

**Office of the Auditor General, Nepal**  
Public audit reform and capacity building

# **Government Auditing Standards**

Part 2: Operational guidelines

October 2005

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## **Preface**

This Government Auditing Standards - Part 2: Operational guidelines sets a basis for auditing government entities and should be read in conjunction with the Government Auditing Standards - Part 3: Segment Audit guidelines:

- Revenue Audit;
- Procurement Audit; and
- Project Financial Statements.

We have reviewed the current audit guidelines/standards currently applied by the OAGN against better practices, i.e. the INTOSAI standards, ISA and applicable legislation/regulations.

From our discussions, interviews with OAGN's personnel and review of selected audit files, we noted the following areas for improvement in terms of the audit methodology currently used by the OAGN:

- enhancement to the audit strategy and planning document;
- audit programmes should be developed for each area of audit;
- there should be clear reference of audit evidence to support audit findings and conclusions;
- format of work paper documentation and file arrangement should be standardised;
- there should be consistency in review and interpretation of audit findings; and
- formal system of debriefing subsequent to completion of audit should be implemented.

This audit guidelines has been updated accordingly to reflect the abovementioned areas.

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## Abbreviations

Except where the context otherwise requires, the following abbreviations are applied throughout this Guideline:

“AG”	Auditor General
“AAG”	Assistant Auditor General
“CAAT”	Computer Assisted Audit Technique
“COD”	Control Overview Document
“DAG”	Deputy Auditor General
“DTCO”	District Treasury Controller Office
“EDP”	Electronic Data Processing
“FAR”	Financial Administrative Rules
“FPA”	Financial Procedural Act
“FCGO”	Financial Comptroller General’s Office
“FS”	Financial Statements
“HMG/N”	His Majesty’s Government, Nepal
“IAS”	International Accounting Standards
“INTOSAI”	International Organization of Supreme Audit Institutions
“ISA”	International Standards on Auditing
“NRs”	Nepali Rupees
“NRB”	Nepal Rastra Bank
“OAGN”	Office of the Auditor General, Nepal
“PMR”	Project Management Report
“QCC”	Quality Control Committee
“SAI”	Supreme Audit Institutions
“SOE”	Statement of Expenditure

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# Introduction

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## 1.1 Introduction

**1.1.1** The overall objective of an audit of the financial statements is to obtain sufficient appropriate audit evidence to form an audit opinion as to whether the financial statements are free of material misstatements, providing reliable and useful information for decision makers and helping to improve internal controls and underlying financial management systems. To achieve these purposes, the Office of the Auditor General, Nepal (OAGN's) approach to financial statement audits involves five main activities:

- audit strategy and planning;
- effective audit evidence;
- review and interpretation of audit findings;
- reports and presentation; and
- debriefing.

**1.1.2** These main activities are illustrated in Figure 1 and are summarised on page 3.

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## 1.2 Audit strategy and planning

**1.2.1** Audit strategy and planning covers the selection of audit procedures based on the auditors understanding of the auditee's business and operations, analysis of the financial information and assessments of the risk of significant misstatements. It covers important elements such as allocating tasks and the timing of the work, preparing a timetable and a budget. Audit strategy and planning also includes selecting or confirming the selection of a systems-based approach or a substantive approach for each audit objective. The auditors also select the audit procedures they plan to apply as tests of controls.

**1.2.2** Section 2 – Audit strategy and planning – provides further guidance

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## 1.3 Effective audit evidence

**1.3.1** The principal activities of an audit are performing audit procedures to obtain effective audit evidence to form an opinion on the financial statements. The auditor performs the planned tests of controls to obtain audit evidence about the effectiveness of design and operation of those activities within the auditee's internal control process that are the basis for a systems-based approach for each audit objective. The auditor seeks reasonable assurance, not absolute assurance, about the effectiveness of design and operation.

**1.3.2** Effective audit evidence is sufficient and appropriate to meet one or more audit objectives, obtained cost effectively and with optimum use of resources.

**1.3.3** Section 3 – Effective audit evidence – provides further guidance

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### **1.4 Review and interpretation of audit findings**

**1.4.1** Audit findings may lead the auditor to revise the planned substantive audit procedures. Audit findings may include observations that lead to constructive suggestions to the auditee.

**1.4.2** The activity includes review of work papers, evaluation of sufficiency and appropriateness of the audit evidence obtained to form an audit opinion, evaluation of presentation and disclosures and whether financial statements are free of material misstatements.

**1.4.3** Section 4 – Review and interpretation of audit findings – provides further guidance

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### **1.5 Reports and presentation**

**1.5.1** The auditor reports to the auditee in an audit report that contains a clear written expression of opinion on financial statements. The audit report should communicate important matters identified during the audit, to the auditee. At any time during the audit, the auditor may become aware of deficiencies in internal control. The auditor reports these deficiencies to management on a timely basis.

**1.5.2** Section 5 – Reports and presentation – provides further guidance

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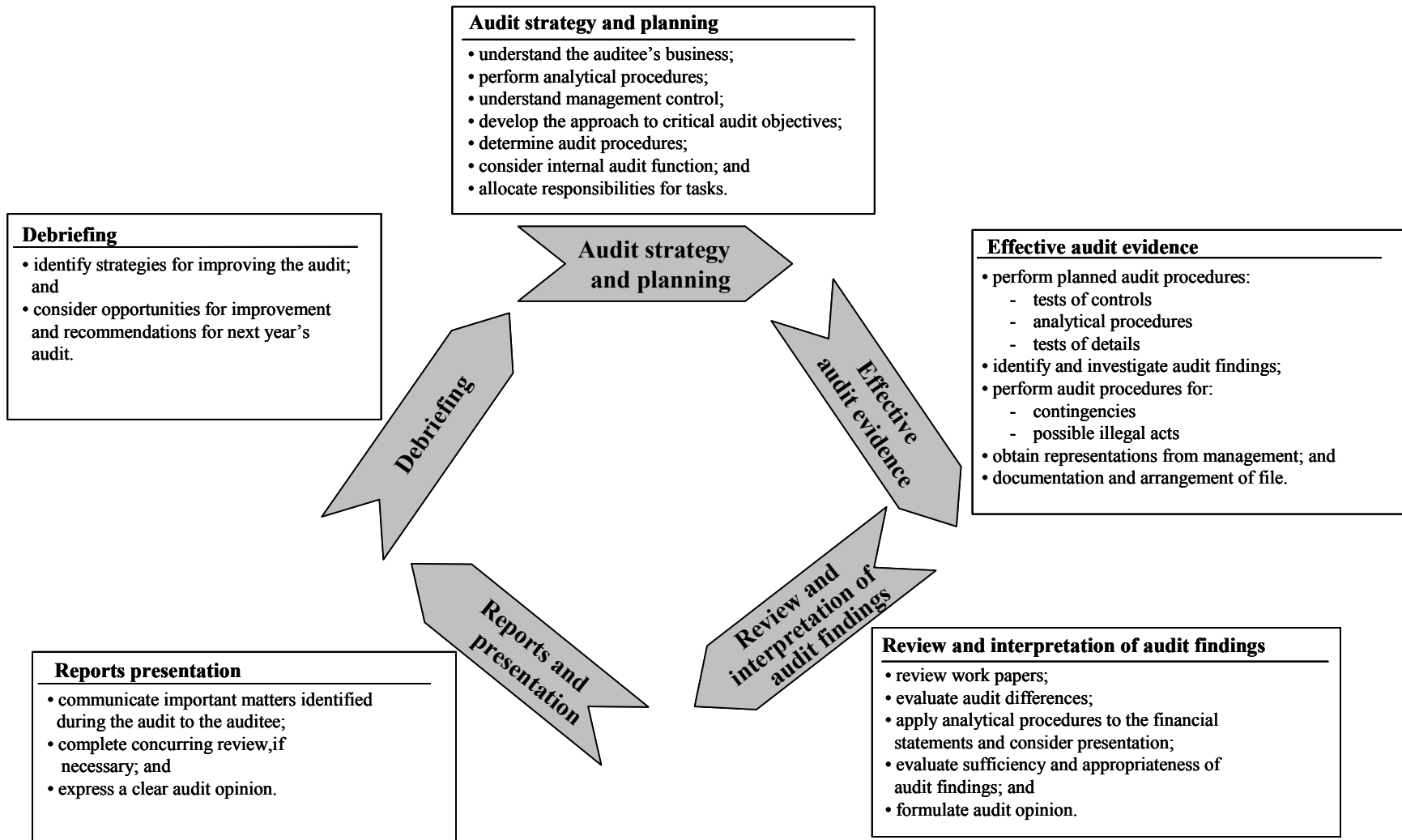
### **1.6 Debriefing**

**1.6.1** Debriefing involves considering the quality of delivery of the audit team with the objective of developing recommendations on ways to improve delivery of the audit team, including the auditors approach to internal controls. The audit team's performance is analysed to identify successes, opportunities for improvement and recommendations for the following year's audit.

**1.6.2** Main advantages of debriefing are to provide improved service in the future by repeating current year's successes, eliminating defects and making more efficient use of auditor's resources.

**1.6.3** Section 6 – Debriefing – provides further guidance

**Figure 1: Illustration of activities in the audit approach**



# Audit strategy and planning

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## 2.1 Introduction

2.1.1 This section provides guidance on:

- matters addressed by audit strategy;
- responsibility for audit planning;
- performance of analytical procedures to assist in planning the audit;
- identification of significant financial statement accounts, classes of transactions and financial statement assertions;
- audit objectives;
- critical audit objectives;
- performance of analytical procedures to assist in planning the audit;
- assessment of inherent risk, control risk and the risk of significant misstatements;
- selection of audit procedures;
- documentation of audit planning;
- approval of audit planning; and
- communication of audit planning.

2.1.2 The audit strategy and planning is the first activity in the financial audit process. It may be defined as the process that sets the direction of the audit and links the understanding of the auditee's operations to the focus of the audit work.

2.1.3 The key operations and financial reporting issues affecting the auditee and their effect on the current year's audit are considered at this stage. Factors that are important to the success of the audit are identified, for developing a programme of work to formulate an audit opinion.

### *Matters addressed by audit strategy*

2.1.4 The matters to be addressed when developing the audit strategy are:

- understand the auditee's business and operations;
- identify the risks facing the auditee's business and operations;
- identify the critical audit objectives and the audit approach to these;
- obtain an overview of internal control, to confirm the feasibility of a systems-based audit approach to routine transactions;
- consider the financial reporting issues;
- identify the need for Electronic Data Processing (EDP) audit specialist on the audit; and
- physical target and progress.

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## Chapter 2

### Audit strategy and planning

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#### 2.1.5 Understand the auditee's operations

The auditor should obtain an understanding of the auditee sufficient to plan and perform the audit in accordance with applicable auditing standards and requirements. In planning the audit, the auditor gathers information to obtain an overall understanding of the auditee and its origin and history, size and location, organization, mission, operations, strategies, inherent risks, the control environment, and internal controls. Understanding the auditee's operations in the planning process enables the auditor to identify, respond to, and resolve accounting and auditing problems early in the audit.

The auditor's understanding of the auditee and its operations does not need to be comprehensive but should include:

- auditee management and organization;
- external factors affecting operations;
- internal factors affecting operations;
- accounting policies and issues;
- annual plan with periodical plan; and
- adequacy of budget allocation and actual requirement.

The auditor should identify key members of management and obtain a general understanding of the organizational structure. The auditor's main objective is to understand how the auditee is managed and how the organization is structured for the particular management style.

The auditor should identify significant external and internal factors that affect the auditee's operations. External factors might include:

- source(s) of funds;
- current political climate; and
- relevant statutory provisions at Ministry level, focusing on high risk areas.

Internal factors might include:

- size of the auditee's operations;
- number of locations;
- structure of the auditee's operations (centralized or decentralized);
- complexity of operations;
- qualifications and competence of key personnel; and
- turnover of key personnel.

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### Audit strategy and planning

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In identifying accounting policies and issues, the auditor should consider

- applicable accounting principles and pronouncements, including whether the auditee is likely to be in compliance;
- changes in principles that affect the auditee; and
- whether the auditee's management appears to follow aggressive or conservative accounting policies.

An EDP audit specialist may assist the auditor in understanding the auditee's use of EDP. Documentation of this understanding generally should include the following:

- the specific hardware and software comprising the computer configuration, including the type, number, and location of primary central processing units and whether any such units are interconnected;
- whether processing is primarily centralized or decentralized and whether data are entered only at processing locations or also at remote sites;
- the general nature of software utilities used at computer processing locations that provide the ability to add, alter, or delete information stored in data files, data bases, and program libraries;
- the general nature of software used to restrict access to programs and data at computer processing locations;
- significant computerized communications networks, interfaces to other computer systems, and the ability to upload and/or download information;
- the overall impact of microcomputers on the auditee's operations, including the extent of integration of microcomputers in the accounting system (such as whether microcomputers are used to generate or process information for financial reporting);
  - relative number of microcomputers in use,
  - general nature of microcomputer use (such as word processing, spread sheets, or data base), and
  - adequacy of policies and procedures to control the access to microcomputers and use of software;
- the significant changes since any prior audits/reviews;
- the general types and extent of significant purchased software used;
- the general types and extent of significant software developed in-house;

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### Audit strategy and planning

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- the method of data entry (interactive or non-interactive);
- the types of computer processing performed (stand alone, distributed, or networked);
- the use of service bureaus; and
- the approximate number of transactions processed by each significant system (as considered appropriate).

The auditor gathers planning information through different methods (observation, interviews, reading policy and procedure manuals, etc.) and from a variety of sources, including:

- the auditee's top level management;
- the auditee's management responsible for significant programs;
- internal audit management (including any internal control officer); and
- the auditee's legal representatives.

The auditor gathers information from relevant reports and articles issued by or about the auditee, including:

- financial statements;
- the auditee's prior reports, including the overview;
- the auditee's budget and related reports on budget execution;
- internal audit reports;
- consultant reports; and
- material published about the auditee in newspapers, magazines, and other publications.

#### 2.1.6 Identification of the risks facing the auditee

The risks facing the auditee's operations need to be considered, and whether these risks are likely to affect the financial statements and therefore have audit implications. The cause of these risks may be factors affecting the operations environment of the auditee, or factors affecting the industry or economy generally.

Discussions with management enable the auditor to understand management's perceptions of the risks facing the operation and to analyse these in the broader context of the industry and the economy. The risks facing the operations that have significant implications for the audit are then translated into critical audit objectives and determine the approach to these audit objectives.

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### Audit strategy and planning

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#### 2.1.7 Identification of critical audit objectives and the proposed audit approach

The purpose of the audit is to provide reasonable assurance that the financial statements are free of material misstatement. The auditor is rarely able to obtain conclusive audit evidence that all the items making up the financial statements are correct.

There are usually some items that carry a greater risk of significant misstatements and involve considerable judgement or are difficult to verify. An audit objective is considered to be critical when inherent risk is high, and:

- the related financial statement assertion requires a considerable degree of judgement; or
- it is difficult to obtain audit evidence or to apply audit procedures.

As part of the audit strategy and planning, the Assistant Auditor General (AAG) is responsible to provide overall direction for the audit approach to critical audit objectives. Audit strategy and planning addresses the audit approach to critical audit objectives broadly, including:

- the nature, timing and extent of audit procedures;
- the involvement of more experienced audit staff; and
- use of external experts.

#### 2.1.8 Obtaining an overview of internal control.

The purpose of obtaining an overview of internal control is to:

- develop an understanding of how the auditee responds to risks facing the operations;
- decide the overall audit approach to internal control; and
- identify areas where the audit team may be able to develop useful recommendations.

For every audit, regardless of its size, when developing audit strategy the planning, the AAG obtains a high-level understanding of internal control, mainly through discussions with management. The details and documentation are dealt with as part of audit planning by other members of the audit team.

Internal control consists of the following inter-related components: risk assessment, the control environment, information and communication, monitoring and control activities. Section 2.2 – Internal control - provides further guidance.

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### Audit strategy and planning

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For purposes of developing audit strategy and planning, the AAG's understanding of the auditee's risk assessment process and the control environment is fundamental to judgements about the extent to which a systems-based approach may be applied.

A satisfactory control environment implies that:

- a systems-based approach to some or many audit objectives relating to systematically processed routine transactions is likely to be appropriate; and
- management's judgements concerning the non-routine transactions are less likely to be unintentionally or intentionally biased.

An unsatisfactory control environment implies that:

- people in the auditee's organisation may have little regard for internal control;
- financial information may be affected by errors or deliberate misstatements;
- a substantive audit approach to most audit objectives is likely to be appropriate; and
- there is a possibility that management decisions concerning non-routine transactions are influenced by the desire to report certain results.

The information that the AAG obtains about internal control for the purposes of developing audit strategy and planning may include information for which details are to be developed in audit planning. If so, the information is communicated to the other members of the audit team for purposes of developing the audit plan to understand, document and test relevant activities that can be identified with audit objectives.

#### 2.1.9 Identification of financial reporting issues

To address financial reporting issues that have been identified, the following needs to be considered:

- the auditee's accounting practices and policies;
- new accounting standards/pronouncements; and
- legal and regulatory changes that may affect financial reporting.

#### 2.1.10 Identification of the need for EDP Audit Specialists

While the auditor is ultimately responsible for assessing inherent and control risk, understanding the impact of a computerised financial management system generally requires the assistance of a person with specialised technical skills. Such EDP audit specialists should possess sufficient technical knowledge and experience to understand the EDP concepts discussed in the manual and to apply them to the audit.

