for example, re-performance of pension calculations, recipients of hospital treatment or engineering models etc.

Re-performance may be done manually or by using a computer assisted audit techniques. Some examples of re-performance are:

- Review of individual case files to test whether the audited entity made the correct decisions or provided the appropriate service in accordance with the relevant criteria.
- Process steps re-performed to test the appropriateness of visas or residence permits issued.
- Re-computation of taxation deductions on audited body staff payroll to confirm the correct amounts payable in taxation.
- Confirming the correct application of criteria for making benefit payments involve payments to persons meeting specific requirements.
- Where elderly benefit payments (pension or assistance) involve payments to persons over a certain age, the audited entity's selection of recipients from a public database may be re-performed by public sector auditors using computer assisted audit techniques to test the accuracy of the entity's process.
- Re-performing the tender selection process using the selection criteria to test that the correct bids (tenders) have been selected.



### Analytical procedures

In analytical procedures, auditors compare data, or investigate fluctuations or relationships that appear inconsistent. In compliance auditing, opportunities for analytical procedures may be limited, and their usage will depend upon the availability of reliable financial and operational information and statistics. An example would be, comparing increases and decreases in benefits payments (pension allowance) from one year to the next with demographic information such as the number of citizens having reached retirement age within the last year. If the pension benefits payments having been in the range of 5%-6% of government spending during 2005 to 2013 have increased to 11% in

2014, auditors should examine whether this change is due to non-compliance in computing pension liabilities etc.

**Illustration:** For VAT (Value Added Tax) audit the auditors have the option of using either one or all of these tools in gathering and evaluating evidence as shown below:

Table 4.1: Evidence gathering techniques

Techniques	Application of Techniques in the case of VAT Audit
<b>Observation</b>	Auditors observe whether (a) a Risk Management Unit (RMU) is established and (b) it is staffed with competent staff. Auditors may visit the RMU in the National Tax Office (NTO) and see how the staff is working.
<b>Inspection</b>	Auditors can randomly select a few VAT cases and examine whether the tax has been correctly calculated. Further, auditors may also do the same exercise for VAT refunds which is high risk area.
<b>Inquiry</b>	Auditors inquire from the government officials involved in VAT management through <b>written letters, discussion, interviews, or surveys</b> about applicable slabs, exemptions, and other procedural requirements to see whether or not the officers are on the same page. In many cases, non-compliance occurs because the government officials concerned do not clearly understand relevant rules and regulations.
<b>Confirmation</b>	Auditors may request the businessmen paying VAT whether they were getting VAT refund timely and as per their entitlement.
<b>Re-performance</b>	Auditors can compute VAT or VAT refund considering that a tax payer has paid certain amount of VAT on sales and another amount on purchase of taxable supplies. Based on these hypothetical figures, auditors can determine the amount of VAT payable/refundable as the case may be. If They can ask the NTO to work out VAT payable/refundable using their own system. /computerized
<b>Analytic Procedures</b>	Auditors may tabulate information on VAT collected and refunded for three years and compare the figures to see if there is any abnormal change in VAT collection/refund. In case auditors see significant changes/abnormal linkages in the collection and refund, they should look for explanation. They will need to use professional judgment in arriving at a conclusion.



### 4.3.1 Procedures to Obtain Evidence for Reasonable and Limited Assurance Engagements

The exact nature, timing and extent of procedures will vary from one audit to the other. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other circumstances regarding the audit.

A reasonable assurance engagement involves:

- a. Based on an understanding of the underlying subject matter and other circumstances, identifying and assessing the non-compliance and compliance deviation in the subject matter information;
- b. Designing and performing procedures to respond to the assessed risks and to obtain reasonable assurance to support the auditor's conclusion; and
- c. Evaluating the sufficiency and appropriateness of the evidence obtained in the context of the engagement and, if necessary in the circumstances, attempting to obtain further evidence.

The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are limited relative to a reasonable assurance engagement. An underlying subject matter-specific standard may establish that, for example, sufficient appropriate evidence for a particular type of limited assurance engagement is obtained primarily through analytical procedures and inquiries. For other types of limited assurance engagements, the procedures for gathering sufficient appropriate evidence may or may not primarily be analytical procedures and inquiries and will vary with the circumstances of the engagement. And in particular, the underlying subject matter, and the information needs of the intended users and the engaging party, including relevant time and cost constraints.

Determining the nature, timing and extent of procedures is a matter of professional judgment and will vary from one engagement to the next.

A limited assurance engagement involves:

- a. Based on an understanding of the underlying subject matter and other engagement circumstances, identifying areas where a non-compliance of the subject matter information is likely to arise;
- b. Designing and performing procedures to address those areas and to obtain limited assurance to support the auditor's conclusion; and
- c. If the auditor becomes aware of a matter that causes the auditor to believe the subject matter information may be non-compliant, designing and performing additional procedures to obtain further evidence.

### 4.3.2: Professional Skepticism in Gathering Audit Evidence:

Professional skepticism is an attitude that entails auditors being alert to:

- a. Evidence that is inconsistent with other evidence obtained;
- b. Information that calls into question the reliability of documents and responses to inquiries to be used as evidence;
- c. Circumstances that suggest the need for procedures in addition to those required by relevant standards; and
- d. Conditions that may indicate likely non-compliance or compliance deviation.

Auditors need to maintain professional skepticism throughout the audit to reduce the risk of:

- Overlooking unusual circumstances;
- Over generalizing when drawing conclusions from observations; and
- Using inappropriate assumptions in determining the nature, timing and extent of procedures and evaluating the results thereof.





Professional skepticism is necessary to the critical assessment of evidence gathered by the auditor. This includes questioning inconsistent evidence and the reliability of documents and responses to inquiries. It also includes consideration of the sufficiency and appropriateness of evidence obtained in the light of the circumstances.

Also, the auditor is not expected to disregard past experience of the honesty and integrity of those who provide evidence. Nevertheless, a belief that those who provide evidence are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism during the audit.

#### 4.3.3 Professional Judgment in gathering audit evidence:

Professional judgment is essential to the proper conduct of an assurance engagement. This is because interpretation of relevant ethical requirements and relevant standards of audit and the informed decisions required throughout the audit process cannot be made by the auditor without the application of relevant training, knowledge and experience to the facts and circumstances. The importance of professional judgment in determining materiality and risk is discussed in the earlier chapter. It is also equally important in the decisions about:

- The nature, timing, and extent of procedures used to meet the requirements of relevant audit standards and obtain evidence.
- Evaluating whether sufficient appropriate evidence has been obtained, and whether more needs to be done to achieve the objectives of relevant standards. In particular, in the case of a limited assurance compliance audit, professional judgment is required in evaluating whether a meaningful level of assurance has been obtained.
- The appropriate conclusions to draw based on the evidence obtained.

The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

## 4.4. CONSIDERATION OF NON-COMPLIANCE INDICATIVE OF FRAUD AND UNLAWFUL ACTS

During the course of audit the auditor may come across instances of non-compliance which may be indicative of fraud. While detecting fraud is not the main objective of compliance audit, auditors should include fraud risk factors in their risk assessments and remain alert to indications of fraud when carrying out their work<sup>[5]</sup>. When the auditor identifies instance of fraud, he or she should exercise due professional care and caution so as not to interfere with any future legal proceedings or investigations.

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

As pointed out in chapter 3 – Planning, factors that contribute to fraud includes:

- poor internal controls
- management override of internal control
- collusion between employees, and
- collusion between employees and third parties.

[5] ISSAI 400.51, ISSAI 400.55



Auditors use different techniques for gathering evidence as explained in section 4.3 above. Some of the same techniques are extensively used in identifying fraud as explained below[6].

- i. **Observation:** Auditors may observe the extent to which the management and staff are complying with policies, procedures, and internal controls. Observation may reveal a deficient control environment including a lack of ethics and integrity on the part of top management. This implies higher fraud risk for the entity.
- ii. **Inspection:** Auditors may examine the record for journal entries involving large rounded amounts at or near the close of accounting.
- iii. **Interviews:** Auditors may interview top managers/key officials and note changes in management and employee behavior indicating deception, corruption, red flags, and other abnormal occurrences that indicate fraud. Interviews would become more meaningful if auditors suspect fraud during their observations/inspection.
- iv. **Analytical reviews:** Auditors compare financial information from period to period to identify abnormal financial data relationship. An unexpected increase in expenditure or revenue may be a sign of fraud.
- v. **Walk through:** Auditors may trace an original source document through recording processes to test reliability of the internal control systems and discover opportunity points for fraud.

Auditors need to be aware of on how the management of the audited entity responds to audit findings and report on it. This is an indicator of entity's seriousness toward compliance issues. In cases where the management does not give due importance to the irregularities identified, which would be reflected in the documents without any information as reference of corrective actions being taken, the risk of fraud in that kind of environment is going to be higher. Auditors need to be alert to such signals while carrying out risk assessment in conducting the audit.

While gathering audit evidence, if the auditor comes across suspected unlawful acts or fraud, auditors are entitled to assess if the evidence is in compliance with laws and regulations. In cooperation with the management of the SAI, the auditor considers the SAIs mandate and internal reporting policies. When the

auditor has assessed that there is suspected fraud he/she considers how to inform the relevant authorities, and follow-up to ensure that relevant action has been taken.

## 4.5 CONCLUSION

The quality of audit work and the level of assurance provided depend on the sufficiency and appropriateness of audit evidence. It is important for auditors to understand different techniques that may be used to collect evidence. Gathering evidence is an essential part before evaluating and forming conclusions in the compliance audit process. In the next chapter we will discuss about this.

[6] *Risk Factors and Red Flags for State Auditors*, Jerry E. Spratt (2009), Assistant Legislative Auditor for the Arkansas Division of Legislative Audit, USA. The full text of the paper can be seen at the website.  
[http://www.nasact.org/conferences\\_training/nsaa/conferences/AnnualConferences/2009AnnualConference/PresentationsHandouts/Spratt,%20Jerry.pdf](http://www.nasact.org/conferences_training/nsaa/conferences/AnnualConferences/2009AnnualConference/PresentationsHandouts/Spratt,%20Jerry.pdf)



## **Chapter 5:**

# **Evaluating Audit Evidence and Forming Conclusion**



## 5.1 INTRODUCTION

In the previous chapter we have discussed about the audit procedures identified in the audit planning process based on which auditors gather sufficient and appropriate audit evidence. Next step in the process is to evaluate audit evidence and form audit conclusions as part of the audit execution. This chapter explains the key considerations for the auditors in evaluating evidence and forming audit conclusions.

## 5.2 EVALUATING EVIDENCE AND FORMING CONCLUSIONS

Auditors evaluate the evidence obtained and determine whether it is sufficient and appropriate to reduce the audit risk at an acceptably low level. Evaluation of evidence includes exercising professional judgment and professional skepticism.

### 5.2.1 Evaluating Evidence

Whether sufficient appropriate evidence has been obtained on which to base the auditor's conclusion is a matter of professional judgment, which involves considering the relationship between the cost of obtaining evidence and the usefulness of the information obtained. The auditor uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

An audit is a cumulative and iterative process. As the auditor performs planned procedures, the evidence obtained may cause the auditor to change the nature, timing or extent of other planned procedures. Information may come to the auditor's attention that differs significantly from that expected and upon which planned procedures were based. For example:

- The extent of non-compliance that the auditor identifies may alter the auditor's professional

judgment about the reliability of particular sources of information.

- The auditor may become aware of discrepancies in relevant information, or inconsistent or missing evidence.
- If analytical procedures were performed towards the end of the engagement, the results of those procedures may indicate a previously unrecognized risk of non-compliance.

In such circumstances, the auditor may need to reevaluate the planned procedures.

Having gathered all audit evidence the auditor should take the necessary steps to form conclusions. When evaluating the audit evidence, the auditor reviews documentation to determine whether the subject matter has been sufficiently and appropriately examined. Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of non-compliance or compliance deviation remain appropriate or whether they need to be revised.

The evaluation process entails considering evidence that both supports and seems to contradict the audit report, conclusion or opinion on compliance or non-compliance. If audit evidence obtained from one source is inconsistent with that obtained from another, or if there are any doubts about the reliability of the information to be used as evidence, the auditor should determine what modifications or additions to the audit procedures would resolve the matter and consider the implications, if any, for other aspects of the audit<sup>[7]</sup>.

[7] ISSAI 400



### 5.2.2 Forming Conclusions

While drawing a conclusion or opinion, auditors evaluate evidence in relation to identified materiality in order to identify potential instances of material non-compliance. Determining the significance of findings is based on the concept of materiality. What represents a material compliance deviation is a matter of professional judgment and includes considerations of context as well as quantitative and qualitative aspects of the transactions or issues concerned. The list below identifies some of the factors that the auditors have to consider in applying professional judgment to determine whether or not an instance of non-compliance is material[8].

- Importance of amounts involved (monetary amounts or other quantitative measures such as number of citizens, entities or organisations involved, pollutant emissions levels, time delays in relation to deadlines, etc.).
- Circumstances.
- Nature of the non-compliance – law, regulation or internal procedure.
- The cause leading to the non-compliance – negligence or fraudulent act.
- Possible effects and consequences non-compliance may have.
- Visibility and sensitivity of the criteria or program in question, (for example, is it the subject of significant public interest, does it impact vulnerable citizens, etc.).
- Needs and expectations of the legislature, the public or other users of the audit report.
- Nature of the relevant authorities.
- Extent or monetary value of the non-compliance.

While evaluating audit evidence auditors consider whether material non-compliance are pervasive or not. If it is unable to obtain sufficient and appropriate audit evidence due to an uncertainty or scope limitation auditors evaluate whether it is both material and pervasive.

In evaluating their evidence the auditors can conclude that the audit evidence is conflicting. Some evidence supports the subject matter information, and other evidence appears to contradict it. The auditors need to weigh the extent and credibility of conflicting evidence in order to determine the true situation. This is where auditors can use the hierarchy of evidence reliability, so that for example written external evidence is more credible than an informal management representation to the contrary[9].

After evaluating whether the evidence is sufficient and appropriate given the assurance level of the audit, the auditor should consider how best to conclude in the light of the evidence[10].

Auditors need to properly document all significant activities that they carry out while gathering and evaluating evidence. They need to revise their strategy and audit plan considering the results of their work in this phase. Frequently, additional information comes to the notice of auditors that require them to relook at subject matter, criteria, scope, control/risk assessment, and materiality consideration as explained above. Auditors may, during compliance testing, come across instances that indicate fraud risk within the audited entity. How to address the issue is explained earlier.

During this phase, auditors also need to engage with management to seek clarification on some issues that have bearing on how they are looking at subject matter, criteria, scope, audit risk, and materiality. This interaction helps auditors to make proper adjustments in their audit strategy and audit plan. Further, it also helps management to identify control weaknesses and other systemic weakness that it can begin to tackle promptly.

[8] ISSAI 4100.

[9] *Compliance Audit Field Manual, State Audit & Administrative Control Bureau, SAI of Palestine, 2013.*

[10] ISSAI 400



### 5.3 CONCLUSION

Auditors exercise professional judgment and skepticism in determining whether audit evidence is sufficient and appropriate throughout the audit phase. Factors that the auditors have to consider in the audit to evaluate evidence and form conclusions are discussed in this chapter. The next chapter will discuss how the results of evaluation of evidence and conclusion formed is reflected in compliance audit reports.





## Chapter 6:

# Documentation and Communication



## 6.1 INTRODUCTION

This chapter aims to provide the compliance auditors with basic information on documentation and communication while conducting audit with reference to the ISSAIs. The credibility and impact of audit depend on the quality work that SAIs do. Proper documentation throughout an audit cycle (from planning to report stages) helps SAIs in producing high quality audit reports. Continuous good communication with the audited entity is also important during the entire audit process. The chapter explains how auditors can make use of documentation and communication in a compliance audit to improve the quality of their work. Since limited guidance is available in the ISSAIs regarding these two concepts inasmuch as they relate to compliance audit, good practices have been adapted to provide useful guidance.

## 6.2 DOCUMENTATION

Audit documentation is the written record of the basis on which auditors draw their conclusions or opinion in a compliance audit. Thus, documents prepared during planning, conducting or reporting stage of a compliance audit can be examined to see whether or not auditors have carried out a compliance audit as per the ISSAIs. Documents will contain sufficient information to enable an experienced auditor, having no previous connection with the audit:

- The relationship between the subject matter, criteria, audit scope;
- Risk assessment, audit strategy;
- Audit plan and the nature, timing, extent and results of the procedures performed;
- Evidence obtained in support of the auditors conclusion or opinion;
- The reasoning behind all significant matters that required the exercise of professional judgment; and
- Conclusions.

Proper documentation helps reviewers of audit work to understand what has been done, how it has been done, and why it has been done. Auditors need to do proper documentation at every stage of the audit process. For any compliance audit, documents should indicate:

- a. How the auditors decided the subject matter, criteria and scope.
- b. What analytical and other audit procedures were carried out to collect audit evidence to determine whether the subject matter was/was not in compliance with the criteria. That the conclusion and opinion in the report were based on sufficient and appropriate evidence.

Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues. Office memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation are some examples of documents. Audit documentation may be in the form of paper, electronic files, or other media.



### Quality Management through Documentation Review

The SAI Pakistan has developed a Quality Management Framework (QMF) to assess whether auditors' planning, conducting and reporting of results are consistent with the required auditing standards. A team of quality management specialists periodically visit each of the 26 Field Audit Offices (FAOs) across the country and studies whether FAOs are following prescribed standards in audit planning, conducting and reporting. The scope of this review is restricted to planning, conducting or reporting during a review. In December 2013, the quality assurance specialist carried out a review of planning phase. They picked up 6-8 compliance audit conducted by each of the 26 FAOs and checked whether these FAOs complied with prescribed planning standards and practices. The team bases its opinion on the quality of documentation used in the FAOs. The report also pointed out reasons for non-compliance with standards and suggested steps for improving the situation.

#### 6.2.1 What to document

The auditor may be advised to document:

- a. The risk assessment procedures performed, including those related to gaining an understanding of internal control system.
- b. His or her responses to the assessed risks of material non-compliance, the procedures performed to test compliance with the applicable compliance requirements, and the results of those procedures, including any tests of controls.
- c. Materiality, qualitative and quantitative,
- d. and the basis on which they were determined.
- e. How the audit team complied with the specific public sector audit requirements (if any) that are supplementary to auditing standards.

The auditor's documentation of evidence regarding identified or suspected non-compliance with authorities may include, for example:

- a. Copies of records or documents.
- b. Minutes of discussions held with management, those charged with governance, or other parties inside or outside the entity.

Auditors are required to document the audit procedures performed, evidence obtained, and conclusions reached with respect to compliance audit criteria used in audit. Auditors would develop/maintain documents that will clearly show that the work was in fact performed.

In determining the nature and extent of the documentation for a typical compliance audit , auditors may be advised to consider the following factors:

- Nature of the auditing procedures performed;
- Risk of material non-compliance with the applicable criteria, and auditors' response to the assessed risks;
- Extent to which professional judgment was applied in work especially in the context of materiality consideration;
- Materiality of the evidence obtained against criteria;

Documentation should be sufficiently detailed to enable an experienced auditor, with no prior knowledge of the audit, to understand the following: the relationship between the subject matter, the criteria, the audit scope, the risk assessment, the audit strategy and audit plan and the nature, timing, extent and results of the procedures performed; the evidence obtained in support of the auditor's conclusion or opinion; the reasoning behind all significant matters that required the exercise of professional judgment; and the related conclusions<sup>[11]</sup>.

[11] ISSAI 400.48



### 6.2.2 When to document

Documentation should be prepared at the appropriate time and should provide a clear understanding of the criteria used, the scope of the audit, the judgments made, the evidence obtained and the conclusions reached.

Documentation should take place throughout the entire audit process. Different supporting documentation will be gathered at various phases during the audit process to support outputs at each stage of the audit.

Timeliness of documentation is also important. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditors' report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed. All working papers should be assembled and reviewed prior to issuance of the audit report.

The auditor should prepare relevant audit documentation before the audit report is issued, and the documentation should be retained for an appropriate period of time<sup>[12]</sup>.

### 6.2.3 Document Retention

Some SAIs may have policies and procedures consistent with their laws and auditing standards to maintain documentation of their work. Documentation retention policies ensure that relevant record is available for use for a certain number of years after an audit. These policies and procedures usually describe (a) documents covered in their scope (b) form in which the documents would be kept/archived, (c) period for which the documents would be retained (d) how these documents can be accessed when needed. SAIs may see whether policies and procedures exist for documentation retention and, in case they have such policies, they should see if these are adequate. In case of inadequacies, SAIs may consider establishing documentation requirements through policies and procedures for the retention of audit documentation. These requirements may be due to the historical significance of certain types of documents which, for example, may require indefinite retention in the

country's national archives. There may also be additional requirements related to national security classifications, including how documentation is stored. Public sector auditors familiarize themselves with applicable legislation in regard to retention of documentation<sup>[13]</sup>.

### 6.2.4 Confidentiality and Transparency Issues<sup>[14]</sup>

SAIs need to establish and ensure that auditors comply with ethical requirements to observe at all times the confidentiality of information contained in audit documentation, unless specific authority has been given by the entity to disclose such information, or there is a legal or professional duty to do so. There is an ongoing need in the public sector to balance confidentiality with the need for transparency and accountability. The balance between confidentiality and transparency requires professional judgment to ensure that documentation of a confidential nature is clearly identified and treated as such, while at the same time granting access as appropriate. It is therefore important to be familiar with the SAIs' policies and procedures addressing confidentiality. Such procedures might include types of audit documentation to be considered confidential, types of audit documentation to be made available to the public, clearly defined lines of responsibility for authorizing disclosure of audit documentation and routines for making such information available if required. Furthermore, public sector auditors may have additional statutory responsibilities related to confidentiality. These responsibilities may be based on the mandate of SAIs or legislation related to official secrets or privacy. Such legislation, for example, could relate to audits of defense, health, social service or tax agencies. Public sector auditors familiarize themselves with the particular local requirements related to confidentiality to which they are bound.

<sup>[12]</sup> ISSAI 400.48

<sup>[13]</sup> Practice Notes ISSAI 1230

<sup>[14]</sup> Practice Notes, ISSAI 1230



Public sector auditors also familiarize themselves with any legislation that grants public access to audit correspondence, for example where electronic or other post journals are open to public scrutiny. This type of correspondence may include letters to and from the audited entity, or other parties, related to the gathering of audit evidence, as well as considerations and judgments related to audit issues. It is not unusual in the public sector to have to respond to requests from outside parties to obtain access to audit documentation. This can be especially sensitive when the outside party attempts to obtain information indirectly from the audit organization that it is unable to obtain directly from the audited entity.

As a matter of principle, when the audited entity has a statutory obligation to gather and retain certain information, requests from outside parties for such information are normally referred to the audited entity. In situations where public sector auditors consider granting access to audit documentation, they normally consult with relevant parties (such as the audited entity to whom the request relates) prior to the information being disclosed.

In some environments, public sector audit work is contracted out by the SAIs to other auditors. The acceptance of such appointments normally requires the auditor performing the work to acknowledge that audit documentation may be subject to inspection by the Supreme Audit Institution that appointed the auditor. The audit documentation may also be subject to inspection by review agencies that have statutory rights of access to information relevant to the auditor's duties.

## 6.3 COMMUNICATION

### The Role of Communication

Communication takes place at all audit stages; before the audit starts, during initial planning, during the audit proper, and at the reporting phase. Any significant difficulties encountered during the audit, as well as instances of material non-compliance should be communicated to the appropriate level of management or those charged with governance. The auditor should also inform the responsible party of the audit criteria<sup>[15]</sup>.

Good communication with the audited entity throughout the audit process may help make the process more effective and constructive. Effective two-way communication is important in assisting<sup>[16]</sup>:

- a. The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;
- b. Public sector auditors need to be particularly sensitive to meet the needs and expectations of the legislature or appropriate regulators about matters communicated to other governance levels, particularly where the matters may be of broad public interest or speculation.
- c. The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events.

### The Communication Process

SAIs need to have a system in place to see that requires the auditor to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If the two-way communication is not adequate, it is advised that the auditor take appropriate action. In the public sector, appropriate action may include communicating with the legislature or the appropriate regulators, or funding agencies.

<sup>[15]</sup> ISSAI 400.49

<sup>[16]</sup> ISSAI 1260.4



Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice<sup>[17]</sup>.

Communication takes place at various phases and at various levels<sup>[18]</sup>.

### 6.3.1 Communication at the Planning Phase:

Auditors interact with the appropriate level of management and those charged with governance considering relevant provisions of laws that govern such interaction. Key points that may be reviewed with the audited entity include:

- i. Overall audit strategy;
- ii. Timing and duration of the audit;
- iii. Responsibilities of auditors and the audited entity. Usually, a focal person is notified by the audited entity who is available to provide necessary information and support throughout audit;
- iv. Audit criteria. In cases where such criteria are not straight forward, auditors need to review and agree on criteria in consultation with management.