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### Audit strategy and planning

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#### *Responsibility for audit planning*

**2.1.11** The AAG is ordinarily responsible for audit planning decisions within the framework of audit strategy and planning.

#### *Performance of analytical procedures to assist in planning the audit*

**2.1.12** Analytical procedures are performed to assist in planning the audit and to enhance the overall understanding of the auditee's operations. To the extent that it has not been covered during the development of audit strategy and planning, the auditors:

- analyse relevant information; and
- discuss results with management.

**2.1.13** Analytical procedures applied in planning the audit usually consider data aggregated at a reasonably high level, such as financial data for specific segments.

**2.1.14** The analytical procedures, which are based on the auditors' judgement, may vary widely depending on the size and complexity of the auditee and the existence of meaningful relationships. For some auditees, the analytical procedures may consist of reviewing changes in account balances between the previous year and the current year using the general ledger or the preliminary or unadjusted working trial balance. In contrast, for other auditees, the analytical procedures may involve an extensive analysis of trimester financial statements, if available. In both cases, the analytical procedures, combined with the auditors' knowledge of the operations, serve as a basis for additional enquiries.

**2.1.15** Typical information the auditor considers includes:

- management reports and analytical data prepared routinely by the auditee to manage the operations;
- current and prior period financial data ie. financial statements;
- non-financial information; and
- the auditee's annual budget and release of budget.

**2.1.16** Often, the auditee's management applies analytical procedures as part of its monitoring of the operations. Management's analytical procedures may be considered to identify trends, fluctuations, and unusual relationships.

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**2.1.17** Audit planning ordinarily includes meetings with management that help the auditor understand more about the auditee's operations and to confirm the auditor's interpretation of the results of the analytical procedures.

**2.1.18** Typical information discussed includes:

- operations issues and accounting developments;
- the auditee's financial statements;
- recent trends, variations from prior years or from budgets and possible future developments.

*Identification of significant financial statement accounts, classes of transactions and financial statement assertions.*

**2.1.19** Based on the results of the analysis of relevant information and discussions with management, the auditor identifies the significant financial statement account balances and classes of transactions.

The following section generally describes the provisions of the FPA and FAR in relation to the preparation and the audit of Annual Financial statements of HMG/N.

*Submission of financial statements at the Central Level provided by the FPA.*

Section 14 sub-section 1 of the FPA, 2055, states that FCGO is required to submit financial statements of consolidated funds including appropriation accounts, revenue, deposits, foreign grants and loans within the time limit specified by the OAGN. Normally such time period is provided by the "Annual Operational Calendar" of OAGN.

Section 14 sub-section 2 of the FPA, 2055 provides that every responsible accounts officer (i.e. secretary of each department/ministry and constitutional bodies) is responsible to submit the financial statements of each subordinate office for each financial year to the FCGO and OAGN within a specified time period.

If the financial statements could not be submitted within the stipulated period the responsible accounts officer or responsible officer may request for an extension of time showing valid reasons for not submitting the required documents with the stipulated period. The AG or the officer specified by him may provide additional time up to 35 days, however if the responsible person is unable to submit the financial statements given the additional time, the immediate higher level officer may be charged NRs.25 for the first time and for second time NRs.50 each and if delays are repeated, departmental action will be taken as per the prevailing laws.

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#### *Submission of financial statements at the Central Level provided by the FAR.*

Chapter 12 of the FAR 2056, states that every office shall submit the annual financial statements to the DTCO and concerned department/ministries within 35 days from the expiry of the financial year. Such financial statements include amongst others the SOE, details of outstanding advances and bank accounts statements. In the case of projects involving foreign assistance, the financial statements will also include details of commodity grant, direct payment, turnkey assistance, technical and other assistance and reimbursable amount in the format approved by OAGN.

At district level, each DTCO is required to reconcile the annual approved budget (i.e. by the appropriation head and source), disbursement and expenditure against the bank statements and financial statements provided by the auditees. Each department/ministry or constitutional body shall maintain the central accounts on the basis of financial statements received from the subordinate offices on a trimester basis.

All departments/ministries or constitutional bodies are required to reconcile their central accounts with the records maintained by FCGO and proceed to prepare the consolidated central annual financial statements for submission to FCGO and OAGN within the last day of the month of Kartik (Nov 15/16).

The consolidated financial statements comprises the following:

- Statements of expenditure in accordance to the budget appropriation (for cash payment);
- Statements of expenditure in accordance to the budget appropriation (for direct payment and commodity grant);
- Statements of budget disbursement and expenditure based on source categories (e.g. HMG/N fund, grant or loan fund by donors); and
- Statements of budget disbursement and expenditure based on office categories (e.g. each budget units).

#### *Audit of Annual Financial Statements by OAGN*

The above annual financial statements are subject to audit by the OAGN. This forms the basis for OAGN to conduct the audit and prepare the annual report.

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**2.1.20** The significant financial statement accounts usually are apparent from the discussions with management and the understanding of the operations. Significant means more than the amount of the balance in an account. This is because the balance is the net result of the transactions that flow through the account. An account with a small monetary balance such as cash may be significant because it is the net result of two significant classes of transactions, cash payments and cash receipts.

**2.1.21** The account balances reflect the classes of transactions (including internal transfers and allocations) recognised during the period. These include:

- routine transactions; and
- non-routine transactions.

**2.1.22** The significant classes of transactions are used when the auditor assesses the risk of significant misstatements.

**2.1.23** Management asserts that the financial statements are fairly presented. In making this general statement, management also implicitly makes more detailed assertions about individual account balances, classes of transactions and other data presented in the financial statements.

**2.1.24** These assertions may be categorised as:

- completeness – there are no unrecorded assets, liabilities or classes of transactions that require recognition in the financial statements;
- existence or occurrence – a recorded transaction or class of transactions have occurred during the period covered by the financial statements;
- accuracy – details of assets, liabilities and classes of transactions are recorded, processed and reported with respect to party, date, description, quantity, and price;
- valuation – government entities have to maintain a memorandum record of assets;
- ownership – the auditee has the appropriate rights (for example, title) to the assets reflected in the financial statements; and
- presentation and disclosure – appropriate information is disclosed, classified and described in accordance with acceptable accounting policies and, if applicable, legal requirements.

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**2.1.25** A line item or an account should be considered significant if it has one or more of the following characteristics:

- its balance is material (exceeds design materiality) or comprises a significant portion of a material financial statement amount;
- a high combined risk (inherent and control risk) of material misstatement (either overstatement or understatement) is associated with one or more assertions relating to the line item or account; and
- special audit concerns, such as regulatory requirements, warrant added consideration.

The auditor should determine that any accounts considered insignificant are not significant in the aggregate.

**2.1.26** An assertion is significant if misstatements in the assertion could exceed test of materiality for the related line item, account, or disclosure. Certain assertions for a specific line item or account, such as completeness and disclosure, could be significant even though the recorded balance of the related line item or account is not material. For example:

- the completeness assertion could be significant for an accrued payroll account with a high combined risk of material understatement even if its recorded balance is zero; and
- the disclosure assertion could be significant for a contingent liability even if no amount is recordable.

**2.1.27** If the financial statements include a monetary amount for fixed assets, management asserts that this amount is fairly stated at the time of acquisition. This general assertion can be broken down into more detailed assertions. For example, fixed assets are complete, they exist, related property rights are owned by the auditee, they are properly classified and described and valued in accordance with stated accounting policies which are appropriate in the circumstances. Inventory records of capital goods should be maintained and physical verification is to be carried out yearly/half-yearly.

#### *Audit objectives*

**2.1.28** To form an audit opinion on the financial statements, the auditor sets audit objectives to obtain audit evidence as to whether financial statement assertions are free of misstatements that would be material to the financial statements taken as a whole.

**2.1.29** The auditor defines the audit objectives for those assertions that relate to significant financial statement account balances and classes of transactions.

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**2.1.30** An audit objective is the goal of obtaining audit evidence about a set of related financial statement assertions. At the simplest level, the audit objectives may mirror management's assertions.

**2.1.31** Usually it is more practical for audit objectives to cover more than one assertion simultaneously, or to address only part of an assertion. For example:

- all revenues are recorded accurately. This audit objective addresses management's assertions of completeness and accuracy of revenues.

#### *Critical audit objectives*

**2.1.32** The auditor identifies those audit objectives that may benefit from the judgements of the most experienced members of the audit team.

**2.1.33** These are referred to as critical audit objectives. An audit objective is considered to be critical when the inherent risk (see paragraphs 2.1.35 -2.1.40) is high and:

- the related financial statement assertion requires a considerable degree of judgement; or
- it is difficult to obtain audit evidence or to apply audit procedures.

**2.1.34** Critical audit objectives are more likely to relate to account balances and classes of transactions resulting from processing non-routine transactions, rather than from systematically processed routine transactions.

#### *Assessment of inherent risk, control risk and the risk of significant misstatements*

##### **Inherent risk**

**2.1.35** Inherent risk is the risk that significant misstatements, both intentional and unintentional, may occur, disregarding the effectiveness of internal control to prevent or detect and correct such misstatements.

**2.1.36** The auditor cannot, in the short term, influence inherent risk: the task is to assess the risk.

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**2.1.37** Misstatements occur when there is a failure to capture, process or report data correctly or misstatements are introduced into the data at any time. The number and size of misstatements depend on many conditions or events relating to the auditee's operations. These conditions or events can be divided between those that are:

- ministry/department/agency-wide; and
- specific to individual financial statement assertions.

**2.1.38** When the auditor develops the audit strategy and planning, the auditor considers the company-wide conditions or events that may increase the risk of significant misstatements.

**2.1.39** When assessing inherent risk, the auditor consider the combined effect of both ministry/ agency and specific conditions or events. The assessment of inherent risk is an audit judgement – the risk that significant misstatements may occur, disregarding internal control.

**2.1.40** Indicators of inherent risk that the auditor may consider for each audit objective include the following:

<i>Indicators of higher inherent risk</i>	<i>Indicators of lower inherent risk</i>
<p><b>Susceptibility to misappropriation:</b></p> <p>Classes of transactions and related account balances involve:</p> <ul style="list-style-type: none"> <li>▪ cash receipts or disbursements</li> <li>▪ negotiable items</li> <li>▪ items susceptible to theft such as inventory items</li> <li>▪ items that are susceptible to misappropriation either directly or indirectly through devices such as kickback arrangements or fictitious transactions, employees, vendors or customers</li> </ul>	<p><b>No susceptibility to misappropriation:</b></p> <p>Classes of transactions and related account balances involve:</p> <ul style="list-style-type: none"> <li>▪ intangible or tangible assets not susceptible to theft or conversion to items susceptible to theft</li> <li>▪ liability or valuation accounts not ultimately settled by cash, negotiable items or items susceptible to misappropriation</li> </ul>
<p><b>Nature of items included in classes of transactions and account balances:</b></p> <ul style="list-style-type: none"> <li>▪ fewer, large items</li> <li>▪ complex calculation</li> <li>▪ manual intervention is required</li> </ul>	<p><b>Nature of items included in classes of transactions and account balances:</b></p> <ul style="list-style-type: none"> <li>▪ many small items</li> <li>▪ amounts are straight forward</li> </ul>

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#### **Control risk**

**2.1.41** The auditor assesses the effectiveness of internal control to provide reasonable assurance that significant misstatements are prevented, or detected and corrected, at the level of audit objectives. The intrinsic limitations of internal control mean there is always a risk that significant misstatements may occur and remain undetected.

These limitations may be due to:

- resource constraints and the need to consider the cost of internal control in relation to expected benefits;
- the limits of human judgement and such human failures as simple errors or mistakes due to carelessness, distraction, mistakes or the misunderstanding of instructions;
- the ability of management to override internal control;
- the possibility of collusion of two or more people inside or outside the auditee; and
- the reality that breakdowns may occur.

**2.1.42** The auditor refers to the risk of internal control failing to prevent, or detect and correct, significant misstatements as control risk.

**2.1.43** If the audit considers internal control to be effective in preventing, or detecting and correcting significant misstatements, the auditor assesses control risk as low.

**2.1.44** If the auditor considers internal control to be ineffective in preventing, or detecting and correcting, significant misstatements, or the auditor considers that it would not be efficient to evaluate the effectiveness of internal control, the auditor assesses control risk as high.

**2.1.45** During audit planning the auditor obtains an understanding of internal control and make preliminary assessments of control risk for each audit objective (assessments are preliminary until the tests of controls are completed).

Section 2.2 - Internal control - provides further guidance.

#### **The risk of significant misstatements**

**2.1.46** The risk of significant misstatements is the combination of inherent risk and control risk.

**2.1.47** If the auditor assesses the risk of significant misstatements as low, it is believed that a significant misstatement in the financial statement assertions covered by the audit objectives is unlikely.

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**2.1.48** If the auditor assesses the risk of significant misstatements as high, it is believed that a significant misstatement in the financial statement assertions covered by the audit objectives is likely.

**2.1.49** The following general guidelines may be useful:

- the higher the inherent risk, the more assurance management requires from the internal control process;
- if the risk of significant misstatements is low, usually it is because internal control is effective;

*For example, most entities provide for internal control to prevent theft, misappropriation, and other irregularities involving cash receipts, cash disbursements, cash balances, negotiable items and inventory items involved in many or most of an auditee's routine transactions.*

- when inherent risk is low, management requires less assurance from the internal control process;

*For example, the auditor expects to find few control activities directed to preventing theft of an office building (existence). However, the auditor may expect to find control activities directed to preventing unauthorised liens and protecting title (ownership).*

- risk of significant misstatement always exists, at some level, for an audit objective. Substantive audit procedures are required to address the risk that is present.

#### *Relationship between the risk of significant misstatements and planned substantive audit procedures*

**2.1.50** There is a direct relationship between the risk of significant misstatements in financial statement assertions and the audit evidence the auditor requires from their substantive audit procedures. The higher the risk of significant misstatements the more persuasive the audit evidence the auditor requires.

**2.1.51** As the risk of significant misstatements decreases, the auditor may modify the substantive procedures by altering their nature, timing and/or extent. For example:

- perform more analytical procedures and fewer tests of details;
- perform more audit procedures in advance of year-end; or
- confirm few accounts of tax payers who are in tax arrears, amount of loan provided by the government and interest thereon.

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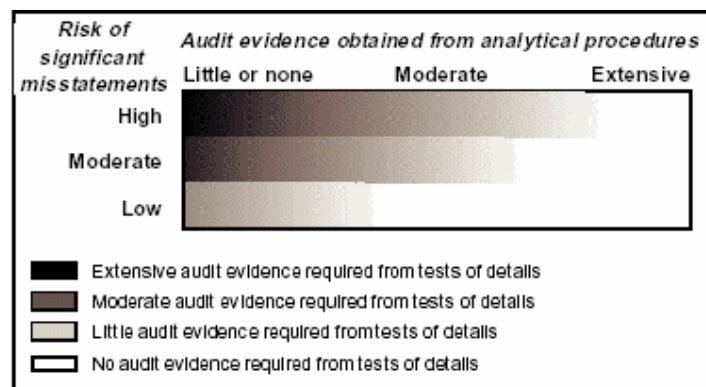
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**2.1.52** Even if the risk of significant misstatements is low, the auditor does not altogether eliminate substantive audit procedures for an audit objective. The auditor may obtain substantive audit evidence by performing either analytical procedures or tests of details. Section 3 – Effective audit evidence provides further guidance.

**2.1.53** The relationship between the risk of significant misstatements, the audit evidence obtained from analytical procedures and the audit evidence required from tests of details is illustrated below:



**2.1.54** As the need for tests of details increases, the auditor may modify the audit procedures by altering their:

- Timing - For example, perform tests of details closer to the year-end; and
- Extent - For example, circularise more account balances.

#### *Documentation of audit planning*

**2.1.55** The auditor documents the audit planning decisions in the Strategy and Planning Memorandum.

**2.1.56** The planned audit procedures are documented in the Audit Programme.

The audit programme template is attached in **Appendix 1**.

**2.1.57** The Planning Memorandum serves a number of purposes:

- as a source of reference when carrying out the audit work;
- to help measure progress toward completion; and
- to communicate between members of the audit team.

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The Strategy and Planning Memorandum summarises significant planning decisions. It usually includes the following items to the extent they apply:

- technical aspects:
  - background information, a brief history of the auditee, (ministry/department/project) and current financial position;
  - recent developments, performance during the year, changes in auditee's operations, acquisitions, and dispositions/auctions;
  - objectives and duties of the operations (ministries) highlighting analysis of key areas of the operation's 5-year plan and long term plans;
  - incorporation and analysis of the operation's (Ministry's) budget and work plan for the year and comparison of budget against the actual results of the auditee;
  - a summary of the approach to obtaining an understanding of internal control;
  - a summary of the nature, timing and extent of audit procedures for critical audit objectives; and
  - a summary of work to be performed by internal auditors and/or specialists.
- logistical aspects:
  - staffing, including details of the audit team members and other auditors
  - key people in the auditee's organisation to be contacted
  - the required type and timing of report on the audit of the financial statements and other reports to the auditee; and
  - timetable.

#### *Approval of audit planning*

**2.1.58** The DAG approves the Strategy and Planning Memorandum before the start of significant fieldwork. If audit planning decisions are modified as the audit progresses, the auditor documents the changes and the AAG approves them when the changes are made. Changes usually are documented in the Completion Memorandum.

#### *Communication of audit planning*

**2.1.59** Audit planning decisions are communicated to members of the audit team, as appropriate. For example, a meeting may be held at which the AAG and Director discuss the planned audit approach with the audit team.

## **2.2 Internal Controls**

### *Introduction*

**2.2.1** This section provides guidance on:

- the approach to internal control;
- what internal control is;
- what the auditor needs to understand;
- how the auditor obtains an understanding;
- reporting control deficiencies;
- how to decide between a systems-based or substantive approach for each audit objective;
- how the auditor makes preliminary assessments of control risk; and
- preparing the Control Overview Document and other documentation.

### *Definition*

**2.2.2** Internal control is a process, effected by an auditee's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in one or more of the following categories:

- effectiveness and efficiency of operations;
- reliability of financial information; and
- compliance with applicable laws and regulations.

**2.2.3** This definition implies that internal control is:

- a means by which management controls the auditee's activities, being a series of actions built into, rather than being added onto, the process for managing an auditee's operations;
- accomplished by the people of an auditee, by what they do and what they say; and
- can provide only reasonable assurance regarding attainment of an auditee's objectives.

**2.2.4** Management seeks to monitor and mitigate the operations' risks that an auditee's objectives will not be attained as the result of all the chiefly external factors, pressures and forces brought to bear on the auditee. Internal control depends on the risks management perceives to be the greatest. Perceptions of risks and appropriate responses to the risks differ from operations to operations and from individual to individual.

**2.2.5** Every auditee develops strategies to achieve diverse objectives. By considering these objectives in three broad categories, i.e. operations, financial reporting and compliance, the auditor may distinguish what can be expected from each category. The auditors may then focus more specifically on what is relevant to the audit of the financial statements.

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#### **Operations**

**2.2.6** Achievement of objectives relating to the auditee's effective and efficient use of the auditee's resources is not always within an auditee's control. Internal control cannot prevent bad operations judgements and decisions or external events that can cause an operations to fail to attain its operating goals. For these objectives, internal control can provide reasonable assurance only that management is aware of the extent to which the auditee is moving toward those objectives.

#### **Financial reporting**

**2.2.7** Internal control, if effectively designed and operating, may be expected to provide reasonable assurance of attaining objectives relating to reliability of financial reporting. Achievement of those objectives can be measured against performance indicators/set targets set by the auditees.

#### **Compliance**

**2.2.8** Achievement of those objectives relating to the auditee's compliance with applicable laws and regulations. However, laws and regulations may stem from many sources, leading to overlap or even conflict. Laws and regulations may be complex and are sometimes ambiguous.

#### *Components of internal control (COSO)*

**2.2.9** Internal controls consists of inter-related components:

- risk assessment; (2.2.10-2.2.13)
- control environment; (2.2.14-2.2.15)
- information and communication; (2.2.16-2.2.19)
- monitoring; and (2.2.20-2.2.21)
- control activities. (2.2.22-2.2.38)

#### **Risk Assessment**

**2.2.10** Management sets both auditee-wide objectives and activity-level objectives, identifying and analysing the risks that these objectives will not be achieved. All entities, regardless of size, structure, nature or industry are subject to operations risks. Operations risks affect each auditee's ability to survive, compete successfully within its entity, maintain its financial strength and positive public image and safeguard the overall quality of its products, services for the well-being of its people.

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**2.2.11** The decision to be in operations is a decision to accept risk. There is no practical way to reduce risk to zero. Management decides what risks to accept and the extent and methods to be applied to monitor and mitigate the risks. Because economic, industry, regulatory and operating conditions continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

**2.2.12** The risk assessment process is less formal and less structured in smaller entities. Smaller entities are usually more centralised and have fewer levels of authority. As a result, it may be easy and effective to communicate management's objectives to personnel.

**2.2.13** In smaller entities, the process of identifying and analysing risks to the achievement of objectives often consists of management receiving information directly from outsiders and employees. Management learns about operations risks from external sources through direct contact with customers, suppliers, the auditee's banker, lawyer, independent auditor and others. Management is aware of risks from internal factors through continuous contact with employees. Risk assessment can be particularly effective because management has both access to appropriate information and a good understanding of its implications.

#### **Control environment**

**2.2.14** The control environment consists of those factors that set the tone of an auditee's operations and thereby influence the control consciousness of people in the auditee's operations. The factors reflected in the control environment include the following:

- integrity and ethical values;
- commitment to competence;
- management's philosophy and operating style;
- the entity's organisational structure;
- methods of assigning authority and responsibility;
- human resource policies and practices; and
- control methods over budget formulation and execution.

**2.2.15** The control environment is the foundation for the other components of internal control, providing discipline and structure. It provides an atmosphere in which people conduct their activities and carry out their control responsibilities.

#### **Information and communication**

**2.2.16** Information refers to what is identified, captured and communicated in a form and time frame that enables people within the auditee's operations to carry out their responsibilities.

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**2.2.17** Communications refers to providing information down, across and up the auditee's operations as well as externally, as appropriate. Effective communication includes a clear message from management that control responsibilities are taken seriously as well as information about how each individual in the auditee's operations relates to internal control and the work of others.

**2.2.18** An auditee's information system is the collection of an auditee's resources (people, expertise, facilities, processes, hardware, software and data) designed to provide information to accomplish operations objectives. A financial information system is part of the auditee's larger information system.

**2.2.19** An information system provides reports containing operational, financial and compliance-related information that make it possible to operate and control the operations. An information system deals not only with internally generated data, but also with information about external events, activities and conditions necessary for informed operations decision-making and external reporting.

#### **Monitoring**

**2.2.20** Monitoring activities are directed toward assessing the performance of the internal control system over time. Monitoring may be performed through ongoing activities, separate evaluations or a combination of the two. Effective monitoring provides for reporting of internal control deficiencies upward, with serious matters reported to management. Usually, some combination of ongoing monitoring and separate evaluations provide assurance that internal control maintains its effectiveness over time.

**2.2.21** Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities and other actions personnel take in performing their duties. The scope and frequency of separate evaluations depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures.

#### **Control activities**

**2.2.22** Control activities are the policies and procedures that help provide assurance that management's directives are carried out. They help provide assurance that necessary actions are taken to address risks to the achievement of the auditee's objectives. Control activities occur throughout the auditee's operations, at all levels and in all functions. They include a range of activities as diverse as approvals, authorisations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

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**2.2.23** It is sometimes helpful to think of control activities at two levels:

- general control activities that contribute to, or support the effectiveness of, internal control for many financial statement assertions (or audit objectives if viewed from an auditor's perspective); and
- control activities that apply to specific financial statement assertions (or audit objectives if viewed from an auditor's perspective).

**2.2.24** An auditee's information system contributes to the internal control process, but at the same time needs to be controlled. In part, this is accomplished by providing a stable, effective processing environment. That environment is maintained by what the auditor may broadly refer to as computer controls. Computer controls consist of:

- general IT controls; and
- application controls.

**2.2.25** General IT controls are those control activities designed to provide reasonable assurance as to the continued proper operation of the information system. General IT controls include control activities involving:

- application systems development and maintenance;
- access controls;
- computer operations; and
- system software acquisition and maintenance.

**2.2.26** General IT controls usually are a combination of policy, guidelines, manual controls and software applications such as access control systems.

**2.2.27** Application controls are the programmed procedures in application software and related manual procedures designed to provide reasonable assurance about the completeness, accuracy and validity of information processing.

#### *Preventive and detective controls*

**2.2.28** It is often useful to distinguish control activities on the basis of the objectives of those activities. Broadly, all control activities may be grouped into preventive controls and detective controls.

**2.2.29** Preventive controls are designed to prevent misstatements or other conditions resulting from some event.

**2.2.30** Detective controls are designed to detect misstatements or other conditions after occurrence for the purpose of correcting the condition such as correcting the accounting records. Sometimes, detective controls are less costly than preventive controls. Detective controls are inappropriate if the objective is to prevent an event from occurring.

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#### *Effectiveness of internal controls*

**2.2.31** A judgement as to whether an auditee's internal control is effective is based on considering the extent to which the components are present and operating effectively. Effective functioning of all the components provides reasonable assurance as to achievement of one or more of the three categories of objectives (see paragraph 2.2.2.).

**2.2.32** Internal control may be judged effective for each of the three categories of internal control objectives if management have reasonable assurance that:

- they understand the extent to which the auditee's operations objectives are being achieved (operations objectives);
- published financial statements are being prepared reliably (financial reporting objectives); and
- applicable laws and regulations are being complied with (compliance objectives).

**2.2.33** Effectiveness of internal control depends on the presence of all the components of internal control working together. No two entities are likely to have the same internal control system. Nevertheless, even though entities may not respond to similar risks in the same way, the basic components contributing to an auditee's being in control need to be satisfied.

**2.2.34** For the financial reporting objective there is a more detailed criterion, namely, the material weakness concept. A material weakness is defined as follows:

“A condition in which the design or operation of one or more elements of internal control does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements being audited may occur and not be detected and corrected within a timely period by employees in the normal course of performing their assigned duties.”

#### *Obtaining an understanding of internal control*

**2.2.35** Financial statements are the responsibility of management. Because virtually all entities produce financial reports for a number of purposes, they all have a common set of objectives relating to financial reporting. The common set of objectives relates to representations by management (financial statement assertions) embodied in the financial statements. To plan the audit, the auditor needs to understand the internal control process as it applies to these objectives for the reliability of the financial statements.

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**2.2.36** An understanding of internal control is required even if the auditor were to plan a substantive approach for all audit objectives. The minimum level of understanding sufficient to plan the audit is that which permits the auditors to identify:

- the potential types of significant misstatements that may occur;
- the factors that affect the risk of significant misstatements; and
- the nature, timing and extent of the substantive audit procedures.

**2.2.37** The auditor obtains or updates an understanding of internal control by a combination of the following procedures:

- enquiries of management, supervisory and staff personnel;
- observation of an auditee's activities and operations; and
- limited inspection of documents and records.

**2.2.38** Obtaining or updating an understanding of internal control is not a linear process in which one step always follows another.

Nevertheless, an approach likely to be efficient is as follows:

- first, complete or update the understanding of the auditee's risk assessment process and the control environment which was initially obtained during the development of and planning;
- second, identify how the auditee's information system (part of the information and communication component) supports the auditee's significant classes of transactions; and
- third, consider monitoring and control activities as they relate to the financial statements generally and, if appropriate, as they relate to specific audit objectives.

#### **Risk assessment and control environment**

**2.2.39** Management's process for identifying risks, deciding the level of risks to accept and deciding the internal control mechanisms to put into place to monitor and reduce those risks, ultimately may affect the risk of material misstatements in financial statements.

**2.2.40** Management assesses risks to the achievement of specified objectives within the control environment. Information relevant to the perceived risks is captured and communicated throughout the organisation. Control activities are implemented at all levels of the organisation to provide reasonable assurance that management's directives are carried out. The entire process is monitored and modified as conditions warrant.

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**2.2.41** Whether an auditee has a satisfactory control environment depends more on the attitude and actions of management than on anything else. Whether the auditee is committed to good control requires consideration of many subjective matters and judgement at a high professional level. A satisfactory control environment encourages or supports a systems-based approach.

**2.2.42** If the commitment to good internal control is weak, it is likely that the control environment as a whole is also weak. A weak control environment suggests a substantive approach for most or all audit objectives as well as an increased level of professional scepticism during the audit.

**2.2.43** When the auditor obtain an understanding of the risk assessment process and the control environment the auditor is likely to obtain some knowledge about information and communications within the auditee as well as those monitoring activities and control activities applied by management, particularly at higher levels of the organisation. Moreover, because the control environment is the foundation for the other components of internal control, the auditor is able to modify the initial plans if the findings are significantly different from the expectations.

#### **Information and communication**

**2.2.44** As a practical approach to obtaining the understanding, a first step is to identify how the auditee's information system supports the significant classes of transactions. The second step is to obtain an understanding of the following for the auditee's significant classes of transactions:

- how the transactions are initiated;
- how information about the transactions is processed (from initiation of transactions to inclusion in the financial statements) including how the auditee uses information technology to process data; and
- the accounting records, supporting documents and how relevant information is reported in the financial statements.

**2.2.45** In addition to understanding how relevant information for the significant classes of transactions is reported in the financial statements under audit, the auditor is also interested in understanding how the information is communicated to persons within the auditee's operations. How the information is communicated and acted upon may be important to the internal control process.

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#### **Monitoring and control activities**

**2.2.46** The auditor considers monitoring and control activities in two parts:

- monitoring and control activities at a general level; and
- monitoring and control activities as they apply to specific audit objectives.

**2.2.47** The auditor considers monitoring and control activities at a general level to:

- help identify the specific activities that management uses to address the risks to the achievement of the auditee's objectives;

For example, by understanding management's review of financial reporting and other operating information, the auditor may identify activities within this overall review process that may be identified with specific audit objectives.

- understand the extent to which these activities provide the basis for assessing control risk as low or moderate for specific audit objectives.

For example, an internal audit function, of appropriate organisational status, staffed with competent internal auditors and operated to provide an objective viewpoint, may effectively monitor the continued effectiveness of design and operation of control activities for specific audit objectives.

**2.2.48** A systems-based approach to an audit objective involves identifying the monitoring and control activities specific to the audit objective and considering whether these activities are effective to prevent, or detect and correct, significant misstatements. The most efficient approach to identifying these specific activities is to consider management's perspective. The auditor works from the presumption that responsible management is likely to respond to significant risks confronting an auditee by establishing policies and procedures to monitor and mitigate these risks. Therefore, the auditor asks management, at the appropriate levels of the auditee's operations, what monitoring and control activities are established that provide the reasonable assurance that management relies on.

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#### *Reporting control deficiencies*

**2.2.49** When the auditor obtains or update an understanding of internal control (or at anytime during the audit), the auditor may become aware of deficiencies in internal control which do not comply with the Financial Procedural Act and the Financial Administrative Rules. Among other things, the auditor may find that:

- management fails to recognise some risk of significant misstatements and fails to put effective control activities into place;
- management recognises the risk of significant misstatements, but the design of the related control activities is ineffective;
- the control activities in place are inefficient or ineffective in operation; or
- control activities that might otherwise be effective are undermined by a weak control environment.

**2.2.50** The auditors are required to report to management those material weaknesses that come to their attention. Because of their potential effect, it is usually important to report them promptly.

**2.2.51** The auditors also report other control deficiencies related to financial reporting that are not as serious as a material weakness but nevertheless may be important. These control deficiencies are defined as significant deficiencies in the design and/or operation of internal control, which could adversely affect the auditee's ability to record, process, summarise and report financial data consistent with assertions in financial statements.

**2.2.52** The auditor may also become aware of control deficiencies that affect the ability of the auditee to attain its operating and compliance objectives. The auditor may report them to management, as appropriate.

**2.2.53** There are two basic approaches for each audit objective:

- a systems-based approach – the auditor plans to obtain most audit assurance from internal control;
- a substantive approach – the auditor plans to obtain most audit assurance from substantive audit procedures.

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<i>Reasons for a systems-based approach:</i>	<i>Reasons for a substantive approach:</i>
<ul style="list-style-type: none"> <li>– it is difficult to obtain audit assurance another way such as for audit objectives for completeness assertions</li> <li>– audit work often can be conducted earlier, spread over time or when audit staff are more readily available and, sometimes, the audit can be completed by an earlier date.</li> </ul>	<ul style="list-style-type: none"> <li>– a substantive approach is more efficient for certain audit objectives</li> <li>– the auditor has concerns about the risk of significant misstatements for certain audit objectives and the auditor chooses to address the risk by substantive audit procedures</li> <li>– the auditor concludes that internal control may not be effective for certain audit objectives</li> </ul>

**2.2.55** Usually a systems-based approach is selected for some audit objectives and a substantive approach is selected for other audit objectives:

<i>A systems-based approach is presumed to be appropriate for:</i>	<i>A substantive approach is presumed to be appropriate for:</i>
Audit objectives that relate to: <ul style="list-style-type: none"> <li>– financial statement assertions relating to completeness, existence and accuracy of systematically processed routine transactions.</li> </ul>	Critical audit objectives and other audit objectives that relate to: <ul style="list-style-type: none"> <li>– non-routine transactions</li> <li>– valuation, presentation and disclosures assertions</li> </ul>

*Making a preliminary assessment of control risk*

**2.2.56** To make preliminary assessments of control risk, the auditor considers the components of internal control individually and together. These assessments are made for each audit objective when the auditor has obtained or updated the understanding of internal control.

**2.2.57** The auditor makes preliminary assessments of control risk as low or moderate if, based on the understanding, the internal control process appears to be effective for the financial statement assertions addressed by those audit objectives.

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**2.2.58** For the audit objectives for which the auditor plans a substantive approach, both the preliminary and the final assessments of control risk are understood to be assessed as high. It is not necessary to state such assessments in the work papers. The automatic assessment of control risk as high for these audit objectives ordinarily is not because the auditor believes internal control is ineffective. The assessment may be because the auditor chooses to address the audit objective by means of substantive audit procedures.

**2.2.59** If the auditor believes the risk of significant misstatements for an audit objective is high because internal control is ineffective to prevent, or detect and correct such misstatements, the auditor considers whether such an audit objective is a critical audit objective and plan the substantive audit procedures accordingly.