### 6.3.2 Communication at the Gathering Evidence Phase

While gathering evidence for their findings, auditors' interaction with the audited entity becomes extremely critical. As stressed above, the quality of audit depends on the sufficiency and appropriateness of audit evidence. Auditors maintaining good communication with the audited entity are better placed to review initial findings with the relevant officials in the audited entity, firm up their findings, and gather sufficient appropriate evidence in support.

For the audited entity as well, continuous interaction helps in identifying weak areas and taking steps toward rectification. Any significant difficulties encountered during the audit, as well as instances of material non-compliance are promptly communicated to the

appropriate level of management, or to those charged with governance. Though different SAIs may have different approaches for communication with the audited entity, it may be desirable to communicate all identified instances of non-compliance to management so that the management can take appropriate actions.

### 6.3.3 Communication at the Reporting and Follow-Up Phase:

Auditors are required to prepare a written report for the intended users. The practice of finalizing report may differ from SAI to SAI but some SAIs obtain and incorporate the views of management in the report. This allows the intended users to look at management's viewpoint while reviewing auditors' report.

Some SAIs can, according to their audit mandate, order the audited entity to correct identified instances of non-compliance. In doing so, public sector auditors determine whether their independence and objectivity will be impaired, and take appropriate action to avoid such impairment.

<sup>[17]</sup> ISSAI 1260, 7

<sup>[18]</sup> ISSAI 4100.115, 116





## 6.4 CONCLUSION

This chapter focuses on importance of documentation and communication in the audit process. The auditor should always prepare relevant audit documentation for the particular audit before the audit report is issued. Also auditors should use their professional judgment to determine the form and content of the communication. Written communication is preferred as it facilitates proper documentation of the interaction. In the next chapter on reporting a compliance audit we will show how the results of gathering and evaluation of evidence is reflected in compliance audit reports.



## **Chapter 7:**

# **Reporting a Compliance Audit**



## 7.1 INTRODUCTION

This chapter covers the reporting phase of the audit process and focuses on the form and content of the compliance audit report. It also covers the audit follow up. The previous chapters shed light on the techniques and methods of gathering and evaluating the audit evidence, forming conclusions, and the importance of documentation and communication in the audit process. The actions taken by the auditor to reduce audit risk and thus ensuring that the conclusion or opinion is appropriate in the circumstances of the audit is critical to the entire audit process. This assurance in effect forms the basis for the compliance audit report.

## 7.2 REPORTING A COMPLIANCE AUDIT

Reporting is an essential part of any public sector audit and involves reporting the deviations from and violations of the applicable authorities so that corrective actions may be taken, and those responsible for such deviations or violations could be held accountable for their actions.

The report, also, is the most important product of the audit, as the SAI formally presents the results of its audit to the intended users, and other relevant users on the responsible party's compliance with the stated criteria. The report provides an avenue for the responsible party to take corrective action towards addressing instances of non-compliance and for the auditor to facilitate follow-up of its findings and where appropriate to take corrective action.

The ISSAIs on compliance audit entail that a written report, setting out findings in an appropriate form, be prepared at the end of each audit. To ensure that such report is in accordance with acceptable standards of quality and relevant to all users, it should conform to the principles of completeness, objectivity, timeliness and contradictory process, both in its form and content.

- *Completeness* requires the auditor to consider all relevant audit evidence before issuing the report.
- *Objectivity* requires the auditor to apply professional judgment and skepticism to ensure that all reports are factually correct and that

findings and conclusions are presented in a relevant and balanced manner.

- *Timeliness* requires the auditor to report in due time when the findings are applicable and can be relevant to the intended users.
- *Contradictory* process requires the auditor to check the accuracy of facts with the audited entity and incorporate responses from responsible officials as appropriate.

Additionally, reports should be easy to understand, free from vagueness or ambiguity, concise and logical. The SAI has a number of options on how to report on compliance audits: to issue long or short reports, to form conclusions or opinions. However, in arriving at a decision on how to report the auditor is expected to consider the following factors:

- User's needs
- SAI Mandate
- Relevant legislation and regulation
- The level of assurance provided
- Type of engagement
- Customary reporting practice
- Complexity of the reported issues

This list is not exhaustive, while deciding on the length and structure of their compliance audit reports SAIs need to consider the environment in which they are operating.



## 7.3 FORMS OF A COMPLIANCE AUDIT REPORT

In compliance audit there is *short form* or *long form* style of reporting to facilitate effective communication to the intended users. Depending on the circumstances and factors mentioned above, the SAI prepares either a short or a long form report.

*Long form* reports, sometimes referred to as 'compliance audit special reports', include other information and explanations that are not intended to affect the auditor's conclusion. In addition to the basic elements, long-form reports may describe in detail the terms of the engagement, the criteria being used, findings relating to particular aspects of the engagement, details of the qualifications and experience of the auditor and others involved with the engagement, disclosure of materiality levels, and, in some cases, recommendations.

*Short-form* reports ordinarily include only the basic elements. Short form reports are more condensed and generally written in a more standardized format. The auditor may find it helpful to consider the significance of providing such information to the information needs of the intended users.

In cases where the mandate of the SAI establishes a form of reporting that differs from the compliance audit guidelines, the guidelines may, nonetheless, be useful to public sector auditors and may be applied, adapted as appropriate in the particular circumstances.[1]

## 7.4 CONTENT OF A COMPLIANCE AUDIT REPORT

In general the compliance audit report should include the following elements; however, it may not necessarily be in the order given hereunder:

- a. Title
- b. Addressee
- c. Scope of the audit, including the time period covered
- d. Identification or description of the subject matter
- e. Identified criteria

- f. Identification of the auditing standards applied in performing the work
- g. A summary of the work performed
- h. Findings
- i. A conclusion/opinion
- j. Responses from the audited entity (as appropriate)
- k. Recommendations (as appropriate)
- l. Report date
- m. Signature[2]

The following are brief explanations on specific sections of the report.

### a. Title:

The title should briefly give a picture of the audit scope for an outside reader.

### b. Addressee:

An addressee identifies the party or parties to whom the audit report is directed. The audit report is ordinarily addressed to the responsible party, but in some cases there may be other intended users.

### c. Scope of the audit, including the time period covered

The introduction part of the report sets out the audit scope in the form of a clear statement of the focus, extent and limits of the audit in terms of the subject matter's compliance with the criteria, The introduction also includes the time period covered by the audit.

### d. Identification and description of the subject matter[3]

Subject matter refers to the information, condition or activity that is measured or evaluated against certain criteria. This should be clearly described in the audit report.

[1] ISSAI 4100 paragraph 142.

[2] ISSAI 400, 59

[3] ISSAI 100.26



### e. Identified Criteria<sup>[4]</sup>

The criteria against which the subject matter is assessed should be identified in the auditor's report. Clear identification of the criteria in the report is therefore important so that the users of the report can understand the basis for public sector auditors' work and conclusions. The criteria may be included in the report itself, or the report may make reference to the criteria if they are contained in an assertion from management or otherwise available from a readily accessible and reliable source.

In cases where the criteria are not readily identifiable, or have had to be derived from relevant sources, the criteria applied in the audit are clearly stated in the relevant section of the auditor's report. In cases where the criteria are conflicting, the conflict is explained. In such a case, the potential consequences of the situation are explained to the extent possible and recommendations are provided as appropriate.

It may be relevant in the circumstances to disclose:

- The source of the applicable criteria, and whether or not the applicable criteria are embodied in law or regulation, or issued by authorized or recognized bodies of experts that follow a transparent due process, that is, whether they are established criteria in the context of the underlying subject matter (and if they are not, a description of why they are considered suitable).
- Measurement or evaluation methods used when the applicable criteria allow for choice between a number of methods.

Any significant interpretations made in applying the applicable criteria in the engagement circumstances.

### f. Identification of the auditing standards applied in performing the work

Where an SAI's auditing standards are based on or consistent with the INTOSAI Fundamental Auditing Principles, these may be referred to in audit reports by stating:

*... We conducted our audit in accordance with [standards], which are based on [or consistent with] the Fundamental Auditing Principles (ISSAIs 100-999) of the International Standards of Supreme Audit Institutions.*

SAIs in some jurisdictions may choose to adopt the Compliance Audit Guidelines as the authoritative standards for their work. In this case, reference may be made by stating:

*... We conducted our [compliance] audit[s] in accordance with the International Standards of Supreme Audit Institutions [on compliance auditing].*

The reference may be included in the audit report or communicated by the SAI in a more general form covering a defined range of engagements.

Identifying relative responsibilities informs the intended users that the responsible party is responsible for the underlying subject matter, that the measurer or evaluator is responsible for the measurement or evaluation of the underlying subject matter against the applicable criteria, and that the auditor's role is to independently express a conclusion about the subject matter information.

### g. A summary of the work performed

The summary of the work performed helps the intended users understand the auditor's conclusion. For many audits, infinite variations in procedures are possible in theory. In practice, however, these are difficult to communicate clearly and unambiguously. Hence, the summary of the work performed should give a brief explanation for an outside reader of how the audit was performed.

Factors to consider in determining the level of detail to be provided in the summary of the work performed may include:

- Circumstances specific to the entity (e.g. the differing nature of the entity's activities compared to those typical in the sector).
- Specific audit circumstances affecting the nature and extent of the procedures performed.

<sup>[4]</sup> ISSAI 4100/4200., section 9.1.1.1.



- The intended users’ expectations of the level of detail to be provided in the report, based on market practice, or applicable law or regulation.

It is important that the summary is written in an objective way that allows intended users to understand the work done as the basis for the auditor’s conclusion. However, it needs to be ensured that the summary is not so brief that it makes it difficult to understand the work of auditors especially how they have arrived at a conclusion or opinion.

**h. Findings**

The findings section comprises the auditor's description of the gathered evidence compared with the criteria. It is structured in a logical manner, based on the identified criteria in a way that assists the reader in following the logical flow of a particular argument. When significant amounts of data are included to support audit findings, such data may be more appropriately included in appendices.

**i. A conclusion/opinion**

The auditor's report on compliance subject matters normally contains a conclusion based on the audit work performed. When compliance audit is performed together with the audit of financial statements, the conclusion may take the form of an opinion (see Opinion). The conclusion may also be expressed as a more elaborated answer to specific audit questions[5]. The nature of the wording may be influenced by the mandate of the SAI and the legal framework under which the audit is conducted[6].

Next section explains in detail about the auditor’s conclusion/opinion in a compliance audit.

**j. Responses from the Audited Entity (as appropriate)**

Incorporating responses from the audited entity by reporting the views of officials of the responsible party is part of the principle of contradiction. The principle of contradiction is a unique and important feature of public sector auditing. It relates to the presentation of weaknesses or critical findings in such a way as to encourage correction. This involves agreeing the facts with the audited entity to help ensure that they are complete, accurate and fairly presented. It may also involve, as appropriate, incorporating the audited

entity's response to matters raised, whether verbatim or in summary.

**k. Recommendations (as appropriate)**

The auditor's report may include, as appropriate, recommendations designed to result in improvements. While such recommendations may be constructive for the audited entity, they should not be of such a detailed nature that the public sector auditor's objectivity may be impaired in future audits. If the auditor makes a specific recommendation and the responsible party does not implement that particular recommendation but considers another option, the auditor may in subsequent audits be tempted to judge this as non-compliance. In such instances, the key is to determine whether broad recommendations leaves the scope for the entity to use whatever mechanism it considers suitable in the circumstances to achieve compliance.

**l. Report Date**

The compliance audit report should be dated and signed. The auditor should ensure that the report is not to be dated before he or she has obtained sufficient and appropriate audit evidence to support the conclusion.

**m. Signature**

The compliance audit report should be signed by someone with appropriate authority to do so, namely the Head of the SAI, or someone to whom authority has been so delegated.

As mentioned earlier section of this chapter, the auditor may decide to produce a long form report for various reasons depending on the need of the users or the specific objectives of a particular audit. The long form report, also known as a special report, follows the same basic structure as the short form report, however, there are some slight variations. Two noted differences are the inclusion of an Executive Summary and the structure of the observations and findings.

[5] ISSAI 4100/4200, section 4 definitions.

[6] ISSAI 4100/4200, section. 9.1.1.2.





## 7.5 CONCLUSIONS/OPINIONS IN COMPLIANCE AUDIT

Compliance audit reporting may vary depending on the various forms of *conclusions* and brief standardized *opinions*. When compliance audit is performed together with the audit of financial statements, the conclusion may take the form of a clear written statement of *opinion on compliance*. When this occurs, the opinion on compliance is clearly set apart from the *opinion on the financial statements*. Regardless of the type of engagement or the level of assurance given, the auditor can decide on whether to issue a conclusion or an opinion and this should be clearly and explicitly stated.