#### *Documentation of the understanding of internal control*

**2.2.60** The auditor documents the understanding of internal control as it relates to the reliability of the financial statements the auditor is auditing. Minimum documentation includes the following:

- Control Overview Document;
- the understanding of how the auditee's significant classes of transactions are initiated, processed and reported in the financial statements;
- preliminary assessments of control risk as moderate or low for audit objectives for which the auditors plan a systems-based approach;
- the specific activities in the internal control process that are the basis for such preliminary assessments of control risk as moderate or low; and
- planned tests of controls for the specific activities that are the basis for preliminary assessments of control risk as moderate or low.

**2.2.61** The extent of documentation is influenced by the auditee's size, complexity and the nature of its internal control process. Choice of the form of documentation depends on the availability of auditee documentation, and preferences of the audit team. For example, documentation may combine documentation prepared by the auditee and by OAGN, and it may include a combination of flowcharts, narratives, questionnaires and decision tables.

**2.2.62** Assessments of control risk and planned tests of controls may be documented in the Audit Programme or in other work papers. Selection of planned tests of controls is discussed in section 2.3 - Routine transactions.

### **Control Overview Document (COD)**

**2.2.63** The Control Overview Document includes summaries of the components of internal control together with notes about weaknesses, suggestions for improvement or other observations. For each component, and overall, the auditor considers whether the understanding increases the professional scepticism and, therefore, affects the approach to the audit. The effect on the audit approach is documented, in the Control Overview Document, in the Audit Planning Memorandum and/or the Audit Programme, as appropriate.

The Control Overview Document includes the following:

- **the auditee’s risk assessment process.** A description of the auditee’s risk assessment process together with suggestions for improvement or other observations the auditor may have.
- **the control environment.** A description of the control environment and a judgement of whether it appears satisfactorily supportive of preliminary assessments of control risk as low or moderate for the audit objectives for which the auditor plans a system-based approach. If the control environment is unsatisfactory, the risk of significant misstatements may be high for many audit objectives.
- **the information and communication systems.** A description of the information and communication systems together with observations the auditor may have on the adequacy for internal and external financial reporting.
- **the general monitoring and control activities:**
  - a description of management’s review of financial reporting and other operating information, general IT controls and internal audit function and a judgement of the extent to which these reviews may contribute to preliminary assessments of control risk as low or moderate for specific audit objectives for which the auditor plans a systems-based approach.

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## **2.3 Routine transactions**

### *Introduction*

**2.3.1** This section provides guidance on:

- what routine transactions are; and
- the audit approach to routine transactions.

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**2.3.2** Routine transactions record the auditee's day-to-day operations transactions with the outside world, such as its ordinary purchases, cash payments and cash receipts. Routine transactions are likely to be:

- numerous;
- recurring;
- objectively measurable, requiring little or no judgement in determining the amount to be recorded; and
- processed in a similar way each time they occur.

**2.3.3** Despite these characteristics, in the absence of effective internal control, the risk of significant misstatements for many routine transactions is likely to be high. Many routine transactions are classes of transactions that involve:

- cash receipts or disbursements;
- negotiable items;
- items susceptible to theft such as inventory items; and
- transactions or items that are susceptible to theft or conversion to cash indirectly through fictitious transactions with/to employees, suppliers or contractors.

**2.3.4** Management usually establishes effective internal control over the recording, processing and reporting of these transactions to provide reasonable assurance regarding the achievement of objectives relating to operations, financial reporting and compliance with laws and regulations.

**2.3.5** The characteristics of routine transactions often permit highly automated processing by the information system with little or no manual intervention. The characteristics may also permit building operations rules into the system to the end that each transaction entered into the system for processing is compared to established criteria and subjected to a number of tests. Moreover, reporting may be designed to highlight exceptions for follow-up, and flag matters such as changes in size, volume and amounts of transactions.

#### *Audit approach to routine transactions*

**2.3.6** Ordinarily, the auditor plans a systems-based approach for audit objectives relating to the completeness, existence and accuracy of significant classes of transactions resulting from routine transactions.

*For example routine purchases, cash receipts and cash payments.*

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**2.3.7** Nevertheless, it may sometimes be more efficient to plan a substantive approach for audit objectives relating to the completeness, existence and accuracy of significant account balances resulting from routine transactions when the related classes of transactions are not significant.

*For example, if the procurement of capital goods/expenditure is significant but there may be few transactions during the year.*

**2.3.8** The auditors presume that a substantive approach is appropriate for audit objectives relating to valuation, ownership and presentation and disclosure assertions for significant account balances resulting from routine transactions.

*For example, audit objectives relating to revenue receivables/arrears*

*Additional procedures to extend understanding of internal control*

**2.3.9** For those audit objectives for which the auditor plans a systems-based approach:

- the auditor makes preliminary assessments of control risk as low or moderate based on the understanding of internal control as discussed in Section 2.2 - Internal control; and
- the auditor identifies the specific activities in the internal control process that are the basis for the systems-based approach.

**2.3.10** It is important that the specific activities are linked to the audit objectives for which the auditor plans a systems-based approach.

- The auditor plans and performs tests of controls to obtain audit evidence about the effectiveness of design and operation of such specific activities;
- based on the audit findings, the auditor confirms or revises the preliminary assessment of control risk and modify the audit plan and audit programme if required; and
- the auditor reports the findings to the auditee, as appropriate.

**2.3.11** Section 2.2 - Internal control - discusses the approach to internal control, including how the auditor obtains an understanding of internal control and preparation of the Control Overview Document summarising the understanding of each of the components of internal control at an overview level.

### **Identifying specific monitoring and control activities**

**2.3.12** In obtaining a detailed understanding of internal control, it is usually efficient to consider first the monitoring and control activities that management routinely applies to monitor and mitigate the auditee's operations risks. These activities carried out at higher levels of the organisation often include detective controls that apply to many processes within an information system.

*Examples of specific monitoring and control activities that may be effective to detect certain misstatements include:*

- *review of financial reports by operations management responsible for the transactions on an ongoing basis through operating reports that are integrated or reconciled with the financial reporting system; and*
- *internal audit activities.*

**2.3.13** Detective controls often are applied to account balances that are the result of several classes of transactions.

*Examples of detective controls that may be relevant include:*

- *following up on exception reports that identify transactions that do not comply with the operations rules built into the application system*
- *comparing recorded amounts to third-party records, such as reconciling the amount in the general ledger to statements received (in electronic form or otherwise) from banks.*

**2.3.14** If the auditor does not identify specific activities at these higher levels that provide sufficient assurance about the effective design and operation of internal control for individual audit objectives, the auditor may extend the understanding to identify more detailed activities, such as preventive controls applied at lower levels of the auditee's operations.

### **IT/EDP controls**

**2.3.15** Many control activities are likely to be computer controls. Depending on the technical design of the information system, the emphasis of computer controls may be on general IT controls or application controls. Understanding the emphasis within the auditee's operations is important to judge the relative importance of general IT controls. General controls are considered as part of the general understanding of internal control as documented in the Control Overview Document.

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**2.3.16** General IT controls are usually pervasive, covering most applications. Effective design and operation of general IT controls may provide assurance that application controls are appropriately designed and function consistently over time. Therefore, before the auditor looks to application controls, the auditor obtains an understanding of whether and to what extent general IT controls apply to those audit objectives for which he auditor plans a systems-based approach.

**2.3.17** Because it is important that processing of data take place using authorised applications, the auditor needs to understand, with respect to these same audit objectives, how the general IT controls operate to provide assurance that:

- only authorised applications are used; and
- those applications meet appropriate criteria for design, performance and acceptance by users.

**2.3.18** When general IT controls provide reasonable assurance on these points, the auditor may limit the extent to which the auditor seeks an understanding of application controls.

#### **Other control activities**

**2.3.19** Other control activities relevant to specific audit objectives may include:

- proper authorisation of transactions;
- separating the responsibilities of authorising transactions, recording transactions, and maintaining custody of related assets so that individuals are not in positions to both perpetrate and conceal errors or irregularities in the normal course of performing duties;
- safeguards over access to and use of assets and records only by authorised personnel, including access to computer programs and data files;
- design of documents and records that promote complete and accurate recording of transactions and events and use of such documents and records to prevent or detect errors; and
- independent checks of performance and proper valuation of recorded amounts.

#### *Planned test of controls*

**2.3.20** The auditor plans to perform tests of controls to obtain audit evidence to confirm or refute the preliminary assessment of control risk. Tests of controls may consist a combination of:

- enquiry;
- observation;
- inspection of documents; and

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- reperformance (usually consisting of some combination of the first three items and calculations).

**2.3.21** The procedures the auditor performs to obtain or update the understanding may, at the same time, provide audit evidence about the effectiveness of design and operation of internal control and thereby serve as tests of controls. It is unlikely that such procedures alone will provide sufficient, appropriate audit evidence about the effectiveness of the relevant internal control activities. Nevertheless, if planned appropriately, the understanding of internal control and the tests of controls may be performed concurrently, in whole, or in part. See Section 3.2- Tests of controls.

#### *Substantive audit procedures*

**2.3.22** The audit evidence the auditor obtains from tests of controls may confirm a systems-based approach but does not entirely eliminate substantive audit procedures. A systems-based approach may enable the auditors to:

- modify the nature of the planned substantive audit procedures;
- modify the timing of the planned substantive audit procedures; and
- reduce the extent of the planned substantive audit procedures.

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## **2.4 Non-routine transactions**

### *Introduction*

**2.4.1** This section provides guidance on:

- what non-routine transactions are; and
- the audit approach to non-routine transactions.

### *Definition*

**2.4.2** Non-routine transactions are transactions that are unusual, either due to size or nature, or that occur infrequently. Non-routine transactions may:

- be relatively few in number;
- be unpredictable;
- require judgement to determine amounts and the accounting period for recording; and
- involve questions of intent or economic substance.

**2.4.3** Non-routine transactions include:

- operations transactions that are unusual in some respect;

*For example, non-allocated but approved budget, i.e. foreign delegates to Nepal (separate budget allocation – contingent budget), retirement benefits, insurance schemes etc.*

- operations transactions outside the routine activities of the auditee;

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*For example, dispositions/auctions of capital goods, sale or privatisation of public enterprises, expenditure relating to exchange visits of dignitaries.*

- accounting entries outside the normal course of operations.

*For example, closing entries made only at year-end or other external reporting dates, entries to correct misstatements, adopt new accounting policies, and re-allocations of amounts between different account balances.*

**2.4.4** Inherent risk may be high. There may be:

- greater management intervention to specify accounting;
- greater manual intervention for data collection and processing;
- greater judgement required in determining amounts; and
- complex calculations or accounting principles.

**2.4.5** The nature of non-routine transactions may make it difficult for management to implement effective internal control for non-routine transactions as compared to routine transactions.

**2.4.6** Consequently, the risk of significant misstatements may be high.

Even though it may be difficult for management to implement effective internal control for non-routine transactions, management may have a responsibility to do so.

*For example, monitoring and control activities may include policies and procedures for authorisation and approval of non-routine transactions.*

**2.4.7** If the auditors believe there are control deficiencies, the auditors report them to management.

#### *Audit approach to non-routine transactions*

**2.4.8** In the absence of effective internal control, a substantive approach for audit objectives relating to non-routine transactions is required.

**2.4.9** Even if internal control is established, the recording, processing, and reporting of non-routine transactions often involves questions about accounting principles, valuation, presentation and disclosures. Accordingly, the auditor presumes that a substantive approach is appropriate for audit objectives relating to non-routine transactions.

**2.4.10** Tests of details ordinarily are appropriate to obtain audit evidence about non-routine transactions.

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**Confirmations**

**2.4.11** When the auditee has entered into an unusual or complex transaction and the risk of significant misstatements is high, the auditor needs an understanding of the substance of the auditee's arrangements and transactions with third parties to determine whether confirmation of the terms of the transactions with the other parties is warranted in addition to examining documentation held by the auditee.

*For example, the auditor may confirm terms such as side agreements*

**2.4.12** Section 3.4 - Tests of details - provides further guidance (see paragraphs 3.4.30 – 3.4.41)

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**2.5 Internal audit**

*Introduction*

**2.5.1** This section provides guidance on internal audit carried out by the Financial Comptroller General's Office (FCGO):

- understanding the internal audit function;
- considering internal audit work as audit evidence;
- testing internal audit work;
- the effect of internal audit work on the audit.

*Understanding the internal audit function*

**2.5.2** If the auditee has an internal audit function, the auditor obtains an understanding of the internal audit activities sufficient to identify those that are relevant to planning the audit.

*For example, many internal audit functions monitor internal control; this may affect the nature, timing and extent of the tests of controls.*

*For example, internal auditors may perform substantive tests of account balances which may affect the nature, timing and extent of the substantive audit procedures.*

**2.5.3** To obtain an understanding of the internal audit function:

- the auditor considers its organisational status within the auditee
- the auditor enquires of management and internal audit personnel about:
  - the mission statement or similar directive from management for internal audit;
  - the internal audit plan for the current year;
  - internal audit access to records and whether there are restrictions on internal audit work; and

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- application of professional standards within the internal audit function.

**2.5.4** After the auditor obtains an understanding of the internal audit function, the auditor makes a judgement about internal audit activities. In either of the two following situations, the auditor need not give further consideration to the internal audit function unless the auditor requests direct assistance from the internal auditors:

- the auditor concludes that internal audit activities are not relevant to the financial statement audit; and
- the auditor concludes that internal audit activities are relevant to the financial statement audit, but the auditor concludes that it would not be efficient to consider further the work of the internal auditors.

**2.5.5** The following procedures may be helpful in assessing the relevancy of internal audit activities:

- consider knowledge from prior-year audits;
- review how the internal auditors allocate their audit resources to financial or operating areas in response to their risk-assessment process; and
- read internal audit reports to obtain information about the scope of internal audit activities.

#### *Considering internal audit work as audit evidence*

**2.5.6** If the auditor concludes that it would be efficient to make use of internal audit work to modify the nature, timing and extent of the audit procedures, the auditor considers the competence and objectivity of the internal audit function in light of the intended effect of internal audit work on the audit.

**2.5.7** The auditor considers the competence and objectivity of internal audit by obtaining information about matters such as the following:

#### **Competence**

- policies for continuing education and professional certification
- policies for assignment of internal auditors
- policies for evaluation of internal auditors' performance
- supervision and review of internal auditors' activities

#### **Objectivity**

- reporting high enough in the organisation to provide broad audit coverage and adequate action on audit findings
- regular direct access to the auditee's management

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#### **Competence**

- educational level and professional experience of internal auditors
- comprehensiveness and quality of audit programs and procedures
- quality of work papers, reports and recommendations

#### **Objectivity**

- the auditee’s management oversees employment, promotion and remuneration
- freedom to communicate with OAGN’s audit team
- prohibiting internal auditors from auditing areas where relatives are employed in important positions

**2.5.8** In considering the objectivity of internal audit, the auditor may consider policies prohibiting internal auditors from auditing areas in departments where they were recently assigned before joining, or are scheduled to be assigned upon leaving, the internal audit function.

**2.5.9** If the auditor is satisfied about the internal auditors’ competence and objectivity, the auditor plans audit procedures to test the internal auditors’ work.

#### *Testing internal audit work*

**2.5.10** The auditor performs audit procedures to evaluate the quality and effectiveness of internal audit work that significantly affects the nature, timing, and extent of the audit procedures. In selecting the audit procedures, the auditor considers matters such as the following:

- whether the scope of internal audit work is appropriate to meet its objectives;
- whether internal audit work programmes are adequate;
- whether work papers adequately document work performed;
- whether conclusions are appropriate in the circumstances; and
- whether reports are consistent with the results of the work performed.

**2.5.11** The tests of the internal audit work may include:

- whether conclusions are appropriate in the circumstances; and
- reperforming some of the audit procedures previously performed by the internal auditors.

*For example, the auditor may test the same control activities, transactions or balances as internal auditors tested.*

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- performing different audit procedures.

*For example, the auditor may test control activities, transactions or balances other than those internal auditors have tested.*

**2.5.12** The nature, timing and extent of the tests is a judgement that depends on the extent of the effect of internal audit work on the audit procedures.

*The effect of internal audit work on our audit*

**2.5.13** The auditors are responsible for obtaining sufficient appropriate audit evidence to form the audit opinion. This includes making judgements about assessments of the risk of significant misstatements and the sufficiency and appropriateness of the audit evidence the auditor obtains. The auditor cannot share this responsibility with internal audit, even though many internal audit procedures may be similar to the auditor's.

**2.5.14** However, the auditor may make use of internal audit work to modify the nature, timing and extent of the audit procedures. This may often be appropriate for objectives that relate to systematically processed routine transactions.

**2.5.15** In making judgements about the extent of the effect of internal audit work on the audit procedures, the auditor considers:

- the materiality of financial statement amounts;
- the risk of significant misstatements for the audit objectives; and
- the subjectivity in the evaluation of audit evidence.

**2.5.16** As the materiality of the financial statement amounts increases and the risk of significant misstatements or the subjectivity of the audit evidence increases, the need to perform our own tests also increases. The auditor considers the results of work (tests of controls or substantive tests) performed by internal auditors. Nevertheless, internal audit work cannot alone reduce the audit risk to the acceptably low level to eliminate the necessity for the auditors to perform tests.

**2.5.17** Critical audit objectives often involve a high risk of significant misstatements and subjectivity in the evaluation of audit evidence. Audit objectives relating to non-routine transactions may also involve higher risk of significant misstatements or subjectivity in the evaluation of audit evidence.

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**2.5.18** Accordingly, for audit objectives such as these, the audit procedures ordinarily are significant. Internal auditors' work cannot alone eliminate the substantive audit procedures for audit objectives for which the risk of material misstatement or the degree of subjectivity involved in the evaluation of audit evidence is high.

**2.5.19** When internal audit work significantly affects the audit procedures, ordinarily the auditor plans to coordinate the work with the work of the internal auditors.

*For example, the auditor may hold periodic meetings, jointly schedule audit work, arrange for reciprocal access to certain work papers, read internal audit reports and discuss accounting and auditing issues.*

*Using internal auditors to provide the auditors with assistance*

**2.5.20** The auditor may request assistance from internal audit.

*For example, internal auditors may assist the auditors in obtaining an understanding of the internal control structure or in performing tests of controls or substantive tests.*

**2.5.21** As would be the case with the own professional staff, the auditor supervises the work and reviews the work papers internal auditors prepare on the behalf.

*For example, the auditors requests internal auditors to bring all significant accounting and auditing issues identified during the audit to the attention. Similarly, the auditor informs internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing and extent of their audit procedures, such as possible accounting and auditing issues.*

**2.5.22** The review of the internal auditors' work papers includes testing and evaluating their work.

A template of the audit strategy and planning memorandum is attached in Appendix 2.

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## Effective audit evidence

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### 3.1 Introduction

3.1.1 This section provides guidance on:

- what effective audit evidence is;
- audit techniques;
- audit procedures; and
- other matters, such as audit findings, illegal acts, and representations from management.

#### *Definition of effective audit evidence*

3.1.2 The principal activities of an audit are performing audit procedures to obtain effective audit evidence to form an opinion on the financial statements. Effective audit evidence:

- is sufficient and appropriate to meet one or more audit objectives. Sufficiency relates to the extent of the audit procedures the auditor performs. Appropriateness relates to the nature and timing of the audit procedures; and
- is obtained cost effectively, with optimum use of the resources.

*The difficulty or expense required to test a particular item is not in itself a valid basis for omitting any audit procedure. If there is reasonable doubt about one or more assertions, the auditor seeks to obtain audit evidence to remove such doubt. If the auditor is unable to obtain audit evidence, the auditor does not express an unqualified opinion.*

#### *Sufficiency*

3.1.3 The sufficiency of audit evidence relates to the extent of the audit procedures the auditor performs. Extent denotes different things for different audit procedures.

*The extent of an enquiry may refer to the number of questions asked, the number of persons asked and the number of times asked during the period.*

*Extent may have little meaning for analytical procedures which frequently apply to the entire population.*

*The extent of tests of details usually refers to the number of individual items or the aggregate monetary amount to which one or more audit procedures are applied.*

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**3.1.4** The auditor judges the required extent of audit procedures by considering:

- the nature of the account balance or class of transactions, including the number and relative sizes of items in the population;
- the risk of significant misstatements in the financial statement assertions covered by the audit objectives;
- the nature and timing of the planned audit procedures; and
- the audit evidence obtained from other audit procedures.

#### *Appropriateness*

**3.1.5** The appropriateness of audit evidence is related to the nature and timing of audit procedures.

#### **Nature**

**3.1.6** When considering the nature of audit procedures, the following generalisations may be useful:

- audit evidence obtained from outside the auditee is more persuasive than that obtained from within the auditee;
- audit evidence obtained from or created by unrelated third parties is more persuasive than that obtained from related parties;
- audit evidence obtained from inside the auditee's operations is more persuasive when related internal control is effective;
- audit evidence obtained directly through performing a comparison, inspection or observation is more persuasive than that obtained indirectly by enquiry of others;
- audit evidence in the form of documents and written representations is more persuasive than oral representations; and
- audit evidence obtained from several sources that suggest the same conclusion is more persuasive than that obtained from only one source.

**3.1.7** The auditor may gain increased assurance when audit evidence obtained from different sources or of a different nature is consistent. In these circumstances, the auditor may obtain a cumulative degree of audit assurance higher than that which attaches to the individual items of audit evidence by themselves. Conversely, when audit evidence from one source is inconsistent with that from another, further audit procedures usually are performed to resolve the inconsistency.

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**Timing**

**3.1.8** The auditor may perform audit procedures to obtain audit evidence before, during or after the period covered by the financial statements. Performing audit procedures before the period end allows the auditors to consider significant matters that may affect the year-end financial statements and to change the audit plan if necessary.

**3.1.9** When the auditor performs audit procedures before the period-end, the auditor recognises the potentially increased risk that the auditor will not detect significant misstatements that may exist at the period-end. The auditor reduces this potential increased audit risk by selecting additional audit procedures to cover the remaining period. The auditor selects audit procedures in a way that provides a reasonable basis for extending the audit conclusions to the period-end.

**3.1.10** If the auditor believes internal control may not be effective during the remaining period, the auditor considers whether the effectiveness of substantive audit procedures required to cover that period is impaired.

*For example, if there were no effective control activities over the preparation of documents for goods received, substantive audit procedures that are based on such documents for the remaining period may be ineffective because the documents may be incomplete.*

*Likewise, substantive audit procedures applied to the remaining period that relate to the existence assertion at the completion date of financial year (July 16 to July 15) may be ineffective if control activities over the custody and physical movement of assets are not effective.*

*In both of the above examples, if the auditor concludes that the effectiveness of the substantive audit procedures may be impaired, the auditor seeks additional audit assurance. Otherwise the auditor performs substantive audit procedures at the completion of financial year (July 16 to July 15).*

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**3.1.11** If the auditor finds misstatements in account balances, the auditor considers whether to modify the planned nature, timing or extent of substantive audit procedures or whether to perform additional auditing procedures at the completion date of financial year. In making this decision, the auditor considers:

- the implications of the nature and cause of misstatements detected;
- the relationship to other parts of the audit;
- the corrections subsequently recorded by the auditee; and
- the results of auditing procedures covering the remaining period, including those that are responsive to the particular possibilities for misstatement.

#### *Audit techniques*

**3.1.12** Performing audit procedures involves using one or more of seven types of audit techniques. These seven types are:

- comparison;

*Visually or electronically identifying what is the same and what is different between two or more documents, tangible items or data.*

- computation;

*Checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.*

- confirmation;

*A response, ordinarily in writing, to an enquiry, also ordinarily in writing, to corroborate information contained in the accounting records.*

- enquiry;

*Seeking appropriate information of knowledgeable persons inside or outside the auditee. In the context of tests of controls, asking knowledgeable auditee personnel for information, listening to and considering their responses, asking follow-up questions and corroborating information, as appropriate. Enquiries may be formal or informal, written or oral.*

- inspection;

*Reading records or documents, either visually or electronically. Unlike observation, the auditor does not need to be present at the time a process or procedure is performed to obtain audit evidence.*

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- observation;  
*Looking at a process or procedure being performed by others.*
- physical examination;  
*Inspection of a tangible item, usually other than a document, such as an item of equipment.*

#### *Computer-Assisted Audit Technique*

**3.1.13** The auditor may use the computer as an audit tool to apply some of the above audit techniques. The use of the computer as an audit tool is known as Computer-Assisted Audit Technique (CAATs).

**3.1.14** CAATs can remove much of the mechanical routine of audit work. They can be used to apply tests of controls, analytical procedures and tests of details. The auditor always considers using CAATs if the auditee's accounting system is computer-based.

**3.1.15** There are a number of factors that influence the use of CAATs, such as whether:

- file interrogation may permit an efficient 100 percent examination of accounting data;  
*For example, an interest calculation can be made in full rather than on a sample basis.*
- file interrogation may allow the auditors to define and efficiently select unusual items and accounting data. This leaves the auditor more time to concentrate on investigating and following up such items. A file interrogation that confirms that there are no unusual items provides useful information; and
- data interrogation may allow the auditors to apply audit procedures that would otherwise be very time consuming, because of the sheer volume of information to investigate the complexity of the procedures, or a combination of both; and

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- data interrogation may permit audit procedures that are not possible using manual method.

*For example, in Electronic Data Interchange (EDI) systems or other paperless systems, data may exist only in electronic format; there may be no audit trail in paper form; or detailed accounting transactions are aggregated before entry in the general ledger and the details exist only in a database.*

#### *Audit procedures*

**3.1.16** An audit procedure is the application of an audit technique to obtain audit evidence. Audit procedures may be grouped together in three different ways, namely as:

- tests of controls;
- analytical procedures; and
- tests of details.

#### **Tests of controls**

**3.1.17** Tests of controls are applied to obtain audit evidence about:

- the design of control activities;

*Is the design of control activities suitable to prevent, or detect and correct, significant misstatements?*

- the operation of control activities;

*Are the control activities applied as designed? Audit evidence about effective operation relates to how control activities are applied, the consistency with which they are applied and by whom they are applied.*

**3.1.18** Tests of controls usually consist of some combination of enquiry, observation and inspection of documents. Other audit techniques may also be applied. Section 3.2 - Tests of controls - provides further guidance.

#### **Analytical procedures**

**3.1.19** Analytical procedures consist of the application of comparisons, computations, enquiries, inspections and observations to analyse and predict relationships among financial and operating data. Analytical procedures involve comparing recorded account balances or classes of transactions with expectations the auditor develops as well as analysing ratios or trends. When the auditor finds unusual items and unexpected fluctuations, the auditor investigates their nature and cause.

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**3.1.20** Analytical procedures are often effective for audit objectives relating to:

- routine transactions, for which relationships and trends may be estimated;
- account balances and classes of transactions for which amounts vary within relatively small ranges;
- account balances and classes of transactions for which potential significant misstatements would not be apparent from examination of the individual transactions; and
- account balances and classes of transactions for which audit evidence, such as completeness, is difficult to obtain from other audit procedures.

**3.1.21** Section 3.3 - Analytical procedures - provides further guidance.

#### **Tests of details**

**3.1.22** Tests of details are the application of one or more of seven types of audit technique to individual items or transactions that make up an account balance or class of transactions. Tests of details are often effective for audit objectives relating to non-routine transactions as these do not often follow predictable trends. Also, non-routine transactions are not usually directly comparable to other classes of transactions or account balances in the current or prior periods. Section 3.4 - Tests of details - provides further guidance.

#### *Audit findings*

**3.1.23** Audit findings exist if the auditor does not agree with the amount, classification, presentation or disclosure of items or totals in the financial statements. The auditor considers whether the audit findings identified during the audit indicate that a potential for further misstatement exists. The significance of the finding and the way the auditor reports the matter to the auditee may depend on identifying the causes. Without identifying the causes, the auditor may not be able to make recommendations for improvements.

**3.1.24** Section 3.5 - Audit findings - provides further guidance.

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#### *Illegal acts*

**3.1.25** Illegal acts refer to violations of laws or government regulations by auditees.

*For example, acts of bribery and corruption, breaches of local employment law, theft and fiscal offences attributable to the auditee's management or employees acting on behalf of the auditee are illegal acts. The auditors are primarily concerned with laws and regulations affecting the financial statements.*

**3.1.26** The auditor enquires about the auditee's compliance with laws and regulations and the auditee's procedures relating to the prevention of illegal acts.

**3.1.27** The auditor applies audit procedures to detect material misstatements in the financial statements. If information comes to the attention that suggests that illegal acts may have occurred that could have a material effect on the financial statements, the auditor applies audit procedures specifically directed to determining whether an illegal act has occurred.

**3.1.28** The auditor does not accept specific responsibility for detecting all illegal acts. However, the auditors carry out certain audit procedures in those instances when:

- the responsibility is acceptably defined by local statute, constitutional or contractual requirements;
- a specific audit procedure is prescribed by local professional requirements or policies; and
- there is reason to believe an illegal act had occurred.

**3.1.29** Section 3.6 - Illegal acts - provides further guidance.

#### *Management representations*

**3.1.30** Representations are statements made to the auditors concerning the financial statements or matters relating to the financial statements. Throughout the audit the auditor obtains representations from management in response to the enquiries. For the representations that relate to matters material to the financial statements, including management's responsibility for the presentation of the financial statements, the auditor:

- performs audit procedures to obtain corroborating audit evidence about the representations; and
- considers whether the representations appear reasonable and consistent with other audit evidence.

**3.1.31** Section 3.7 - Management representations - provides further guidance.

## 3.2 Test of controls

### *Introduction*

3.2.1 This section provides guidance on:

- what tests of controls are ;
- performing tests of controls; and
- considering the implications of the findings.

### *Definition*

3.2.2 When the auditor plans a systems-based approach for one or more audit objectives, the auditor identifies activities in the components of the internal control process that the auditor judges to be effective in preventing, or detecting and correcting significant misstatements. The identified activities are the basis for preliminary assessments of control risk as low or moderate for these audit objectives and the basis for modifying the nature, timing and/or extent of the planned substantive audit procedures.

3.2.3 The auditor obtains audit evidence about the preliminary assessments of control risk by performing tests of controls. Tests of controls represent the application of audit procedures to obtain audit evidence about the effectiveness of design and operation of those activities, within the framework of the internal control process, that are the basis for a systems-based approach for one or more audit objectives.

3.2.4 Tests of controls usually consist of some combination of enquiry, observation and inspection of documents but may also involve other audit techniques. The purpose of tests of controls is to obtain audit evidence about:

- design of specific activities in the internal control process;  
*Is design suitable to prevent, or detect and correct, significant misstatements?*
- operation of specific activities in the internal control process.

*Are the activities applied as designed? Audit evidence about effective operation relates to how activities in the internal control process are applied, the consistency with which they are applied and by whom they are applied.*

3.2.5 Enquiry is an important technique both in understanding internal control and in performing tests of controls to obtain audit evidence that internal control is effective.

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The auditor recognises that enquiry is more than simply asking auditee staff to confirm that they perform specified activities.

*For example, enquiry involves:*

- *considering the knowledge, independence and qualifications of the individual to be interviewed;*
- *asking clear, concise and open questions. Open questions promote complete and detailed answers. Closed questions restrict the interviewee's response and are better used when wishing to confirm a point*
- *listening actively and effectively. The auditor encourages information by active listening. Good listeners have a powerful appeal as they encourage people to talk. Effective listening requires an open mind*
- *considering the interviewee's response and asking follow-up questions. This requires an attitude of professional scepticism. The auditor does not accept important answers at face value, similarly the auditor does not reject out of hand. If the interviewee provides a seemingly inappropriate answer or misunderstands the point, the auditor follows with another question*
- *concluding with a short summary of the understanding of the facts. This allows the interviewee to confirm the understanding.*

**3.2.6** Re-performance is a term often used to refer to a test of controls involving performing an activity a second time to ascertain that the employees assigned the responsibility to do so correctly performed the activity. Re-performance ordinarily consists of a combination of computation, comparison, enquiry, inspection and observation. Other audit technique, confirmation, may also provide evidence, directly or indirectly, about the effectiveness of internal controls.

**3.2.7** A walk-through is a term often used to refer to a combination of enquiry, inspection and observation that the auditor performs to obtain an understanding of internal control. A walk-through does not, by itself, ordinarily provide sufficient persuasive audit evidence about the effectiveness of design and operation of internal control.

*Performing tests of controls*

**3.2.8** Sufficient appropriate audit evidence about the effectiveness of internal control depends on the nature, timing and extent of the tests of controls. In considering what constitutes sufficient appropriate audit evidence about the effectiveness of design and operation of internal control, the auditor may consider audit evidence from tests of controls in prior years.

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**3.2.9** Some control activities within the internal control process that are the basis for the final assessment of control risk as moderate or low do not change, or change very little, from one year to the next.

*For example, automated control procedures continue to operate consistently until the procedures are changed. The auditor may test control activities for systems development in the period that management implements a system. In subsequent periods, the auditor may focus on control activities relating to security and maintenance of the system.*

**3.2.10** The auditor needs audit assurance about the effectiveness of design and operation of internal control for each audit objective for which the auditor applies a systems-based approach. Within this constraint, the auditor may choose to vary the nature, timing and extent of audit procedures applied as tests of controls from year to year.

*For example, the auditor may vary the combinations of audit procedures such as enquiry, observation and inspection. The auditor may vary the dates the auditor performs tests of controls prior to year-end. The auditor may choose to apply more extensive tests to certain controls in some years and to other controls in other years. When an auditee has many locations subject to the same control activities, the auditor may often vary the locations selected for tests of controls.*

#### *Nature*

**3.2.11** The choice of audit procedures is influenced by the type of activity the auditor is testing.

*For example, for IT-based systems, internal control places more emphasis on general IT controls, exception reports and other monitoring activities. Tests of controls tend to involve enquiry, observation and inspection techniques.*

*For example, if internal control is based on control activities such as segregation of duties, re-performance of procedures by a second individual and reconciliations, tests of controls tend to involve inspection of documents and re-performance techniques.*

**3.2.12** A single audit procedure may not be effective.

*For example:*

- *individuals being interviewed may provide the answers they think the auditor wants to hear rather than telling the auditors what really happens. The auditor may unconsciously lead the interviewee and elicit answers the auditor expects, but that may not be correct*

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- *observation provides direct audit evidence about the observed activity only at the time of observation. In extending conclusions to time periods when the activity is not observed, the auditor needs to be aware of the possibility that the activities may not be performed or be performed with less care when the auditor is not present*
- *inspecting documents that indicate performance (by initials or signatures) does not always mean that performance actually occurred*
- *the fact that the auditor finds no errors when re-performing a control activity is not conclusive if the items the auditor tests do not contain misstatements.*

**3.2.13** A combination of audit procedures overcomes some of the limitations of individual audit procedures and usually provides more persuasive audit evidence than one type of audit procedure alone.