The conclusions/opinions should have a direct link to the subject matter and the evidence gathered. They may clarify and add meaning to specific findings in the report. Deviations from criteria should logically flow from the findings. Conclusions/opinions go beyond merely restating the evidence. Whereas the audit findings are identified by comparing what should be (assessment criteria) to what is actually happening (conditions based on audit evidence), the conclusions/opinions reflect the SAI's summary and opinions based on these findings. Conclusions/opinions might include identifying a general topic or a certain pattern in the findings.

As mentioned above the conclusion may take the form of a clear written statement of opinion on compliance, often in addition to the opinion on the financial statements. It may also be expressed as a more elaborate answer to specific audit questions. While an opinion is common in attestation engagements, the answering of specific audit questions is more often used in direct reporting engagements. Where an opinion is provided the auditor should state whether it is unmodified or has been modified on the basis of the evaluation of materiality and pervasiveness. Delivering an opinion would normally require a more elaborate audit strategy and approach[7].

The concepts of direct reporting engagements and attestation engagements were introduced in the chapter highlighting Main Concepts. In both types of engagements, the final output is the compliance report. In the attestation engagement the auditor is provided with the subject matter information and as such

expresses a conclusion/opinion on whether the assertions made by the responsible party are correct or not. The auditor may provide limited or reasonable assurance for an attestation engagement. On the other hand in the direct reporting engagement, the auditor conducts the audit based on the criteria and subject matter that has been identified by the SAI. Again, the conclusion/opinion can be a limited or reasonable assurance.

Regardless of the type of engagement, the report should clearly state any limitation of scope, relevance of the criteria and the level of assurance provided. It is to be noted that while an opinion is common in attestation engagements, it does not necessarily mean that only opinions can be modified or unmodified. ISSAI 4100 says that conclusions (not opinions) can also be modified or unmodified which have been illustrated with examples in this section. These conclusions can be similar to opinions, but can also be the answers to the specific questions.

### 7.5.1 Conclusions/opinions in reasonable and limited assurance engagements:

In forming conclusions and opinions, the auditor considers the level of assurance provided:

**Reasonable assurance:** Here the audit conclusion/opinion is expressed positively, conveying that, in the auditor's opinion, the subject matter is or is not compliant in all material respects, or, where relevant, that the subject matter information provides a true and fair view, in accordance with the applicable criteria.

Examples of conclusions expressed in a form appropriate for a reasonable assurance engagement include:

- When expressed in terms of the underlying subject matter and the applicable criteria, "In our opinion, the entity has complied, in all material respects, with criteria";

[7] ISSAI 400.59



- When expressed in terms of the subject matter information and the applicable criteria, “In our opinion, the forecast of the entity’s activity is properly prepared, in all material respects, based on criteria”;

**Limited assurance** - the audit opinion/conclusion states that based on the procedures performed, nothing has come to the auditor’s attention to cause the auditor to believe that the subject matter is not in compliance with the applicable criteria. The procedures performed in a limited assurance audit are limited compared with what is necessary to obtain reasonable assurance, but the level of assurance is expected, in the auditor's professional judgment, to be meaningful to the intended users. A limited assurance report conveys the limited nature of the assurance provided.

Examples of conclusions expressed in a form appropriate for a limited assurance engagement include:

- When expressed in terms of the underlying subject matter and the applicable criteria, “Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe that [the entity] has not complied, in all material respects, with criteria.”
- When expressed in terms of the subject matter information and the applicable criteria, “Based on the procedures performed and evidence obtained, we are not aware of any material amendments that need to be made to the assessment of key performance indicators for them to be in accordance with criteria.”

As explained above, the compliance reporting form may vary widely; however, consistency in the reporting format may help users to understand the work performed and the conclusions reached as well as to identify unusual circumstances when they arise. This, in turn, facilitates the quality of decision making based on audit reporting. The following short form report examples can be used by auditors when expressing the opinions/ conclusions:

## 7.5.2 Unmodified conclusion/opinion

When the auditor has no instances of material non-compliance to report the auditor expresses an unmodified conclusion when the auditor concludes: In the case of a reasonable assurance engagement, that the subject matter information is prepared, in all material respects, in accordance with the applicable criteria; or

In the case of a limited assurance engagement, that, based on the procedures performed and evidence obtained, no matter(s) has come to the attention of the auditor that causes the auditor to believe that the subject matter information is not prepared, in all material respects, in accordance with the applicable criteria.

### Example of Unmodified conclusion:

In this example, the compliance subject matter relates to the national tax office, and the audit revealed no instance of non-compliance with the relevant act. The introductory sections on management's and the auditor's responsibilities, and final sections of the report are similar to those set out in the example given at section 7.6 of this chapter.

The following short form report example is for illustrative purposes only. Some SAIs may use a long form report where findings are described in more detail in the body of the report.

..... [appropriate introductory sections of the report]...

[We have audited National Tax Office's compliance with the Value Added Tax Act CAP 223A dated xx.xx.20XX.]

**Unmodified Conclusion**

Based on the audit work performed, we found that, the National Tax Office is in compliance, in all material respects with the Value Added Tax Act CAP 223A.

..... [appropriate concluding sections of the report].....



### 7.5.3 Modified conclusion/opinion

Public sector auditors modify their conclusions appropriately [8] in cases of:

- a. Material instances of non-compliance. Depending on the extent of the noncompliance, this may result in:
  - i. A qualified opinion or conclusion (*'Based on the audit work performed, we found that, except for [describe exception], the audited entity's subject matter information is in compliance, in all material respects with [the applied criteria]...'*), or
  - ii. An adverse opinion or conclusion (*'Based on the audit work performed, we found that the subject matter information is not in compliance...'*); or
- b. Scope limitation. Depending on the extent of the limitation, this may result in:
  - i. A qualified opinion or conclusion (*'Based on the audit work performed, we found that, except for [describe exception], the audited entity's subject matter information is in compliance, in all material respects with [the applied criteria]...'*), or
  - ii. A disclaimer (*'Based on the audit work performed, we are unable to, and therefore do not express a conclusion...'*)

### 7.5.4 Qualified conclusion/opinion

The auditor expresses a qualified conclusion when, in the auditor's professional judgment, the effects, or possible effects, of a matter are not so material so as to warrant an adverse conclusion or a disclaimer of conclusion. When compliance audit is performed together with financial statements the auditor may express a qualified opinion when compliance deviations are material, but not pervasive, or if the auditor is unable to obtain sufficient, appropriate audit evidence, and the possible effects are material, but not pervasive).[9]

### Example of a Qualified Compliance Audit Conclusion:

In this example, the compliance subject matter relates to the national tax office, and the audit revealed an instance of non-compliance which resulted in additional charges and penalties to the audited entity. The compliance deviation is not so material so as to warrant an adverse conclusion. The introductory sections on management's and the auditor's responsibilities, and final sections of the report are similar to those set out in the example given at section 7.6 of this chapter.

The following short form report example is for illustrative purposes only. Some SAIs may use a long form report where findings are described in more detail in the body of the report.

..... [appropriate introductory sections of the report].....

[We have audited National Tax Office's compliance with the Value Added Tax Act CAP 223A dated xx.xx.20XX.]

#### **Basis for Qualified conclusion/opinion**

The VAT legislation requires that the National Tax Office send quarterly reports to Parliament. Reports were not prepared for the period April 1 – June 30 2013.

#### **Qualified conclusion/opinion**

Based on the audit performed, we found that, except for the instance of non-compliance noted in the Basis for the Qualified Conclusion paragraph, the National Tax Office is in compliance, in all material respects with the Value Added Tax Act CAP 223A.

..... [appropriate concluding sections of the report].....

[8] ISSAI 4200.156

[9] ISSAI 4200.169a



### 7.5.5 Adverse conclusion/opinion

When public sector auditors conclude that there are material compliance deviations, the opinion expressed<sup>[10]</sup> is either:

- a. Qualified (if compliance deviations are material, but not pervasive, or if public sector auditors are unable to obtain sufficient, appropriate audit evidence, and the possible effects are material, but not pervasive); or
- b. Adverse (if compliance deviations are material and pervasive).

The auditor obtained sufficient and appropriate audit evidence, concludes that compliance deviations whether individually or aggregate are both material and pervasive.

**Example of an Adverse Compliance Audit Conclusion:**

In this example, the compliance subject matter relates to the national tax office, and the audit revealed that measures were not implemented for the delinquent taxpayers by the tax office as stipulated in the Act. The compliance deviation is considered to be material. The introductory sections on management's and the auditor's responsibilities, and final sections of the report are similar to those set out in the example given at section 7.6 of this chapter.

The following short form report example is for illustrative purposes only. Some SAIs may use a long form report where findings are described in more detail in the body of the report.

..... [appropriate introductory sections of the report].....

[We have audited National Tax Office's compliance with the Value Added Tax Act CAP 223A dated xx.xx.20XX.]

**Basis for the Adverse conclusion/opinion**

The VAT legislation states that seizures and garnishing for non-compliance should be applied to delinquent taxpayers who owe more than \$10,000.00 in arrears. Although there were instances of delinquent taxpayers in that category, these measures were not implemented as stipulated in the Act.

**Adverse Conclusion**

Based on the audit work performed, we found that, because of the significance of the matter noted in the Basis for the Adverse Conclusion paragraph above, the National Tax Office is not in compliance, in all material respects, with the Value Added Tax Act CAP 223A.

..... [appropriate concluding sections of the report].....

### 7.5.7 Disclaimer conclusion/opinion

When public sector auditors are unable to obtain sufficient, appropriate audit evidence on compliance with authorities, and the possible effects are material and pervasive, public sector auditors disclaim an opinion on compliance<sup>[11]</sup>.

The auditor is unable to obtain sufficient and appropriate audit evidence due to an uncertainty or scope limitation which is both material and pervasive.

**Example of a Compliance Audit Disclaimer**

A disclaimer is issued when the public sector auditor has not been able to reach a conclusion. In this example, a compliance audit was to be conducted on National Tax Office's compliance with the Value Added Tax Act CAP 223A. The individual taxpayer's files for Value Added Tax were not properly maintained by the respective office; also only 20 of the 200 registered taxpayers had complete files containing assessments. The introductory sections on management's and the auditor's responsibilities, and final sections of the report are similar to those set out in the example given at section 7.6 of this chapter.

<sup>[10]</sup> ISSAI 4200.169 b.



The following short form report example is for illustrative purposes only. Some SAIs may use a long form report where findings are described in more detail in the body of the report.

..... [appropriate introductory sections of the report].....

[We have audited National Tax Office's compliance with the Value Added Tax Act CAP 223A dated xx.xx.20XX.]

**Basis for the Disclaimer**

The individual taxpayer's files containing information on assessment for Value Added Tax were not properly maintained by the National Tax Office. Only 20 of the 200 registered taxpayers had complete files containing assessments. There were no other reliable procedures we could conduct to determine if the National Tax Office was in compliance with the VAT Act with regard to assessing taxpayers.

**Disclaimer**

Based on the audit work performed, because of the significance of the matter noted in the Basis for the Disclaimer paragraph above, we are unable to and therefore do not express a conclusion on the National Tax Office's compliance with the stipulations of the VAT Act.

..... [appropriate concluding sections of the report].....

### 7.5.6 Emphasis of Matter and Other Matter

In some situations there may be a need to elaborate on particular matters which do not affect the compliance conclusion but it is important to mention as it came to auditor's attention. In such circumstances an Emphasis of Matters or Other Matters paragraph is used by the auditor. Decision on whether to put an Emphasis of Matter and Other Matter paragraph is dependent on whether the particular matter is presented or disclosed in the subject matter or not, as explained below.

**An Emphasis of Matter paragraph:**

If the auditor considers it necessary to draw intended users' attention to a *matter presented or disclosed* in the subject matter information that, in the auditor's judgment, is of such importance that it is fundamental to intended users' understanding of the subject matter

information, auditor add an Emphasis of Matter paragraph.

**An Other Matter paragraph:**

If the auditor considers it necessary to communicate *a matter other than those that are presented or disclosed* in the subject matter information that, in the auditor's judgment, is relevant to intended users' understanding of the audit, the auditor's responsibilities or the audit report, auditor add an Other Matter paragraph.

In case of Other matter, the auditor need to clearly indicate in a paragraph in the report, with an appropriate heading, that the auditor's conclusion is not modified in respect of the matter. In the case of an Emphasis of Matter paragraph, such a paragraph shall refer only to information presented or disclosed in the subject matter information. The following example is for illustrative purposes only.