*For example, the auditor may combine inspection of exception reports with enquiries of the person responsible for follow-up of exceptions. The enquiry provides the auditors with information not available from the inspection of documents alone, such as impressions of the individual's skill, knowledge, judgement and motivation. Timing*

**3.2.14** The understanding of internal control is cumulative and is based on information obtained both in the current and prior years. Also, when making the assessments of the effectiveness of the design and operation of activities in the internal control process, the auditor considers the audit evidence obtained in both the current and prior years. The auditor builds on this cumulative knowledge each year by:

- developing the overall approach to internal control during audit strategy and planning;
- enhancing the understanding of internal control during audit planning;
- obtaining audit evidence by performing tests of controls; and
- obtaining audit evidence by performing substantive audit procedures.

**3.2.15** The auditor generally performs tests of controls in advance of the period-end. The auditor also obtains audit evidence that the relevant activities remain effective during the remainder of the period.

*It may be efficient to perform tests of controls at the same time as the auditor updates the understanding of internal control.*

**3.2.16** Audit procedures performed during the remainder of the period are often different in nature and extent from those performed earlier.

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For the remainder of the period, the audit procedures usually consist of:

- enquiries of auditee personnel as to whether the design of control activities was changed; and
- tests of monitoring activities that provide management with assurance that internal control remains effective as to design and operation.

**3.2.17** The factors the auditor considers in determining the nature, timing and extent of audit procedures in the remainder of the year are:

- the length of the remaining accounting period;

*Control activities may become ineffective over time if they do not address changing operations conditions.*

- changes to the information system;

*If the information system is altered it is likely that the specific control activities also change.*

- the importance of the audit objective;

*The more important the audit objective is to the audit opinion, the more persuasive the audit evidence needs to be.*

- the consideration of the control environment;

*The auditor considers whether the control environment continues to support the effective design and operation of relevant control and monitoring activities.*

- monitoring activities

*Effective monitoring activities may provide reasonable assurance that control activities continue to be effective.*

- audit evidence from results of substantive audit procedures.

*The auditor considers whether the results of substantive procedures corroborate the assessments of the effectiveness of internal control.*

**3.2.18** The auditor may plan a systems-based audit approach for only a portion of the period.

#### *Extent*

The extent of tests of controls is a matter of professional judgement.

When making this judgement the auditor considers:

- the importance of the relevant activity to the assessment of the effectiveness of internal control for the audit objective; and
- the importance of the audit objective to the overall audit opinion.

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*Considering the implications of the findings*

**3.2.19** For each of the activities that the auditor tests, the auditor document:

- the nature, timing and extent of the tests of controls; and
- the audit findings.

**3.2.20** If the audit findings from the tests of controls support the preliminary assessment that internal control is effective as to design and operation, the auditor proceeds with the substantive audit procedures as planned.

**3.2.21** When performing tests of controls, the auditor may identify conditions that suggest the activities may not be designed and operating as effectively as the auditor first thought. If so, the auditor investigates the nature and cause of the condition. After discussions with appropriate auditee staff, the auditor may sometimes identify other activities that operate to provide the same assurance. After testing the other activities, the auditor may be able to conclude that the preliminary assessment of the effectiveness of internal control is appropriate for specific audit objectives.

**3.2.22** It may be possible to apply substantive audit procedures to obtain audit evidence that specific control deficiencies have not allowed significant misstatements to remain undetected or uncorrected and, thereby, still form a conclusion consistent with the preliminary assessments of control risk.

**3.2.23** As a result of performing substantive procedures, additional information may come to light that differs significantly from the information on which the auditor based the assessments of the effectiveness of internal control. If so, it may be necessary to revise the assessments of the effectiveness of internal control and re-evaluate the nature, timing and extent of the substantive audit procedures for the audit objectives affected.

**3.2.24** If the auditor concludes there are no effective control activities or mitigating factors, the auditor revises the preliminary assessments of the effectiveness of internal control. The auditor then modifies the nature, timing and extent of the substantive audit procedures accordingly. The auditor documents revised assessments of the effectiveness of internal control as appropriate.

**3.2.25** The auditor reports material weaknesses and other reportable conditions to management. Section 5 - Reports and presentation

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### 3.3 Analytical procedures

#### *Introduction*

3.3.1 This section provides guidance on:

- what analytical procedures are;
- categories of analytical procedures;
- performing analytical procedures;
- opportunities for CAATs; and
- rotation with tests of details.

#### *Definition*

3.3.2 Analytical procedures consist of the application of comparisons, computations, enquiries, inspections and observations to analyse and develop expectations about relationships among financial and operating data.

3.3.3 Analytical procedures may be applied at various stages:

- to assist in planning the audit;  
*For example, to identify significant financial statement accounts, classes of transactions and financial statement assertions with a relatively higher risk of significant misstatements.*
- to obtain effective audit evidence;
- to assist in the review and interpretation of audit findings;  
*For example, comparing the auditee's financial statements to common performance indicators for the entity.*
- to assist in developing information useful for reports to the auditee;  
*For example, analytical procedures may improve the understanding of the operations and insights about relationships the auditor can present in reports to the auditee.*

3.3.4 An analytical procedure generally consists of three components:

- prediction;  
*The auditor may predict an account balance, a class of transactions or a ratio involving financial and/or operating data.*
- comparison;  
*For example, comparison of the budget against the actual results of the auditee and analysing the audit unit's budget and work plan for the year..*
- use of professional judgement in investigating and concluding on the differences observed.

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*Categories of analytical procedures*

**3.3.5** There are three main categories of analytical procedures:

- reasonable tests;
- trend analysis; and
- ratio analysis.

*Reasonableness tests*

**3.3.6** A reasonableness test is a term often used to refer to a computation used to estimate an amount such as an account balance or class of transactions. The auditor develops a model, computes a prediction of the amount through the use of relevant financial and operating data and compares the prediction with the recorded amount.

*Trend analysis*

**3.3.7** A trend analysis is a term often used to refer to the analysis of the changes in a given account balance or class of transactions between the current and prior periods or over several accounting periods. This contrasts with a reasonableness test which involves an analysis of the changes within one accounting period.

**3.3.8** The auditor obtains an understanding of what causes the trend in the account balance and class of transactions. Using this knowledge, the auditor computes what the auditor expects the current year's amount to be, based on the past trend and the knowledge of the auditee's current transactions. The auditor then compares this prediction with the recorded amount. In this way, the auditor may identify potential problems when there is little or no change in the current balance from the prior period but a significant change would reasonably be expected to occur.

**3.3.9** The predictions range from simple calculations of a single variable based on the trend in annual data to more complex analyses using many variables.

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**3.3.10** It is important to understand the reasons why the auditor expects a trend to be predictable, since data sometimes appear to be causally related when they are not.

*For example, there may be no reason to expect expenditures for legal fees in one year to be indicative of expenditures for the next year.*

#### *Ratio analysis*

**3.3.11** A ratio analysis is a term often used to refer to the analysis of the ratio of:

- an account balance to another account balance;

*For revenue and expense accounts, the auditor may analyse the ratios of investment income to investments*

- a class of transactions to an account balance;
- financial data to operating data.

*The auditor may analyse the ratio of payroll expense to average employee numbers*

**3.3.12** The auditor may analyse the changes in ratios within the auditee's operations over time or analyse the ratios of different entities or different segments within the auditee's operations.

#### *Performing analytical procedures*

##### **Stages**

**3.3.13** The stages involved in performing analytical procedures are:

- consider the independence and reliability of the financial and operating data used in the model;
- compute the prediction and compare it to the recorded amount;
- consider whether the difference is significant;
- obtain explanations for significant differences and corroborate important matters; and
- consider audit findings.

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*Considering the independence and reliability of financial and operating data*

**3.3.14** The independence and reliability of the financial and operating data used directly affects the accuracy of the prediction and hence the audit evidence the auditor obtains from the analytical procedure.

**3.3.15** As far as possible, the auditor develops the prediction using data independent of the account being predicted.

**3.3.16** The judgement about the reliability of data considers whether:

- the data comes from independent sources outside the auditee or from sources within the auditee;
- the sources within the auditee are independent of those who are responsible for the amount being audited;
- the data are subject to effective internal control;
- the data are subject to audit procedures in the current or prior year; and
- the auditor develops the predictions using data from a variety of sources.

*Computing the prediction and comparing it to the recorded amount*

**3.3.17** When the auditor compares the prediction with the recorded amount, the auditor takes into account:

- the frequency with which the relationship is measured. The more frequently the auditor observes a particular relationship, the more the auditor can be assured of the consistency of that relationship.
- expected variations and abnormal fluctuations. The auditor distinguishes between expected variations and abnormal fluctuations. When the auditor compares monthly amounts, the auditor often expects to see seasonal variations and not a constant amount each month.
- the absence of expected variations. This highlights the importance of understanding the auditee's operations.

*Obtaining explanations for significant differences*

**3.3.18** Differences may exist because:

- the account or class of transactions the auditor is auditing contains a misstatement; or
- the account or class of transactions the auditor is auditing does not contain a misstatement but the prediction is inaccurate.

*For example, the auditor has or used inaccurate data.*

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**3.3.19** Whenever there is a significant difference between the prediction and the recorded amount, the auditor seeks explanations from management or other appropriate auditee staff and corroborates important matters.

**3.3.20** If there are no reasonable explanations, the auditor reconsiders the data and assumptions the auditor used to calculate the prediction and the consequent range of acceptable values. The auditor may perform the computation again, using a refined model to see whether the difference is still unacceptable.

**3.3.21** If significant differences still exist, tests of details ordinarily are performed to obtain audit evidence as to whether significant misstatements are present.

#### *Audit findings*

**3.3.22** The auditors evaluate the audit evidence the auditor obtains from analytical procedures. The audit findings may include not only misstatements in the account but also observations about the functioning of internal control, the information system and other matters.

**3.3.23** If the auditors identify an audit finding, the auditor investigates its nature and cause, consider whether it indicates a significant misstatement in the financial statement assertions addressed by the audit objective and consider the implications for the auditee's operations. Section 3.5 - Audit findings - provides further guidance

#### *Rotation with tests of details*

**3.3.24** Sometimes, analytical procedures and tests of details are alternative approaches to obtaining sufficient appropriate audit evidence for a given audit objective. If so, the auditor may choose to apply tests of details in one year and choose to apply analytical procedures in another year.

*For example, in the first year of an audit, the auditor may apply tests of details to payroll. In the second year, the auditor may choose analytical procedures recognising that tests of details in the prior year provided persuasive audit evidence about data on which the auditor makes a prediction.*

**3.3.25** In the example, tests of details in the first year provide an anchor for analytical procedures in the subsequent year.

**3.3.26** It may be useful to rotate analytical procedures and tests of details among locations or among audit objectives for which analytical procedures and tests of details are acceptable alternative approaches.

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Rotation may improve the audit, over time, in the following ways:

- audit evidence is more persuasive because it is derived from different types of audit procedures;
- the audit procedures are less predictable to the auditee's employees; and
- by varying the approach, the auditor is more likely to develop useful suggestions for the auditee.

**3.3.27** Analytical procedures are not usually effective to obtain audit evidence for some audit objectives.

*For example, analytical procedures generally cannot replace confirmations of loan balances, interest receivable, confirmations from banks for revenue deposited in government accounts, advances to contractors.*

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## 3.4 Test of details

### *Introduction*

**3.4.1** This section provides guidance on:

- what tests of details are;
- planning tests of details;
- selecting items for tests of details;
- representative sampling;
- performing tests of details; and
- evaluating the results of tests of details.

### *Definition*

**3.4.2** Tests of details are the application of one or more of the seven types of audit techniques to individual items or transactions that make up an account balance or class of transactions. The following techniques are most often applied as tests of details:

- comparison;
- computation;
- confirmation;
- inspection; and
- physical examination.

**3.4.3** Enquiry and observation techniques are often performed when selecting individual items for tests of details or as part of the investigation and follow-up of audit findings.

**3.4.4** Vouching is a term often used to refer to tests of details using a combination of comparison, computation and inspection techniques.

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**3.4.5** The auditor may use CAATs to increase the effectiveness or efficiency of tests of details by:

- producing reports.;
- combining data in two or more files to produce new analyses.
- comparing data in two or more files;

*For example, comparing the payroll with the personnel files to identify employee numbers appearing on the payroll not in personnel files, and vice versa.*

- performing computations;

*For example, computing variances of income and expense accounts compared to budgets and prior periods or computing payroll by multiplying average pay rates x hours worked by payroll category.*

- selecting confirmations;

*For example, selecting balances as well as preparing the confirmation requests. The selection may be made using criteria such as size or age, or it may be a representative sample.*

- inspecting files.

#### *Planning tests of details*

**3.4.6** When planning tests of details, the auditor defines:

- the objectives of the test;
- the population from which the auditor selects individual items; and
- those differences that may require further investigation.

**3.4.7** The objective of tests of details may be either:

- to obtain audit evidence as to whether the financial statement assertions addressed by the audit objective include significant misstatements; or
- to estimate the amount of the audit difference for the financial statement assertions that the auditor believes do include significant misstatements.

**3.4.8** The auditor selects items to be tested from a population. The auditor defines the population in advance, considering the following:

- the auditor cannot obtain audit evidence about the completeness of a population by examining items drawn from that population because omitted items have no chance of selection;

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- the auditor may be able to improve the effectiveness of the audit procedures by subdividing a population, performing different tests for each subdivision; and
- the period covered is important for tests of details applied to classes of transactions. The conclusion does not relate to the entire period unless the items for the test of details are selected from a population that covers the entire period.

**3.4.9** When planning tests of details the auditor defines what constitutes a difference requiring investigation and follow-up. Typical reasons for differences are:

- differences in timing of the recording of transactions  
*For example, items included in the wrong period.*
- differences in description;  
*For example, maintenance expense coded to an asset account.*
- differences in amounts for data captured or processed.
- *For example, transposed digits or other numerical errors.*

#### *Selecting items for tests of details*

**3.4.10** The auditor may apply tests of details to every item in the population or to a selection of the items. If the auditor applies tests of details to fewer than every item in an account, the auditor accepts some uncertainty in the audit evidence obtained. The auditor is able to accept this because:

- the auditor obtains persuasive rather than conclusive audit evidence;
- the auditor combines audit evidence from more than one source, performing analytical procedures in addition to the tests of details; and
- even if the auditor audited all the individual items there may still remain some uncertainty;  
*For example, completeness of transactions.*
- the cost of examining all items, especially routine transactions, is generally uneconomical.

**3.4.11** When the auditor selects fewer than all items from an account, the auditor may select the items on the basis of:

- selection of key items;  
*That is, reading through documents and files of transactions or balances, selecting items that the auditor believes to be prone to misstatement because they are unusual, unexpected or in excess of a designated monetary amount.*

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*Audit procedures applied to these items provide little or no audit evidence about the remaining portion of the population.*

- representative sampling;  
*That is, selecting items representative of the population as a whole.*

**3.4.12** The auditor may sometimes combine both methods.

*The auditor may select items over a predetermined amount and select a representative sample from the remainder of a population.*

The auditor judges whether to select key items for further investigation or whether to apply representative sampling. The following general factors may affect which method is appropriate:

- selecting key items is likely to be more effective when:
  - the auditor applies a systems-based approach and the auditor has substantive audit evidence from analytical procedures for the population and, therefore, requires relatively little substantive audit evidence from the test of details
  - the population contains a small number of individually significant items; therefore, testing a relatively small number of key items efficiently addresses a relatively high proportion of the account
  - the population mainly contains non-routine transactions; therefore, the account is unlikely to consist of similar items that could be sampled.
- representative sampling is likely to be more effective when
  - the auditor has selected a substantive approach and has little or no audit evidence from analytical procedures and, therefore, requires relatively more substantive audit evidence from the test of details
  - the population contains a large number of individually insignificant items; therefore, testing a relatively large number of key items is required to address a significant proportion of the account
  - the population mainly contains routine transactions. Therefore, the account is likely to consist of similar items that may be efficiently sampled.

**3.4.13** When performing tests of details, the auditor applies audit procedures to the population from which the auditor selects individual items to obtain audit evidence that the data reconcile to the financial statements.

*For example, the auditor may check the additions of the account listing and compare the total with the recorded amount in the financial statements.*

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*Representative sampling*

**Design of the sample**

**3.4.14** When designing the size and structure of an audit sample, auditors should consider the specific audit objectives, the nature of the populations from which they wish to sample, and the sampling and selection methods.

**Population**

**3.4.15** The population is the entire set of data from which auditors wish to sample in order to reach a conclusion. Therefore the population from which the sample is drawn has to be appropriate and complete for the specific audit objective.

**Sample size**

**3.4.16** When determining sample sizes, auditors should consider sampling risk, the amount of error that would be acceptable and the extent to which they expect to find errors

**Sampling risk**

**3.4.17** Sampling risk arises from the possibility that the auditors' conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same

**3.4.18** Auditors are faced with sampling risk in both tests of control and substantive procedures as follows:

- tests of controls
  - the risk of placing a higher than necessary assessment on control risk, because the error in the sample is greater than the error in the total population; or
  - the risk of placing a lower than required assessment on control risk, because the error in the sample is less than the error in the population as a whole.
- substantive tests
  - the risk of concluding that a recorded account balance or class of transaction is materially misstated when it is not, because the error in the sample is greater than the error in the population as a whole, or
  - the risk of concluding that a recorded account balance or class of transactions is acceptable when it is materially misstated, because the error in the sample is less than the error in the population as a whole.

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**3.4.19** Sample size is affected by the degree of sampling risk that auditors are willing to accept from the results of the sample, which depends upon the importance of the results of the audit procedure involving sampling to the auditors' conclusions. The greater their reliance on the results, the lower the sampling risk auditors are willing to accept and the larger the sample size needs to be. Auditors consider sample size in the context of the overall risk assessment.

#### **Selection of sample**

**3.4.20** Auditors should select sample items in such a way that the sample can be expected to be representative of the population in respect of the characteristics being tested

**3.4.21** For a sample to be representative of the population, all items in the population are required to have an equal or known probability of being selected.

**3.4.22** While there are a number of selection methods, three methods commonly used are:

- random selection, which ensures that all items in the population have an equal chance of selection

*For example, by use of random number tables*

- systematic selection, which involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection, auditors ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population; and

- haphazard selection, which may be an acceptable alternative to random selection provided auditors are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection which is biased.

*For example, towards items which are easily located, as they may not be representative.*

#### **Evaluation of sample results**

**3.4.23** Having carried out, on each sample item, those audit procedures which are appropriate to the particular audit objective, auditors should:

- analyse any errors detected in the sample, and
- draw inferences for the population as a whole

**Analysis of errors in the sample**

**3.4.24** In analysing the errors detected in the sample, auditors first determine that an item in question is in fact an error. In designing the sample, auditors define those conditions, which constitute an error by reference to the audit objectives.

*For example, advances to staff and suppliers/contractors*

**3.4.25** When the expected audit evidence regarding a specific sample item cannot be obtained, auditors may be able to obtain sufficient appropriate audit evidence through performing alternative procedures.

**3.4.26** In analysing the errors discovered, the auditors may observe that many have a common feature.

*For example, type of transaction, location, product line or period of time.*

**3.4.27** In such circumstances, they may decide to identify all items in the population, which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. They may then perform a separate analysis based on the items examined for each sub-population, so that they have sufficient appropriate audit evidence for each sub-population.

*Performing tests of details*

**3.4.28** The auditors apply appropriate audit techniques to each item the auditors select for the test of details, to determine whether a difference requiring investigation and follow-up exists.

**3.4.29** The following paragraphs provide guidance on confirmations.

**Confirmations**

**3.4.30** The auditor requests confirmations only of matters about which the respondent can reasonably be expected to be knowledgeable.

*For example, confirmations of loan balances, interest receivable, confirmations from banks for revenue deposited in government accounts, advances to contractors and confirmations from District Treasury Offices on revenue deposits.*

**3.4.31** Confirmation of balances or transactions by an external source usually provides persuasive audit evidence. Confirmation is frequently an efficient audit procedure because it may cover both transaction initiation and processing activities.

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If responses to requests for confirmation are prepared by the respondent from its own sources they are also independent of the auditee's records.

**3.4.32** The degree of the professional scepticism is heightened if the auditor obtains information that leads to questions about respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias.

**3.4.33** In these circumstances the auditor should also consider the effects of the information on:

- designing the confirmation request;
- evaluating the results; and
- determining whether other procedures are necessary.

*For example, the auditor considers whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect the response to contribute meaningful, appropriate audit evidence.*

**3.4.34** Ordinarily, the auditor asks the auditee to request the confirmation from the respondents since the respondents would generally be expected not to disclose information to the auditor (a third party) without the auditee's permission. Respondents ordinarily are requested to reply directly to the auditor and the auditor maintains control over the confirmation letters, mailing procedures and reported exceptions throughout the process to minimise the possibility of interference by auditee personnel.

**3.4.35** The following sequence of steps is ordinarily appropriate for confirmation requests:

- prepare confirmation requests (the selection and preparation of requests can often be efficiently combined by CAATs), or request the auditee to prepare them;
- check confirmation requests and addresses for accuracy and mail them in envelopes that bear the auditors address and contain a postage-paid return envelope addressed (with departmental reference, when appropriate) to the auditors;
- investigate confirmation requests returned undelivered by checking the addresses and seeking corroborative audit evidence that the customer exists; and
- take appropriate follow-up action for non-responding accounts. Consider second and, sometimes, third requests (oral or written). If appropriate, perform other audit procedures.

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**3.4.36 Positive requests.** Positive confirmations request a direct response from respondents to data provided by the auditee. Non-responses provide little or no audit evidence. Confirmation of specific details, such as individual invoices, rather than account balances, may increase response rates. The more closely the confirmation request follows the respondent's information system, the more likely a response becomes.

**3.4.37 Negative requests.** These are requests that elicit a response only if the respondent disagrees with information stated on the request. Unfortunately, the auditor is unable to distinguish between those non-respondents who agree with the confirmation request and those who have ignored it. Because of the uncertainty about the audit evidence provided by negative requests, the auditor ordinarily does not use them as a primary source of audit evidence. Nevertheless, negative requests may be appropriate when the risk of significant misstatements is low.

**3.4.38 Oral confirmation responses** are documented in the work papers. If the information confirmed is significant, the auditor ordinarily requests the respondent to send a written confirmation of the specific information directly to us.

**3.4.39 Alternative audit procedures.** The auditor usually applies alternative audit procedures to the data for which the auditor does not receive responses to confirmation requests. However, the auditor may consider not performing alternative audit procedures if:

- non-responding confirmation requests in the aggregate may not affect the decision about whether the financial statements are free of material misstatements even if the data were 100 percent in error; and
- there is no indication of unusual characteristics of the non-responding confirmation requests.

**3.4.40 Section 2.4 - Non-routine transactions** - provides further guidance on confirmation of unusual or complex transactions and balances.

**3.4.41** If management requests that the auditor not confirm certain accounts, the auditor considers whether there are valid reasons for the request. The auditor also applies alternative procedures to those accounts.

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## 3.5 Audit findings

### *Introduction*

**3.5.1** This section provides guidance on:

- definition;
- investigating the cause of audit findings;
- procedures when the findings indicate that irregularities may exist; and
- reporting audit findings.

### *Definition*

**3.5.2** Audit findings exist if the auditor does not agree with the amount, classification, presentation or disclosure of items or totals in the financial statements. Audit findings fall into the following categories:

- known errors or other misstatements;

*These are audit findings the auditor has quantified, normally as a result of applying audit procedures.*

- most likely error.

*The auditor's best estimate of misstatements based on analytical procedures or on projecting the results of a representative sample to the population tested.*

### *Investigating the cause of audit findings*

**3.5.3** If the auditors identify an audit finding they investigate its nature and cause, with an appropriate degree of professional scepticism.

Audit findings may be due to:

- errors, which are unintentional mistakes in financial statements;

*For example, mathematical or clerical mistakes in the underlying records and accounting data, oversight or misinterpretation of facts.*

- irregularities, which are intentional misrepresentations of financial statements; and

*For example, manipulation, falsification or alteration of records or documents; misappropriation of assets; omission of transactions from records; recording transactions without substance.*

- internal control issues and non-compliance with laws and regulations.

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**3.5.4** The auditors consider whether audit findings indicate a pattern. If a pattern appears to exist, the auditors consider whether to apply additional or other audit procedures specifically to detect that type of misstatement.

**3.5.5** In the light of the investigation, the auditors reconsider the risk of significant misstatements, again with an appropriate degree of professional scepticism. Unless the risk of undiscovered significant misstatements is low, the auditor ordinarily requests the auditee to identify and resolve the findings before the auditor extends the audit procedures or apply other audit procedures.

*Procedures when the audit findings indicate that irregularities may exist*

**3.5.6** If the audit findings indicate possible irregularities, the auditors consider the potential effect on the financial statements. If the auditors believe suspected irregularities may indicate material misstatements in the financial statements, they perform such other or additional audit procedures as they judge to be appropriate.

**3.5.7** Irregularities include intentional distortion of the financial statements.

**3.5.8** Performing additional or other audit procedures usually enables the auditor to confirm or dispel a suspicion of irregularities. However, it is not always possible to reach a conclusion about the true cause of an audit finding or the intentions of those involved.

**3.5.9** If irregularities are confirmed, the auditor reports the findings in the audit report.

**3.5.10** If the auditors are unable to obtain audit evidence either to confirm or dispel a suspicion of irregularities, the auditors consider the possible effect on the financial statements and the opinion. The auditors also consider relevant laws and regulations and may wish to obtain legal advice before issuing an audit report on the financial statements.

**3.5.11** Unless circumstances clearly indicate otherwise, the auditors do not assume that an instance of irregularity is an isolated occurrence. If the auditors believe internal control should have prevented or detected the irregularity, they reconsider the prior evaluation of internal control and, if necessary, adjust the nature, timing and extent of the audit

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procedures. If irregularities involve a member of management, the auditors reconsider the reliability of representations made by that person to us.

#### *Reporting audit findings*

**3.5.12** The auditors promptly communicate the findings to management in the following circumstances:

- the auditors find errors that indicate significant misstatements in the financial statements;
- the auditors find errors that indicate a material weakness or other reportable condition in internal control;
- the auditors find irregularities; and
- the auditors believe irregularities may exist, even if the potential effect on the financial statements would be immaterial.

**3.5.13** The auditors prepare a summary of audit findings. Section 4.4 - Evaluating whether financial statements are free of material misstatements - provides further guidance on the review of the summary of audit findings.

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## **3.6 Illegal acts**

### *Introduction*

**3.6.1** This section provides guidance on:

- what illegal acts are;
- responsibilities;
- identifying illegal acts;
- audit procedures in response to possible illegal acts; and
- response to detected illegal acts.

### *Definition*

**3.6.2** An illegal act is a violation of laws or government regulations.

**3.6.3** Illegal acts by auditees are acts attributable to the auditee whose financial statements are under audit or acts by management or employees acting on behalf of the auditee. Illegal acts by auditees do not include personal misconduct by the auditee's personnel unrelated to their operations activities.

**3.6.4** From the perspective as auditors, illegal acts fall into two categories:

- those that have a direct and material effect on the determination of financial statement amounts;
- those that may have an indirect effect on the financial statements.

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*For example, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities.*

**3.6.5** Whether an act is illegal is a determination that is normally beyond the professional competence. The training, experience and understanding of the auditee may provide a basis for recognition that some acts of the auditee may be illegal. The auditors may decide whether a particular act is illegal on the advice of an informed expert qualified to practise law or may have to await final determination by a court of law.

#### *Responsibilities*

**3.6.6** Management is responsible for establishing activities to achieve objectives of compliance with relevant laws and regulations.

**3.6.7** The auditors obtain audit evidence as to whether financial statements are free of material misstatements. In obtaining audit evidence, the auditors consider those laws and regulations that are generally recognised to have a direct and material effect on the determination of financial statement amounts. The consideration of such laws and regulations is from the perspective of their known relationship to financial statement assertions covered by the audit objectives and not from the perspective of determining legality in and of itself. Therefore, the auditors seek reasonable assurance that violations of such laws and regulations have not occurred or, if they have occurred, that the financial statements properly reflect the consequences.

**3.6.8** The auditors do not have the expertise to recognise possible violations of all laws and regulations. Generally, the further removed an illegal act is from the events and transactions usually reflected in financial statements, the less likely the auditors are to become aware of the act or to recognise its possible illegality. The auditors may recognise those with an indirect effect as the result of the need to disclose a contingent liability because of an allegation or determination of illegality by third parties.

#### *Identifying illegal acts*

**3.6.9** Except as discussed in paragraph 3.6.7, the auditors do not normally perform audit procedures specifically designed to detect illegal acts apart from:

- enquiring of management as to the auditee's policies relative to the prevention of illegal acts and the use of directives by the auditee and periodic representations obtained by the auditee from management at appropriate levels of authority concerning

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- compliance with laws and regulations;
- enquiring of management and the auditee's legal counsel concerning litigation, claims and assessments;
- performing audit procedures for the purpose of forming the opinion on the financial statements, which procedures may bring possible illegal acts to the attention.

**3.6.10** While performing audit procedures for the purpose of forming the opinion on the financial statements, the auditors may obtain information that raises questions concerning possible illegal acts, such as:

- large payments;
  - for unspecified services to consultants, affiliates or employees
  - in cash, or purchases of bank cashiers' cheques payable to bearer, transfers to numbered bank accounts, or similar transactions;
- unusual payments:
  - agents' fees that appear excessive in relation to those normally paid by the auditee or to the services actually received
  - unexplained amounts paid to government officials or employees
  - fines or penalties;
- unauthorised transactions, improperly recorded transactions or transactions not recorded in a complete or timely manner to maintain accountability for assets;
- incorrectly or incompletely recorded transactions;
- reports of examinations by regulatory or government agencies, or of enforcement proceedings; and
- evidence of failure to file tax returns or pay government duties or similar fees that are common to the auditee's industry or the nature of its operations.

#### *Response to possible illegal acts*

**3.6.11** If the auditors become aware of information concerning a possible illegal act, the auditors apply procedures to obtain an understanding of the nature of the act, the circumstances in which it occurred and sufficient management at a level above those involved, if possible.

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**3.6.12** If management does not provide satisfactory information that there has been no illegal act, the auditors:

- consult with the auditee's legal counsel or other specialists;  
*For example, the auditors discuss the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Usually the auditee arranges for consultation with its legal counsel when it is necessary.*
- perform additional audit procedures, such as the following:
  - inspect supporting documents, such as cancelled cheques and agreements;
  - confirm significant information concerning the matter directly with the other party to the transaction or with intermediaries, such as banks or lawyers;
  - if applicable, determine whether the transaction is properly authorised; and
  - consider whether other similar transactions or events may have occurred, and apply procedures to them.

#### *Response to detected illegal acts*

**3.6.13** If the auditors conclude, based on information obtained and, if necessary, after consultation with either the auditee's, that an illegal act has or is likely to have occurred, the auditors consider:

- the effect of the illegal act on the amounts presented in financial statements;  
*For example, contingent losses may arise due to fines, penalties, damages as a result of non-compliance to tax laws or contractual obligations and threats over misuse of assets.*
- the adequacy of disclosure in the financial statements of the potential effects of the illegal act on the auditee's operations;
- the implications of the illegal act in relation to other aspects of the audit, particularly the reliability of management representations.

*The implications of particular illegal acts depend on the level of management or employees involved, their role in the internal control process and the specific activities involved in the illegal act and its concealment, if any.*

**3.6.14** If illegal acts have come to the attention, the auditors consider whether management with appropriate authority and responsibility is adequately informed.

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**3.6.15** The auditors are not usually responsible for disclosing an illegal act to parties other than management. In fact, disclosure may not be permitted by the ethical or legal obligations of confidentiality, unless:

- the matter affects the opinion on the financial statements; and
- disclosure is required by law or regulations.

**3.6.16** If the auditor judges that an illegal act indicates that there is a material misstatement in the financial statements, the auditors express a qualified or adverse opinion unless the auditee properly accounts for and discloses the illegal act.

**3.6.17** If the auditor judges that an illegal act indicates that there may be a material misstatement in the financial statements, but the auditee precludes the auditor from obtaining audit evidence that an illegal act has or is likely to have occurred, the auditors:

- extend the audit procedures or perform other audit procedures until the auditors are satisfied that the financial statements are free of material misstatement;
- express a qualified opinion due to a limitation in the scope of the audit; or
- disclaim an opinion on the financial statements.

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## **3.7 Management representations**

### *Introduction*

**3.7.1** This section provides guidance on:

- what management representations are;
- acknowledging responsibility for the presentation of financial statements; and
- representations on other matters material to the financial statements.

### *Definition*

**3.7.2** Management representations are statements management makes to the OAGN concerning matters relating to the financial statements. Management representations may be oral or written, formal or informal. They are not a substitute for other audit evidence the auditor requires to satisfy the audit objectives.

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*Acknowledging responsibility for the presentation of financial statements*

**3.7.3** The auditor obtains management's written acknowledgement of its responsibility for the appropriate presentation of the financial statements and that management has approved the financial statements.

*Representations on other matters material to the financial statements*

**3.7.4** Throughout the audit, the auditors obtain management representations in response to the enquiries. When the representations relate to matters that are material to the financial statements, the auditor:

- performs audit procedures to obtain audit evidence to support the representation; and
- considers whether the representations appear reasonable and consistent with other audit evidence obtained, including other representations.

**3.7.5** Usually, the auditor can perform other audit procedures to obtain audit evidence to corroborate management's representations.

**3.7.6** There may be limited occasions when the auditor is not able to obtain corroborative audit evidence and could not reasonably expect it to be available. Such instances may be when knowledge of the facts is confined to management;

For example, when an auditee plans to discontinue an area of operations, the auditor may not be able to obtain information through other auditing procedures to corroborate the plan or intent; accordingly, the auditor obtains written representations to provide confirmation of management's intent.

**3.7.7** In these situations the auditor:

- obtains written confirmation of the representation;
- obtains reasonable assurance that other audit evidence available does not conflict with the representation; and
- considers whether the representation, together with such other audit evidence the auditor has obtained, is sufficient and appropriate to meet the audit objectives.

**3.7.8** The auditor requests that representations from management on matters material to the financial statements be documented and signed by members of management who have primary responsibility for the operations and its financial aspects. Such letters are ordinarily dated on the same date as the audit report.

**3.7.9** Written management representations with respect to matters directly relating to the financial statements may be limited to items, either individually or collectively, in excess of a certain amount, provided the auditor has reached an understanding with management on this amount.