**Example of an Emphasis of Matter and Other Matter (s) Paragraph**

The introductory sections on management's and the auditor's responsibilities, and final sections of the report are similar to those set out in the example given at section 6.6.

..... [appropriate introductory sections of the report]...

**Conclusion**

Based on the audit work performed, we found that, the National Tax Office is in compliance, in all material respects with the Value Added Tax Act CAP 223A.

**Emphasis of Matter**

We draw attention to Note xx to the accounts which details total administrative costs of \$xxxx.xx related to the agency's reporting on compliance with the terms of the funding agreement. Our conclusion has not been qualified in respect of this matter.

**Other Matter**

We draw attention to the fact that this report has been prepared for the use of Donor Organisation XYZ and may therefore not be suitable for another purpose.

..... [appropriate concluding sections of the report] ....





## 7.6 EXAMPLE OF A 'SHORT FORM' COMPLIANCE AUDIT REPORT

As explained earlier, the format of compliance audit reports may vary depending on a number of factors, such as the mandate of the SAI, relevant legislation, customary reporting practices or the complexity of issues being reported. However, some consistency in the reporting format may help users of the auditor's report to understand the work performed and the conclusions reached, as well as to identify unusual circumstances when they arise.

The following short form report example is for illustrative purposes only. Some SAIs may use a long form report where findings are described in more detail in the body of the report.

### Compliance Audit Report by the SAI of XXX

[Appropriate Addressee, e.g. Donor Organisation XYZ]

Report on [Government Agency ABC's Compliance with the Terms of the Funding Agreement with Donor Organisation XYZ dated xx.xx.20XX]

We have audited [government agency ABC's compliance with the terms of the funding agreement with donor organisation XYZ dated xx.xx.20XX as set out the project accounts for the year ended 31.12.20XX showing total expenditures of \$ xxxxxx.xx].

#### *Management's Responsibility*

According to [the terms of the funding agreement with donor organisation XYZ dated xx.xx.20XX], management of government agency ABC is responsible for [preparing complete project accounts in compliance with the terms of the funding agreement].

#### *Auditor's Responsibility*

Our responsibility is to independently express a conclusion on [the project accounts] based on our audit. Our work was conducted in accordance with the [INTOSAI Fundamental Auditing Principles and Guidelines for Compliance Audit]. Those principles require that we comply with ethical requirements and plan and perform the audit so as to obtain reasonable assurance as to whether [the use of the project funds are in compliance, in all material respects, with the terms of the funding agreement dated xx.xx.20XX].

An audit involves performing procedures to obtain sufficient appropriate evidence to support our conclusion. The procedures performed depend on the auditor's professional judgment, including assessing the risk of material non-compliance, whether due to fraud or error. The audit procedures performed are those we believe are appropriate in the circumstances. We believe that the audit evidence gathered is sufficient and appropriate to provide the basis for our conclusion.

#### *Conclusion*

Based on the audit work performed, we found that [government agency ABC's use of project funds received from donor organisation XYZ] is in compliance, in all material respects, with [the terms of the funding agreement dated xx.xx.20XX].

[Responses from the audited entity as appropriate, for example in summary under a heading 'Responses from the Audited Entity,' or as an appendix]

[Recommendations as appropriate, for example under a heading 'Recommendations' or as an appendix]

[Date of auditor's report]

[Auditor's signature]





## 7.7 AUDIT FOLLOW UP

Compliance auditing guidelines recommend that auditors should follow-up instances of non-compliance when appropriate.

The follow-up process is one in which the compliance auditor monitors, to ascertain whether and what corrective actions have been undertaken by the responsible party in addressing instances of non-compliance identified in a previous audit report/s. In instances where this is necessary, the SAI should follow-up on its recommendations to be able to provide the intended user with an update on the responsible party's actions and initiatives taken towards compliance.

It should be noted that the follow-up process may not be applicable in all instances and in all SAIs. The mandate of the SAI along with the nature of the audit will determine if follow-up is applicable.

### 7.7.1 Why to follow-up

The SAI has a role in monitoring actions taken by the responsible party in response to matters raised in an audit report. The need to follow-up previously reported instances of non-compliance would vary with the nature of the subject matter, the non-compliance identified and the particular circumstances of the audit. The follow-up process facilitates the effective implementation of corrective actions and provides useful feedback to the audited entity, the users of the report and the auditors in planning future audits.

Follow-up serves many purposes for the three parties. These include:

- For the responsible party:  
Demonstrates the audited entity's effectiveness in addressing the issues.
- For the intended user:  
Provides an update on what has been achieved by the responsible party and the existing gaps if any
- For the auditor:  
To assess the effectiveness of its work

### 7.7.2 What to follow-up

Follow up focuses on whether the audited entity has adequately addressed the matters raised, in a specific audit report.

Here are some examples of what to follow-up:

- Recommendations in the audit report
- Issues raised by intended users', example, Parliament, Public Accounts Committee or the Public.

It is important to note that the auditor may expand the scope to include other relevant aspects outside of its recommendations. The key here is to determine whether the entity complied with all the necessary directives.

### 7.7.3 When to follow-up

The decision as to when to follow up would be based on a number of factors. If the audit was a one off attestation engagement, then follow-up may not be necessary. However if auditors come out with significant deviation having implications for the citizens, even the audit engagement is one off, its results should be followed up.

If the engagement is a direct engagement and is conducted at specific periods then follow-up may be necessary.

The auditor should allow the responsible party sufficient time to implement the recommendations yet still ensure that the follow-up is relevant to the intended users. As a result, the auditor would exercise professional judgment in this regard.

Some SAIs may, depending on the frequency of an audit engagement, conduct follow-up procedures while performing current audits.

### 7.7.4 How to follow-up

SAIs may have established policies and procedures for conducting follow-up. The auditor may prepare an audit plan identifying the resources to be used, the recommendations and audit findings to be examined and timeframe in which to complete.



Some audit procedures that were used during the initial audit engagement may be applicable during the follow-up. The auditor should assess to determine adequacy of these procedures.

Other follow-up processes may include internal reviews and evaluations prepared by the audited entity or others.

Regardless of the form, the auditor should obtain sufficient and appropriate audit evidence to support the findings and conclusions.

The follow-up report could follow the same reporting lines as the audit engagement including submission to relevant intended users.

### 7.7.5 Decisions of the SAI

The SAI may decide, based on the results of the follow-up, to continue monitoring the implementation measures of the audited entity or it may take the decision to undertake an entirely new audit engagement. In audits carried out on a regular basis, the follow-up procedures may form part of the subsequent year's risk assessment.

## 7.8 CONCLUSION

This chapter focused on reporting which is the end product of the compliance audit. The audit report should be complete, objective and timely and subject to the contradictory process before being finalized. The chapter also highlighted the considerations when issuing a conclusion/opinion and the types of reports and conclusions/opinions.

Specific parts of short form reports were highlighted and explained. Finally the concept of follow-up especially when and how it should be done has been explained. Influencing factors such as the type of engagement and the SAI's policy on follow-up would determine how and when follow-up is undertaken.

The focus on this handbook up to now has been to expose the participants to the important considerations in carrying out compliance audit. We are now ready to move to next chapter that shows how SAIs may take concrete steps toward implementing compliance audit ISSAIs.



## **Chapter 8:**

# **Implementation Strategies for Compliance Audit ISSAIs**



## 8.1 INTRODUCTION

Implementation of ISSAIs is a strategic shift in the SAI that requires strategic and institutional considerations by the SAI management. So, before undertaking the implementation initiative it is therefore advisable to examine some key considerations that are related to the SAI's operations. These considerations are, e.g. the mandate of the SAI, its user expectations, resources available to the SAI, environment under which the SAI is operating, its existing audit practices etc. Only after examining these issues thoroughly the SAI would be in a position to realistically ascertain and decide on whether it would like to refer to ISSAIs in its compliance audit (as such other types of audit as well). If the answer is yes, then it will need to know how it can do that, and develop the implementation strategy which is discussed in this chapter.

### 8.1.1 Compliance Audit ISSAI Implementation Strategy

SAIs can use the ISSAIs at Level 3 i.e. the fundamental principles of compliance auditing to establish its national standards based on which it conducts audit or use level 4 ISSAIs. When conducting audits SAIs need to declare which standards they apply in their audits. The SAI may declare that, in their audit they have applied their national standards which it has developed or adopted are based on or are consistent with the Level 3 ISSAIs. However, they can claim that only if their national standards fully comply with all relevant principles of the ISSAIs. In such cases their audit reports may include a reference to the fact that the national standards used were based on or consistent with the ISSAIs on fundamental principles of compliance auditing.

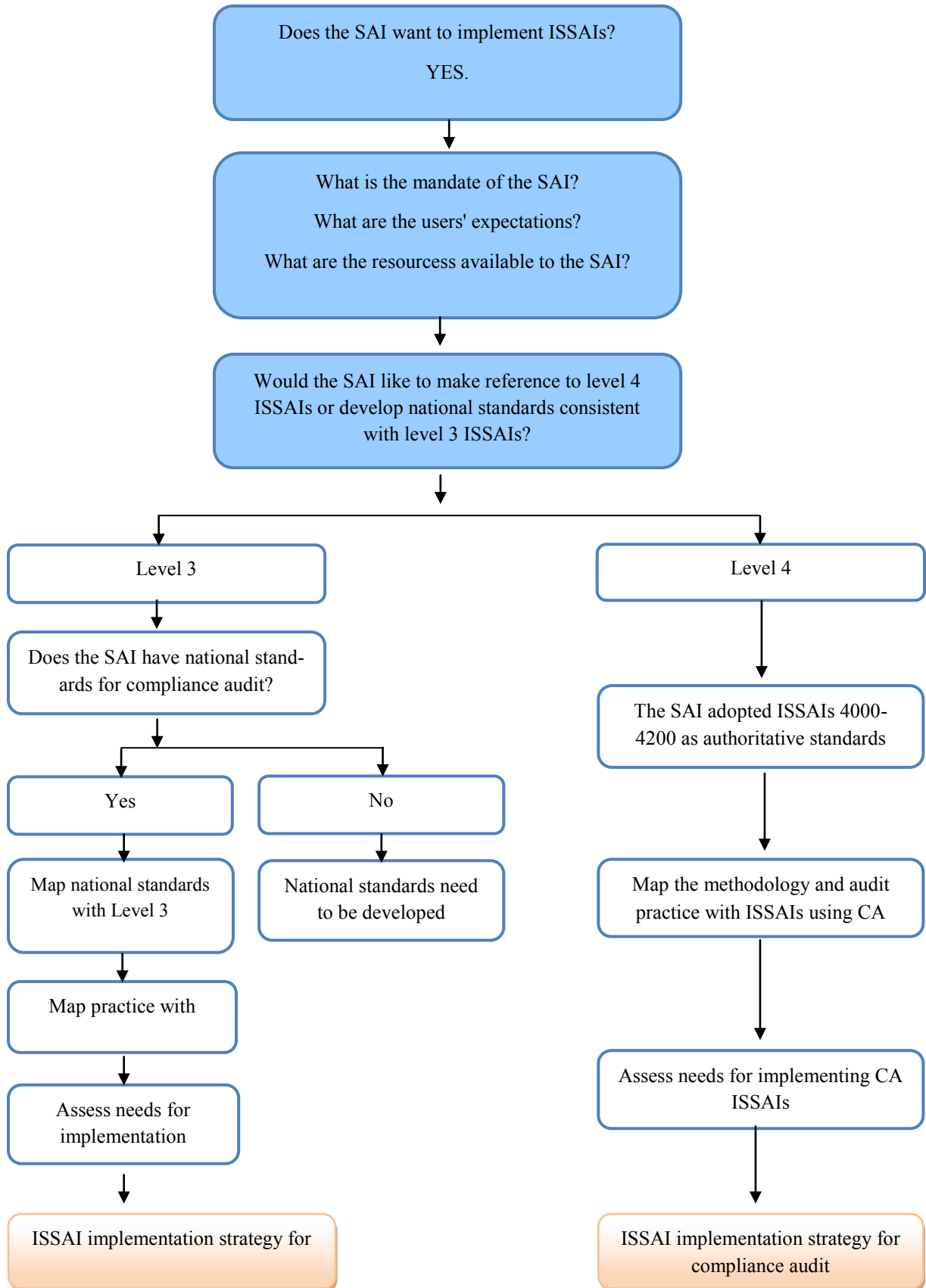
In other case, where the SAI intends to refer to ISSAIs at level 4, then the first step for the SAI would be to ascertain the respective compliance audit ISSAI requirements and assess the status of the SAI audit vis-a-vis the ISSAI requirements. Figure 8.1 provides a snapshot of this decision making process.

The guidance provided in this chapter is for SAIs that have decided to implement level 4 compliance audit ISSAIs i.e. it has adopted ISSAIs 4000-4200 as its authoritative standards. However, as explained above SAIs may also refer to their national standards which is consistent with fundamental principles of compliance

auditing. Though this guidance is limited to compliance audit ISSAI Implementation Strategy, guidance on the overall implementation of the ISSAI framework is planned for development as a separate document. Many SAIs have their strategic plan for a particular period and it is important for a SAI to integrate its ISSAI Implementation strategy for compliance audit with its overall strategy as set out in their own strategic plan.



Figure 8.1: Compliance audit ISSAI implementation decision process





As shown in Figure 8.1 when a SAI aims to implement ISSAIs and set an implementation strategy it needs to consider first, what is its mandate i.e. whether the respective law or act empowers the SAI to conduct compliance audit. If so, then in what form it is mentioned in the act that enables the SAI to conduct the different types of audits? Interpretation of the mandate is also very important, whether the mandate provides a broader scope to conclude that the different types of audit conducted by the SAI are within its authority and mandate.

Along with its mandate SAI also needs to ascertain what the users' expectations from the SAI are, what are the resources available to the SAI e.g. human and other resources, available competent and skilled workforce to carry out the audit professionally, and in what environment it is operating. Along with these aspects the SAI needs to address the key question – how it can refer to relevant ISSAIs in its audit report?

Before formulating an ISSAI implementation strategy for compliance audit SAI needs to decide how it would like to refer to the ISSAIs. The decision making process on two scenarios is illustrated in figure 8.1. As mentioned earlier if a SAI decides to refer to ISSAIs at level 3 it needs to have national standards for compliance audit that aligns with all the principles of ISSAI 400. If the SAI does not have such national standards, but wants to refer to level 3 of ISSAIs it needs to develop its own standards.

ISSAIs at level 3 i.e. the Fundamental Auditing Principles form the core of the General Auditing Guidelines at level 4 of the ISSAI framework. The level 3 principles can be used to establish authoritative standards in three ways:

- as a basis on which SAIs can develop standards;
- as a basis for the adoption of consistent national standards;
- as a basis for adoption of the General Auditing Guidelines as standards.

SAIs may choose to compile a single standard-setting document, a series of such documents or a combination of standard-setting and other authoritative documents.

The next step would be to map the national standards with the requirements of respective level 3 ISSAIs. While referring to ISSAIs at level 3, it is not enough to check that the national standards just follow Level 3 ISSAI requirements. It is equally important to ascertain that the SAI's audit is actually conducted as per the standards. Through this mapping a SAI will be able to identify needs by assessing the gaps in both standards and practice. An implementation strategy can then be formulated to address these issues.

Likewise, as portrayed in figure 8.1, if a SAI aims to refer to Level 4 compliance audit ISSAIs it can start by mapping its current compliance audit practice with ISSAI requirements at level 4. The compliance audit iCAT can be used for this purpose. The next section in this chapter provides guidance on development of an ISSAI Implementation Strategy for compliance audit based on the compliance audit iCAT.

### 8.1.2. ISSAI Implementation Strategy Framework

In integrating Level 4 ISSAIs in their auditing practices, a toolkit of step-by-step process has been developed to provide guidance to the SAIs. This process takes into account several factors that may lead different SAIs to adopt differing strategies in accordance with their mandate, national legislation and regulations. The proposed compliance audit ISSAI Implementation Strategy Framework (Figure 8.2) describes each step that the SAI may need to undergo to formulate ISSAI implementation strategies that are adapted to its nature and the environment.



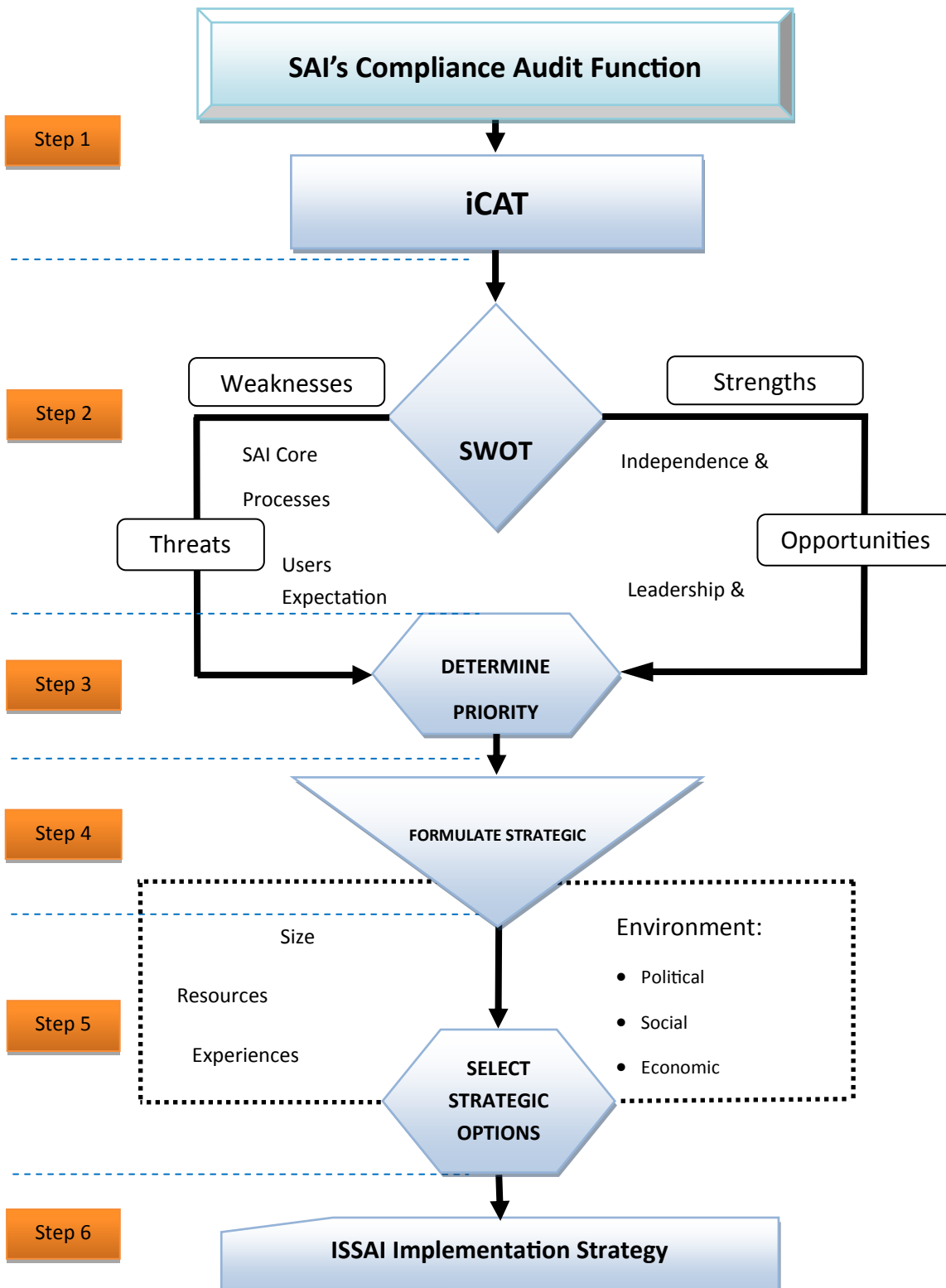


Figure 8.2 Compliance Audit ISSAI Implementation Strategy Framework



## 8.2 PROCESS FOR FORMULATING ISSAI IMPLEMENTATION STRATEGY

As shown in the Figure 8.2, there are several critical steps for the SAI to follow in order to formulate a robust and effective ISSAI implementation strategy that would result in sustainable implementation of the ISSAIs. These steps are:

- Step 1: Map SAI compliance audit practice against the ISSAI requirements
- Step 2: Conduct SWOT analysis
- Step 3: Determine the priority issues for the SAI
- Step 4: Identify strategic options to address the prioritised issues
- Step 5: Select strategic options for the SAI
- Step 6: Formulate compliance audit ISSAI implementation strategy

The six step process is explained below.

### Step 1: Map SAI compliance audit practice against the ISSAI requirements

The first step for the SAI is to map its existing compliance audit practice vis-a-vis the compliance audit ISSAI requirements. The compliance audit ISSAI Compliance Assessment Tool (iCAT) would help the SAI with this exercise. Through this SAI will be able to identify the causes for non-compliance and formulate the necessary actions required to be ISSAI compliant. It is important that the SAI conducts this exercise professionally and diligently as it forms a valuable input into formulating practical and implementable strategies.

*Note: In the 3i Programme, the IDI in collaboration with the three sub-committees of the INTOSAI Professional Standard Committee (PSC) and regional SAIs have trained a pool of ISSAI facilitators in select SAIs. Details of ISSAI Facilitators are available on the 3i Community portal: [www.idicommunity.org](http://www.idicommunity.org). The ISSAI Facilitators in each SAI can help the SAIs conduct the iCAT for their respective auditing practices. Therefore, SAIs are strongly encouraged to engage the trained facilitators to guide and assist the team conducting the iCAT.*



To better understand the six step process of figure 8.2 a simple and fictitious case study of SAI X is used as an illustrative example. The context of SAI X is as follows:

SAI X has a constitutional mandate to conduct financial, compliance and performance audits and has exclusive audit authority over all government agencies. It has an Audit Code which clarifies its constitutional powers and functions, organizational structure, audit jurisdiction.

The SAI has a Code of Ethics which is currently being updated. An Administrative Investigation Office has been created under the office of the SAI Head to conduct investigation of auditors' misbehaviour and violations against the Code of Ethics and the Anti-Corruption Law. Employees' submission of Statement of Assets and Liabilities is strictly enforced in the SAI.

The SAI also has a Continuing Education Centre which continuously provides role based or ladderised training to its personnel in various disciplines. Completing the courses in a particular ladder is required for promotion purposes. The SAI only recruits licensed professionals such as lawyers because of its quasi-judicial functions, Certified Public Accountants, engineers and other professionals who passed the Civil Service Examination.

The SAI awards its employees for commendable performance and for a number of years, its awardees have received national recognition by the head of state.

The auditing code requires that the audited agencies provide a permanent and adequate office space, operating funds and equipment for the SAI's audit teams (Resident audits). The code strictly prohibits audit teams from receiving more than these provisions from the audited entities. Violators are strictly dealt with, with penalties ranging from reprimand to termination with suspension of benefits.

Audit clusters or audit groups undergo an audit focusing process whereby high impact issues which are perceived to be existing in different agencies or where projects are implemented by various agencies are required by the Directors to be looked into simultaneously. When this is done, auditors complete templates for each phase of the audit starting with the understanding of the entity which is the basis for the identification of risks non compliance. Results of each template are linked to the templates for each phase till the audit reaches reporting phase.

While the review process is somewhat elaborate, SAI X has not yet operationalised the Quality Assurance Office to undertake an independent review of audit quality control processes. Just recently, an assessment of the SAI's compliance to the ISSAIs was conducted using the compliance audit iCAT. Partial results are shown below.

SAI X has decided to implement compliance audit ISSAIs at level 4. So, following the six step process its first task is to complete the mapping of its compliance audit practices against the ISSAI requirements.

*Note: The e-course delivered in October-December 2012 under the 3i Programme provided full guidance on conducting the complete mapping using the compliance audit iCAT.*

Table 8.1 below provides an illustration of some compliance audit ISSAI requirements used for the mapping the cases of compliance to the requirements against the audit practice of SAI X. Since it has been emphasized that the iCAT should be done considering what it really takes when a particular requirement is 'met' i.e. the SAI audit practice is in 'compliance' with the requirement. The example given here is for illustration only; it is not for carrying out the full mapping using the iCAT.



The table 8.1 below shows the assessment of a few requirements under Level 4 which exhibits the results of the iCAT conducted by SAI X with a compliance status ascertained as “Met”.

Requirements	Reference	Policy	Implementation mechanism	Output	Communication	Documentation	Management & Quality Control	Justification of Assessment	Reference documents
10.1: Auditor identifies and assesses fraud risk and gathers sufficient appropriate evidence related to identified fraud risks through the performance of suitable audit procedures.	ISSAI 4100.82	Met	Met	Met			Met	Requirement are set out in the compliance audit manual. Standard procedures and questionnaire on fraud are prepared and used by auditors. Instances of fraud included in the report. Management review of the procedure is documented in the audit.	Compliance audit manual.
10.2: When suspected fraud has been identified, public sector auditors take action to ensure that they respond appropriately based upon the mandate of the SAI and the particular circumstances.	ISSAI 4100.82	Met	Met				Met	Set out in manual - auditors consult higher management, legal counselors, legal enforcement organizations. Legal counselor is part of the Audit team, so always "on site". Review by the management documented.	Compliance audit manual, legal guidance.
11.5: Additional substantive procedures are performed when there are significant risks of non-compliance. If the audit approach consists only of substantive procedures, tests of details (not only analytical tests) are performed.	ISSAI 4100.89		Met				Met	Sampling is done on the basis of professional judgement, when high risk areas are concerned there is incertitude about the sufficiency of cases tested. Mainly tests of detail are used. Documented management review.	Compliance audit manual
12.4: The SAI maintains audit documentation which records the criteria used, the work done, evidence obtained, judgements made and review performed. These documents are retained for an appropriate period of time.	ISSAI 4100.113	Met			Met		Met	There are requirements for methods and time of keeping audit files. Timing is appropriate and informed to all relevant divisions to follow. Management supervision is documented.	Rules for Document Management and File keeping.
14.1: Auditors remain alert for indications of unlawful acts, including fraud, in carrying out their work.	ISSAI 4100.118	Met	Met				Met	Requirement are set out in the manual. Standard procedures and questionnaire on fraud are prepared and used by auditors. Documented management review.	Compliance audit manual.

Table 8.1: iCAT of SAI X (step 1) on Level 4 ISSAI requirements with status “Met”



Similarly, the Table 8.2 exhibits few cases of non-compliance with ISSAI requirements in SAI X.

Requirements	Reference	Policy	Implementation mechanism	Output	Communication	Documentation	Management & Quality Control	Justification of Assessment	Reference documents
2.3: Criteria/benchmarks are identified for each audit.	ISSAI 4100.42	Partially met	Not met	Not met		Not met	Partially met	Criteria is not clearly stated in WPs nor in the Audit report because of the broad scope of the subject matter as well as suitable criteria. Certain acts are given in methodology however the list is not exhaustive.	Compliance audit manual
2.6: In identifying criteria, materiality related to the risk of potential non-compliance for each subject matter of the audit is considered.	ISSAI 4100.50		Not met			Not met	Not met	When cases of non-compliance are being evaluated, the qualitative materiality is being considered depending on the circumstances, thus usually in the planning stage materiality is not clearly stated.	
10.4: Relationships between various public sector entities are considered when assessing audit risk, and especially when assessing the risk of fraud or non-compliance.	ISSAI 4100.84			Not met			Not met	Usually audit focuses at relations between public and private sector - it is where fraud may most likely occur. Relations between public entities are rarely considered.	
12.2: Documentation takes place throughout the entire audit process.	ISSAI 4100.113		Partially met				Not met	All requirements are set out in manual but external review report show deficiencies in documentation and ongoing quality review.	Review report, manual
15.5 The auditor performs audit procedures to determine if there are events that have occurred after the completion of the fieldwork and up until the date of the compliance audit report that may result in material non-compliance.	ISSAI 4100.134	Partially met	Not met	Not met		Not met	Not met	Usually all work performed with this regard is based on the accidental finding rather than focused audit procedures. Necessary audit procedures are not clearly set out in methodology.	Audit manual.

Table 8.2: iCAT of SAI X (step 1) on Level 4 ISSAI requirements with status "Not Met/



Reasons for non-compliance can be expressed in terms of:

- The reasons why we say we are not compliant, that is, stating what the actual underlying issue is, or;
- The facts that demonstrate how we are not meeting or partially meeting a requirement as illustrated in this example.

The examples of iCAT from Tables 8.1 and 8.2 provide the insights on the extent of compliance to the Level 4 ISSAI requirements for compliance audit in SAI X. However, to have a complete picture, the SAI has to complete the mapping for the all requirements for compliance audit. The information from the iCAT will assist the assessment team in identifying gaps and systems and practices in place that support compliance with requirements.

**Step 2: Conduct SWOT analysis**

After the assessment of compliance to the ISSAI requirements using the iCAT, the team should conduct the SWOT analysis of the SAI to determine its strengths

and weaknesses in terms of compliance audit. Through SWOT Analysis SAI can assess the current situation and it can guide the SAI for the next step of framing strategic options for it. This exercise would help to explore both opportunities and threats surrounding the SAI, and assist the top management in making informed decisions.

In the iCAT example given in table 8.2 'justification of assessment' column explains the reasons for non-compliance. All ISSAI requirements may have such reasons in the real iCAT if it not complying with the requirement. Once the iCAT is complete it will show that generally the causes for non-compliance with requirements originate from the broader organisational level issues such as the mandate, the legislations, SAI's established procedures and daily practices of its staff. Again, all these organizational issues are lying at the level 2 of ISSAIs that contain issues like independence, value & benefits, transparency and accountability, ethics and quality control.

Figure 8.3 below identifies these level 2 ISSAI elements and grouped them in four discrete domains.







*First domain* refers to the institutional independence of the SAI and describes the requirements under ISSAI 10.

*Second domain* refers to the organizational and professional staff capacity of the SAI that is driven by SAI leadership. A combination of different level 2 ISSAI requirements are placed under this domain.

*Third domain* refers to SAI core processes, which are the SAI level requirements specific to audit processes.

*Fourth domain* refers to external stakeholder relations both in terms of reporting requirements and communicating with stakeholders/users for audit effectiveness and impact.

Based on the compliances and non-compliances identified from the iCAT result as well as from the SAI scenario the SAI can determine its strengths, weakness, opportunities and threats. These can be then categorized under the four domains as depicted in Figure 8.3. Once the weaknesses and associated threats are identified, it would provide proper direction to the SAI to channel its resources for improvement. This would also help explore strengths and opportunities that the SAI can capitalize upon to formulate the strategies to assist in instituting robust compliance audit practices compliant with all the requirements of the ISSAIs.

The SWOT analysis (step 2) for SAI X is exhibited in the Table 8.3.

Table 8.3: SWOT Analysis of SAI X

Strengths	Weaknesses
<p><b>Independence and Legal Framework</b></p> <ul style="list-style-type: none"> <li>• Clear and strong mandate</li> </ul> <p><b>Leadership and Governance</b></p> <ul style="list-style-type: none"> <li>• Strong and dynamic leadership, leads by example</li> <li>• Competent and strong compliance auditors who are also trained on statutory and legal construction, and appreciation of audit evidence</li> <li>• Clear accountability for audit engagement</li> <li>• Assigned and assumed accountability for the audit engagement</li> </ul> <p><b>SAI Core Processes</b></p> <ul style="list-style-type: none"> <li>• Strong system for communicating audit results</li> <li>• Strong legal support</li> <li>• Continuing education for SAI personnel</li> <li>• Audit procedure and methodology ensures auditors implementing and identifying risk and fraud risk</li> </ul>	<p><b>Independence</b></p> <ul style="list-style-type: none"> <li>• Resident audits</li> </ul> <p><b>Leadership and Governance</b></p> <ul style="list-style-type: none"> <li>• Lack of time or not enough resources allocated to carrying the audits</li> </ul> <p><b>SAI Core Processes</b></p> <ul style="list-style-type: none"> <li>• Lack of skills in organizing and preparing working papers that can be easily understood (<i>Documentation principle</i>)</li> <li>• No standardised engagement level quality framework in place</li> <li>• Inadequate understanding of the risk management process of the audited entities</li> <li>• Inadequately prepared overall audit strategy and audit planning</li> </ul>
Opportunities	Threats
<p><b>Leadership and internal governance</b></p> <ul style="list-style-type: none"> <li>• Leadership supports a strong practice by nominating its awardee-auditors for national recognition.</li> </ul> <p><b>SAI core processes</b></p> <ul style="list-style-type: none"> <li>• Exclusive authority in the determination of audit scope, areas and methodology</li> <li>• Freedom from external interventions</li> <li>• Excellent understanding of the audited entities</li> </ul> <p><b>External stakeholders' relations</b></p> <ul style="list-style-type: none"> <li>• Encourages donors to fund training activities with the presence of a Continuing Education Centre and an Audit Manual</li> <li>• Encourages audited entities to train on accounting and auditing laws, rules and regulations and accounting standards with the presence of SAI training facilities</li> </ul>	<p><b>Independence</b></p> <ul style="list-style-type: none"> <li>• Heightened reputational risk due to perceived lack of independence</li> </ul> <p><b>SAI core processes</b></p> <ul style="list-style-type: none"> <li>• Increased audit risk</li> <li>• Inefficient and ineffective audit practices</li> </ul> <p><b>External stakeholders' relations</b></p> <ul style="list-style-type: none"> <li>• Risk of issuance of an inappropriate auditor's report</li> </ul>



On analyzing the issues identified under each quadrangle, we can get an overview of the weaknesses and challenges of the SAI which hinders the SAI to become compliant to ISSAI requirements. On the other hand, from SWOT SAIs can also discern its own strengths and good practices which are attributed for facilitating compliance to the ISSAI requirements. Therefore, the SWOT analysis, if conducted objectively, would present a unique set of facts for each SAI within the four domains of Level 2. For example, ISSAI 4100.82 requirement presented in the iCAT of SAI X in Table 8.1 provides that “Auditor identifies and assesses fraud risk and gathers sufficient appropriate evidence related to identified fraud risks through the performance of suitable audit procedures.”

Concurrently, the SWOT analysis for the SAI X revealed that it has a strength identified as “ Audit procedure and methodology ensures auditors implementing and identifying risk and fraud risk ”.

The link established between the iCAT and the SWOT analysis will explain many of the causal relationship for the gaps identified through the iCAT. Therefore, the analysis will also help to identify the reasons for the gaps. When considering the gaps and their causes across domains, identified as independence and legal framework, leadership and internal governance, SAI’s core processes and external relationships, it may appear that many of the gaps across domains can be linked under a common issue. Example, ISSAI 4100.113 provides that “ Documentation takes place throughout the audit process.” – a requirement not met by SAI X as revealed through the iCAT in table 8.2. On further analysis using SWOT, it revealed that the when cases of non-compliance are being evaluated, the lack of skills in organizing and preparing working papers that can be easily understood, which is a documentation related issue.

Therefore, integrating the results of the two tools, the iCAT and the SWOT would reveal a number of strategic issues that may warrant interventions.

### **Step 3: Determine the priority issues for the SAI**

Once the SWOT analysis for the SAI has been conducted by the team, the results would present the main issues confronting the organisation. At this stage, the assessment team should list the strengths and weaknesses in the different areas. In many cases,

similar strengths and weaknesses may exist across the four domains. The team is expected to group the issues to come up with broad issues that the SAI is facing. The issues should be considered as strategic priorities if they have the potential of directly affecting or deterring the establishment of a robust compliance audit practice in the SAI. As an example, SAI X does not have a “Quality Control Framework” in place. It is an issue of concern for the SAI as the framework could provide direction around timely file finalisation and set-out clear file documentation expectations. Likewise, issues such as lack of skills and staff independence may be the priority issues for SAI X.

At this stage, the team may have to perform more in depth analysis to identify common issues across the main domains. Caution and due diligence should be exercised to identify priority issues under each domain. It may be advisable to involve top management, mid-level managers as well as the entire staff, if possible in the process. However, it is recommended to at least engage staff representatives, team leaders or a focus group which understand the policy, practices and constraints of the current working environment. The involvement of various levels of staff would provide different perspectives and assist with the identification of strategic issues.

The SAI should prioritise the issues included in the weakness quadrangle, and the resource allocation or strategic direction should focus on the remedy of the observed deficiencies and the mitigation of the possible threats. However, a SAI should not neglect its own strengths as they represent different opportunities to leverage the best practices and systems already in place. Building on these strengths will assist the SAI in meeting its ultimate objective that is to implement an ISSAI compliant compliance audit practice.



For SAI X as illustrated in iCAT examples and SWOT analysis some of the priority issues identified (step 3) by the SAI are:

- Audit scoping;
- Weakness in audit planning activities;
- Documentation process including working papers;
- Evidence gathering methodology;
- Quality reviews; and
- Independence of resident auditors.

**Step 4: Identify strategic options to address the prioritised issues**

Based on the priority issues identified under step 3, the team should look for various strategic options to appropriately address the issues. As discussed above, the priority issues should be the focus and get more resources allocated to their resolution.

At this stage the team identifies various strategic options aimed at tackling these issues. Therefore, the team should begin by consultation and brainstorming on the root causes of the issues. As in step 3, the team should involve top management, middle level managers, and the focus group to identify various strategic options. Such participative approach also helps increase the acceptability and reduce the employees' resistance on implementation of the strategies.

In the example, SAI X has identified the priority issues listed under Step 3. To illustrate step 4, some of the

strategic options it has to address the identified priority issues are:

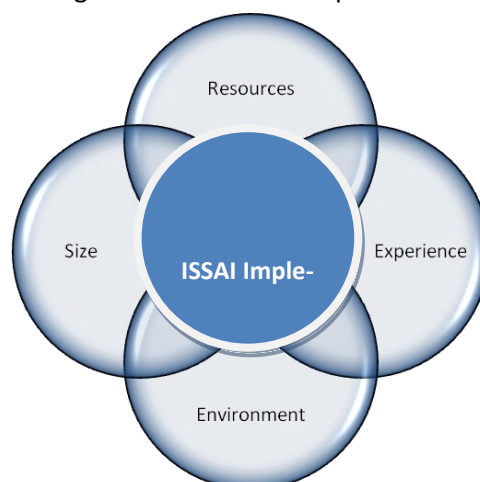
- SAI review of audit scoping practices;
- Update the existing compliance audit methodology for file documentation, risk assessment and audit planning;
- Build team skills and competencies for documenting its compliance audit work; and
- Develop a sound quality assurance system

**Step 5: Select strategic options for the SAI**

Once the team formulates the various strategic options, it should weigh the alternatives on the backdrop of various key factors that would determine the feasibility of the strategies. Therefore, while evaluating the strategic options, the team should consider the resources availability, the size of SAI, the number of years of experiences in conducting compliance audits and the dynamics of the environment it operates in. All of those factors need careful consideration as they may involve intricate issues that may have a potential to undermine the initiatives or proposed strategies during the actual implementation.

Each strategic option identified under Step 4 would undergo screening, weighed against several factors to justify practicality and cost-effectiveness of the proposed strategies. Therefore, the selection of the ISSAI Implementation strategic options has to be looked at from four main aspects or factors as exhibited in Figure 8.4.

Figure 8.4: Factors determining selection of ISSAI implementation strategic options





### **i. Resources**

The choice for any strategic option has to be weighed against the availability of resources, both human and financial. It is quite common, especially for developing SAIs that this consideration weighs too heavy in determining the choice of available alternatives. Since some proposed strategies may involve bringing in an overhaul of the compliance auditing practices, which may include bringing in institutional reforms, development and harmonisation of existing legislations, manuals and policy documents, the resource considerations are fundamental to all of these proposed initiatives. The institutional and human resources are also vital considerations in determining whether the SAIs have the capacity to implement the proposed strategies.

### **ii. Size**

Generally, the small SAIs may find it more difficult to implement the proposed strategies as they likely have limited resources available to undertake projects other than the mandated audit activities as compared to the big SAIs. However, it may not be the case in all the situations depending on the local contexts and other factors. Therefore, the team should consider the options taking into account the actual context of the SAIs' size.

### **iii. Experiences**

There are different SAIs with varied level of experiences in compliance auditing. The general rule is that, the SAIs with more years of experiences may have an edge in implementation of the strategies as compared to those SAIs that are just beginning or have no experience of conducting compliance auditing. Therefore, the selection of strategic options may also largely depend on the number of years of experiences the SAIs have in conducting compliance audit.

### **iv. Environment**

The viability and feasibility of compliance audit ISSAI implementation strategies in SAIs would also largely depend on the environment the SAIs are currently operating in. Therefore, the team should also analyse the environment from various aspects, including the social, economic, political and cultural diversity to select the most viable strategic options. It is important

to note that each SAI is operating in completely different environments, and there may not be a single strategy fit for all SAIs. There are SAIs with institutional set-up under Court system or Westminster system, depending on the country specific political system. Likewise, each SAI is operating in a country with different level of socio-economic development and holding different beliefs and cultural values, thus, having a single straightjacket strategy may not make sense. From the very broad perspectives and the regional location, all the SAIs around the globe are grouped under one of the many regional groups, like ASOSAI, AFROSAI-E, ARABOSAI, CAROSAI, CREFIAF, EUROSAI, PASAI and OLACEFS. However, it is still possible that all SAIs under the regional group may not have a single situation in common, thus warrants a different and unique set of strategy befitting to individual SAI's specific needs and situation govern by its environment.

For the example of SAI X, it has formulated a list of strategic options as outlined in step 4 to choose from. Assuming resources are available, small size, moderate level of experience in conducting compliance audits and an environment conducive to the implementation, the SAI selected the following strategic options (step 5):

- Update the existing compliance audit methodology for file documentation, risk assessment and audit planning
- Develop a sound quality assurance system

*Note: It is important to note that this is an example set for illustration, may not hold true in all situations.*



## Step 6: Compliance audit ISSAI implementation strategy

Implementation of strategies are time consuming, and even more so for beginners. In order to get full scale strategies implemented, it is advisable to look for some quick wins in one or two easy strategies that the SAI has some experience and confidence in dealing with. Starting with small and easy strategies may provide valuable lessons and experiences in dealing with complicated strategies that may bring about major overhaul in the compliance audit practices.

Therefore, the team should take into consideration all the factors discussed above in determining the most viable ISSAI implementation strategy. However, at this stage, it is also important for the team to facilitate a process for getting the Head of the SAI and senior management involved for selecting the most viable strategic options. In fact, the top management is the main driver and would have a larger role on the success or failure on the implementation of the strategies. Therefore, the endorsement of the ISSAI an implementation strategy from the Head of the SAI is very critical.

For SAI X example, from its two strategic options decided to update the existing compliance audit methodology for file documentation, risk assessment and audit planning and formulate an action for this.

Next section describes the process for formulation of an action plan on the four domains identified in step 2 of the six step process. An example and format for preparing in action plan is illustrated in table 8.4.



## 8.3 FORMULATION OF AN ACTION PLAN

The action plan will follow from the SWOT analysis and after undergoing consideration of the needs analysis. This will be presented in the form of four domains with the issues that have been identified. Below is an example of an action plan format for one domain – Independence and legal framework.

Table 8.4: Example & Format of preparing action plan

Domain 1: Independence and Legal Framework				
Actions steps <i>[What will be done?]</i>	Timeline <i>[By when?]</i>	Person(s) responsible <i>[Who will do it?]</i>	Resources <i>[Human/Funds/ Equipment/Tools, etc]</i>	Evaluation <i>[How will SAI know that is making progress? What are the benchmarks?]</i>
Spearhead and work closely with legislature for the enforcement of financial autonomy provision of SAI-X in the audit act.	Q4 of 2014 (LT)	Auditor General and legal officer	Working group	Enforced the financial autonomy provision
Spearhead and work closely with legislature for proposing amendment of the act to give SAI mandate autonomy of SAI-X in recruitment and professional enhancement of auditors.	Q4 of 2014 (LT)	Auditor General and legal officer	Working group	Amendment of SAI-X recruitment autonomy proposed to the parliament.
Prioritize the audit assignments according to financial and human resources available and staff competency.	Q4 2013 (ST)	Heads of Divisions	No costs	<ul style="list-style-type: none"> <li>• Categorised entities into the category of A, B and C [A: Audit annually; B: Audit once in two years; and C: Audit once in three years].</li> <li>• The amount of budget allocated to entities, nature and risk profile used as criteria for categorisation.</li> </ul>

Note: ST-Short Term Solution & LT-Long Term Solution

Approved by:

Signature: \_\_\_\_\_ Date: \_\_\_\_\_

Name: \_\_\_\_\_ Title: \_\_\_\_\_





## 8.4 COMMITMENT OF THE LEADERSHIP IN IMPLEMENTING ACTION PLAN

Once an action plan has been prepared based on number of issues faced by the SAI in implementing the ISSAIs, the same should be placed before the Head of SAIs as the successful implementation would depend on his/her commitment and necessary directives. The timeline and resources indicated in an action plan should be agreed and approved by the Head of an SAI.

To demonstrate the commitment to implement the action plan, for example, an executive order or a standing order should be issued by the Head of SAIs reinforcing the responsible officials to comply with the timeline set in the plan and evaluate the outcome of actions implemented. The SAI should also develop a culture of accountability wherein the responsible officials indicated in the action plan are held accountable for their failure if any, and the performers are rewarded appropriately.

It is also the role of the Head of SAI to seek necessary funding to implement the action plan, especially in the areas of training and procurement of equipment, and putting the related infrastructure in place, which are necessary to achieve the intended outcome.

Since the implementation of ISSAIs may be a completely new area for some of the SAIs, management and adaptation to such changes often become difficult. Therefore, the leadership of the SAI should be committed to managing such change. The Head of the SAI can delegate the responsibility on implementation of action plan. However, he/she should assume the final accountability.

## 8.5 GUIDANCE ON PREPARING AN ACTION PLAN

In translating these options to an action plan, the SAI would need to identify the activities, timelines, resources required and responsibility. The action plans should be evaluated for continuous monitoring to ensure ISSAIs implementation is always on track. After the completion of this action plan it should be discussed at the management level and with the responsible officer and approved by the head of the SAI.

### i. Identifying the activities to reach end Result

In identifying the activities, SAI should list the projects or enhancement to processes that will be undertaken to accomplish the end result.

### ii. Timelines

What is also vital in this action plan is the scheduling of each task and as such, SAIs need to set timelines for the accomplishment/approval of each task. The SAI should determine whether these timelines should be short or long term based on their priorities and current environment. The timelines set by the SAI to accomplish task/activity should be realistic, achievable and depends on the SAI environment and availability of resources. Smaller SAI may have to consider reallocating functions/duties or staff may have to multi-task as they do not have dedicated staff to carry out some of these activities. This may require more time to accomplish tasks. The sourcing of funding may be long-term as some SAIs have to go through a budget process.

### iii. Resources Required

SAIs need to consider the resources needed to implement the solutions. These resources could entail funding, technical experts, materials, equipment, people, systems among other things. The SAI would also need to consider the cost for these resources based on their current environment and situation.

### iv. Responsible Officer

In order for a strategy to be successful, human resource is one of the most critical factors to the



success of any strategy. Therefore, the SAI would need to consider the persons who will carry out the various tasks. The persons chosen should be responsible and act as a change agent to get all people affected by the strategy/project involved, to ensure their support and commitment. The task/activities to be accomplished should be translated to the responsible officer's individual work plan.

#### **v. Monitoring of Plan**

In the action plan, provision should also be made for the monitoring of the plan. This should be done to measure the timely accomplishment of the planned tasks/activities and identify problems and recommend contingent actions.

## **8.6 CONCLUSION**

The formulation of a robust compliance audit ISSAI implementation strategy is key to the ultimate implementation of a solid compliance audit practice, compliant with the ISSAI requirements. The structured approach proposed in this chapter may prove useful to the ISSAI facilitators or team to formulate the compliance audit ISSAI implementation strategy for their respective SAIs.

The step-by-step process takes into account several factors to be considered under each step starting from conducting the iCAT to performing a SWOT analysis. The SWOT can help determine priority issues and explore alternative strategies and select the most viable strategic options, befitting to the nature, experiences and the SAI's environment. The selection of strategic options also takes into account the resource availability as most of the developing SAIs function under resource constraints. All these steps have been illustrated through the example provided for SAI X.

The gaps between the SAI's current situation or practices and the ISSAI requirements are explained through the causal relationship identified in the SWOT analysis conducted for the SAI. The analysis helps to identify several strengths and weaknesses and ascertain the position of the SAI. Integrating the results

of the two tools, the iCAT and the SWOT reveals many of the strategic issues that may warrant intervention. It is interesting to note that many of the gaps identified have a causal relationship with the deficiencies inhibiting at the higher spectrum of the four domains identified under Level 2. Therefore, the key to the successful implementation of robust compliance audit practices in the SAI may rest on eliminating the deficiencies that find their source in the Level 2 main domains.



### **About the IDI 3i Programme**

ISSAI Implementation Initiative Programme (3i Programme) is a global programme launched by IDI to support the implementation of ISSAIs. While programme activities in the five English speaking INTOSAI regions began in 2012, activities will be initiated in other regions in Arabic, French and Spanish in 2014.

### **Partners**

The ISSAI Implementation Programme is as a partnership programme between the INTOSAI Professional Standards Committee, its sub committees on Financial, Performance and Compliance Audit, INTOSAI Capacity Building Committee and relevant English speaking regions. The programme aimed at creating capacity for implementation of level 4 ISSAIs in financial audit (including compliance audit) and performance audit in the five English speaking regions of AFROSAI-E, ASOSAI, CAROSAI, EUROSAI and PASAI.