**3.7.10** If the auditor expects sufficient appropriate audit evidence to be available and yet are unable to obtain it, there may be a limitation in the scope of the audit, regardless of whether the auditor has obtained a management representation or not.

**3.7.11** Management may refuse to provide the written representations that the auditor considers necessary, either because of management's own uncertainty regarding the particular matter or because of a refusal to co-operate. Such circumstances may constitute a limitation in the scope of the audit sufficient to preclude an unqualified opinion. In such cases, the auditor considers the effects of management's refusal on the reliability of other oral representations obtained throughout the audit.

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### **3.8 Documentation and file arrangement**

#### *Introduction*

**3.8.1** This section provides guidance on:

- contents of work papers;
- characteristics of work papers; and
- audit file structure.

#### *Contents of work papers*

**3.8.2** The project management section of the current audit file should include letters of authorisation, engagement letter, financial statements of the auditee and minutes of meetings and discussion letters.

**3.8.3** The Strategy and Planning Memorandum would be maintained on the current audit file, which includes the basis and extent of planning of audit procedures, audit objectives, scope and methodology and sampling criteria used.

**3.8.4** Documentation of work performed to support significant conclusions and judgements. These include audit programmes, schedules supporting information contained in the audit report, third party confirmation, reliance placed on the work of other auditors and other evidence supporting the auditors' findings.

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**3.8.5** Preliminary and final draft reports and auditee's official written comments should be included in the working paper file.

#### *Characteristics of work papers*

**3.8.6** Information should be clear and concise, without requiring supplementary oral support. The legend to tick marks or other symbols used to document performance of audit tests should be explained. However, completeness and accuracy should not be sacrificed and proper support should be provided for contents of the audit report, reflecting nature and extent of audit work performed. Sufficient thought should be given to the content of the working paper before beginning the audit step.

**3.8.7** Working papers should be legible and neat with adequate space for additional data, notes and comments and should contain information that is relevant, important and useful with respect to the objectives established for the examination.

**3.8.8** Files should be organised systematically and work papers should be indexed to facilitate the cross-referencing of working papers to each other and to the report. The relationship of the working papers to the particular areas or segments of the audit should also be indicated.

#### *Audit file structure*

**3.8.9** Information gathered by the auditor should be separated between two audit files, permanent audit file and current audit file. Working papers that may be useful in planning and performing subsequent audits and information that is of permanent nature should be retained in a permanent audit file. The permanent audit file will be maintained at an appropriate level such as the Ministry level or audit unit level. Working papers pertaining only to the current audit comprise the current audit file.

#### **Permanent audit file**

**3.8.10** Materials contained in permanent audit files should generally pertain to the operations rather than to a particular audit and be of a continuing nature considered for possible use in future audits. General data obtained during the audit survey phase should also be included in this file. The permanent file could include the following items:

- description of the auditee, including type of organisation and mission, location, physical and financial size and description of pertinent records;
- description of important policies, procedures and controls, including references to pertinent directives, organisational charts, functional manuals, and agreements;

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- names, titles and areas of responsibility of key personnel. If this information is not included on organisational charts, it should be referenced to the organisational segments shown on the charts; and
- audit history which consists of a brief reference to each audit performed, including nature, date and period of audit, and comments on important results. Items for follow-up or review in subsequent audits should be noted.

A permanent file should be updated throughout the audit process.

#### **Current audit file**

**3.8.11** A current audit file should be established for each audit and should contain the working papers developed during that audit. Materials contained in current files should be arranged in a logical sequence in accordance with the planned file structure developed as part of the overall audit plan.

**3.8.12** Work papers should be divided into sections and filed using section separators according to the area of audit, together with adequate supporting documents.

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## Review and interpretation of audit findings

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### 4.1 Introduction

4.1.1 This section provides guidance on:

- review of workpapers;
- evaluating whether the audit evidence obtained is sufficient and appropriate to form an audit opinion;
- evaluating whether the financial statements are free of material misstatements;
- evaluating financial statement presentation and disclosures; and
- preparing a Completion Memorandum.

### 4.2 Review of work papers

4.2.1 Work papers are reviewed by someone other than the preparer. i.e. Directors to review work of auditors. The reviewer, who is usually senior to the preparer, considers a variety of matters including whether:

- the business and operations of the auditee are understood;
- the audit work is performed in accordance with applicable laws and regulations;
- the objectives of the audit procedures are achieved and conclusions expressed are consistent with the results of the audit work performed and support the audit opinion on the financial statements;
- the audit work papers are relevant to the audit, adequately document the audit evidence obtained and are internally consistent;
- issues were properly identified during the audit fieldwork, brought to the attention of the Director, and resolved, as appropriate.

4.2.2 Reviews are usually more effective, result in more efficient follow-up and improve communication with the auditee if they are performed:

- at the auditee's premises;
- continuously throughout the audit and promptly upon completion of the audit work.

4.2.3 The Director and/or the AAG are responsible for the review of the work papers. The purpose of the review is to reach an affirmative conclusion that the work papers:

- support audit opinion on the financial statements; and
- show that the audit complies with the Strategy and Planning Memorandum.

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### Review and interpretation of audit findings

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**4.2.4** The Director's review of work papers previously reviewed by the audit officer may be limited by the extent to which the Director relies on the audit officer. Nevertheless, the Director retains responsibility for the adequacy of the work papers.

**4.2.5** The Director's review is documented by initialing work papers, signing lead schedules or conclusion sheets covering a related series of work papers or by stating the extent of review procedures in the Completion Memorandum.

**4.2.6** Upon completion of the review, the Director records his or her conclusions in the Completion Memorandum.

**4.2.7** The AAG/Deputy Auditor General (DAG) reviews key work papers relating to critical audit objectives and records his or her conclusions in the Completion Memorandum.

#### **Disposition of review notes**

**4.2.8** Reviewers may write down questions, for example, about work performed or documentation of the work, to facilitate follow-up. Follow-up procedures are documented in the work papers. Completed work papers are self-sufficient without reference to reviewers' questions and contain neither pending matters nor reviewers' notes. Reviewer's review notes must be maintained on file.

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### **4.3 Evaluating whether the audit evidence obtained is sufficient and appropriate to form an audit opinion**

**4.3.1** The auditor evaluates the audit evidence from all sources and considers whether it is sufficient and appropriate to form the audit opinion. The auditor considers all relevant audit evidence regardless of whether it confirms or refutes assertions in the financial statements. If the audit evidence is not sufficient or appropriate to form the audit opinion, the auditor performs additional audit procedures or express a qualified opinion or disclaimer of opinion.

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**4.4 Evaluating whether financial statements are free of material misstatements**

**4.4.1** If the auditor judges that the audit evidence is sufficient and appropriate to form an audit opinion, the auditor evaluates whether the financial statements are free of material misstatements. A conclusion that the financial statements are free of material misstatements, on the basis of sufficient appropriate audit evidence, means the auditor is satisfied that the risk of material misstatements in the financial statements is reduced to an acceptably low level.

**4.4.2** If there are audit findings, the Director/AAG considers them individually and taken together. The Director/AAG judges whether the audit findings indicate that material misstatements in the financial statements exist or may exist. This judgement considers:

- the surrounding circumstances and qualitative aspects of significant audit findings including their effect on presentation and disclosure in the financial statements; and
- whether there were audit findings in the prior year and, if so, their nature and effect on the current year's financial statements.

**4.4.3** If the Director/AAG judges that the financial statements are free of material misstatements, the auditor expresses an unqualified opinion, unless there are other reasons to modify the opinion.

**4.4.4** If the Director/AAG judges that the audit findings indicate there is a material misstatement in the financial statements, the auditor expresses a qualified or adverse opinion unless the auditee corrects the misstatement.

**4.4.5** Alternatively, after considering possible undiscovered error, the Director/AAG may judge that the audit findings indicate there may be a material misstatement in the financial statements. If so, the auditor performs additional or other audit procedures until the auditor is satisfied the financial statements are free of material misstatements. If the auditor is still not satisfied, the auditor modifies the audit opinion.

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#### **4.5 Evaluating financial statement presentation and disclosures**

**4.5.1** In addition to the evaluation of the audit evidence for audit objectives, the auditors read the financial statements after adjustments are made, considering whether:

- the financial statements are prepared in accordance with acceptable accounting policies consistently applied, or, if changed, the changes are presented appropriately;
- appropriate information is disclosed, classified and described in accordance with acceptable accounting policies and, if applicable, legal requirements;
- information in the financial statements is consistent with the knowledge of the auditee's operations.

**4.5.2** The auditors perform analytical procedures, such as comparing the observed ratios and trends in the financial statements with those the auditor expects. The auditors consider whether, in the light of the audit evidence obtained and the accumulated knowledge of the auditee:

- the auditor has obtained, and corroborated, explanations for significant unusual or unexpected matters or relationships in the financial statements;
- the current year's financial statements appear to be reasonable in comparison with the prior year; and
- the financial statements are likely to make sense from the point of view of a reasonable person.

**4.5.3** The results of the analytical procedures may lead the auditors to recommend changes in presentation or disclosure, make additional enquiries, perform other audit procedures or modify the opinion.

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#### **4.6 Preparing a Completion Memorandum**

**4.6.1** The auditor documents the review and interpretation of audit findings in a Completion Memorandum. The Completion Memorandum is intended to bring together into one document the significant audit decisions made after the preparation of the Audit Strategy and Planning Memorandum.

**4.6.2** The Completion Memorandum is an internal document that describes, or refers to other work papers that describe, the following items:

- confirmation that audit work papers were reviewed;
- conclusions as to whether the financial statements are free of material misstatements;

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## Chapter 4

### Review and interpretation of audit findings

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- a discussion of:
  - the audit findings for critical audit objectives;
  - the facts, research and resolution for significant and unusual accounting, auditing and reporting matters; and
  - revisions to audit strategy and planning since the time of preparation of the Audit Strategy and Planning Memorandum.  
*For example, a discussion of complex transactions, highly controversial accounting and reporting matters, the research the auditor carried out, the resulting resolution and rationale and the audit procedures the auditor performed together with the audit findings.*
- conclusions as to whether the audit evidence obtained is sufficient and appropriate to form an audit opinion;
- an evaluation of financial statement presentation.  
*For example, matters on which the auditor consulted with other professionals, significant changes from the auditee's previous accounting policies, matters affecting the current year's report as well as matters addressed in prior years that continue to be of significance.*

**4.6.3** The audit officer, Director and AAG/DAG sign and date the Completion Memorandum prior to the issuance of the report.

**4.6.4** The AAG/DAG approves the Completion Memorandum after the audit team has satisfactorily resolved pending matters to the AAG's/DAG's satisfaction.

## Reports and presentation

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### 5.1 Introduction

5.1.1 This section provides guidance on:

- reporting procedures
- audit reports;
- concurring review; and
- preparing audit reports.

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### 5.2 Reporting procedures

#### 5.2.1 Preliminary report

The audit findings must be drafted by the field audit officers and discussed with the auditees, and based on these findings a preliminary draft must be prepared within 15 days of completion of the audit fieldwork. Reports are issued at field level upon completion of the audit. This report is reviewed by the Audit Supervisor (“Director”) for audit entities located in the Kathmandu Valley and subsequently given to the auditees for their comments, and a copy sent to the Ministry’s Secretariat, DTCO and the Department concerned. A timeframe of 35 days is given to the Department to revert with their responses and settlement of queries. An extension of time is granted if the AG’s office deems the reasons are justified. At this juncture, the auditees are notified that all findings will be incorporated in the Annual Report.

#### 5.2.2 Final draft report

Upon completing the fieldwork for the whole Ministry, the audit officers should compile and prepare the final draft audit report, i.e. sometime between March and May of the financial year, incorporating the responses received from management. The draft audit reports must be reviewed by the Director and AAG, and issued to the concerned entities and copied to the Secretariat of the respective Ministry. Subsequent to receipt of management comments, if responses are acceptable, the AAG may drop the finding and this must appropriately documented on file. The final draft report will be sent to the DAG and AG for their review.

The compiled final draft report should be sent to the concerned Secretariat, and a timeframe of between 7 to 15 days is given for further response. If further comments are raised by the Secretariat, the final draft report must be revisited. If the Secretariat does not revert with their responses, the final draft audit report will incorporate all responses received during the fieldwork and all other findings will remain and will also be highlighted in the audit report accordingly.

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The Reporting Sub-committee, comprising the AAG, DAG and AG, reviews the final report concurrently upon issuance of the final draft reports to the respective Secretariats. Upon expiry of the response time granted to the Secretariat, the Sub-committee should finalise the final draft reports for incorporation into the Annual Report.

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### 5.3 Audit reports

**5.3.1** An audit report, addressed to the auditee, contains a clear written expression of opinion on the financial statements.

**5.3.2** The audit report includes the following basic elements:

- **Title:** The report should be preceded by a suitable title or heading helping the reader to distinguish it from statements and information issued by others;
- **Signature and date:** The opinion or report should be properly signed. The inclusion of a date informs the reader that consideration has been given to the effect of events or transactions about, which the auditor became aware up to that date (which, in the case of financial audits, may be beyond the period of the financial statements);
- **Objectives and scope:** The report should include reference to the objectives and scope of the audit. This information establishes the purpose and boundaries of the audit;
- **Completeness:** The report should be appended to and published with the financial statements to which they relate, but performance reports may be free standing. The auditor's opinions and reports should be presented as prepared by the auditor. In exercising its independence, the audit organisation may acquire information from time to time, which in the national interest cannot be freely disclosed. This can affect the completeness of the audit report. In this situation the auditor should consider the need to make a report, possibly including confidential or sensitive material in a separate, unpublished report;
- **Addressee:** The report should identify those to whom it is addressed, as required by the circumstances of the audit engagement and local regulations or practice. This may be unnecessary where formal procedures exist for its delivery;
- **Identification of subject matter:** The auditor's report should identify the financial statements of the auditee that have been audited, including the date of and period covered by the financial statements. The report should include a statement that the financial statements are the responsibility of the auditee's management and a statement that the responsibility of the auditors is to express an opinion on the financial statements based on the audit;
- **Legal basis:** Audit opinions and reports should identify the legislation or other authority providing for the audit;

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### Reports and presentation

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- **Compliance with standards:** Audit opinions and reports should indicate the auditing standards or practices followed in conducting the audit, thus providing the reader with an assurance that the audit has been carried out in accordance with generally accepted procedures;
- **Scope paragraph:** The report should describe the scope of the audit by stating that the audit was conducted in accordance with generally accepted auditing principles and the guidelines issued by the AG. The report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatements;
- **Opinion paragraph:** The auditor's report should be a clear written expression of opinion or disclaimer of opinion on the financial statements. There are four types of audit opinion: unqualified, qualified, adverse and a disclaimer of opinion; these types require further modification in some circumstances; and
- **Timeliness:** The audit opinion or report should be available promptly to be of greatest use to readers and users, particularly those who have to take necessary action.

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### 5.4 Concurring review

**5.4.1** A concurring review is required for selected AG reports issued for financial statements of entities deemed to involve higher risk engagements.

#### **Who the concurring reviewer is**

**5.4.2** A DAG who has the appropriate expertise and experience and is not otherwise involved in directing the engagement performs the concurring review. The nature of the concurring review does not preclude the DAG from being involved with certain aspects of the audit, but it is important that a high degree of detachment be maintained.

#### **What the concurring reviewer does**

**5.4.3** The concurring review is not a substitute for the Director's or AAG's review. It does not relieve the Director or AAG of responsibility for the adequacy of the examination or for the appropriateness of the audit opinion.

**5.4.4** The concurring review needs to be decided at the audit planning phase and incorporated in the Strategy and Planning Memorandum, to enable the concurring reviewer to carry out the review and to enable the audit team to respond to matters arising.

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## Chapter 5

### Reports and presentation

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**5.4.5** The objectives of the concurring review are to give additional assurance that:

- the audit report and financial statements are clear, concise and understandable to a person not familiar with the details of the engagement;
- professional standards and, when applicable, legal requirements as to disclosure, format and terminology are complied with;
- OAGN's policies as to the audit report are complied with and the opinion (or disclaimer) expressed is appropriate;
- the financial statements appear to conform to applicable accounting and reporting standards and relevant regulatory requirements, unless otherwise referred to in the audit report; and
- the financial statements make sense.

**5.4.6** Before release of the audit report, the concurring reviewer:

- reviews the significant accounting, auditing or reporting considerations by reading:
  - the Strategy and Planning Memorandum
  - the Completion Memorandum
  - other work papers the concurring reviewer considers necessary.
- reads the financial statements and related notes and considers whether presentation and disclosure are appropriate, understandable and in conformity with generally accepted accounting principles (or a comprehensive basis of accounting other than generally accepted accounting principles) applied on a consistent basis;
- reviews the audit report to ascertain whether the unqualified, qualified or adverse opinion, or disclaimer of opinion, and the reasons given, are appropriate; and
- discusses the above matters with the Director/AAG.

**5.4.7** If the concurring reviewer requires explanation of some matters, he or she clarifies them with the Director/AAG or by discussion with other members of the audit team. In the event of differences of opinion, the audit report is not released until matters raised between the Director and concurring reviewer, DAG or AAG, are satisfactorily resolved. Although the AAG and/or DAG are responsible for the ultimate decision, resolution of differences of opinion ordinarily would involve consultation with other DAGs.

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**Documentation**

**5.4.8** Completion of concurring review is documented in the Completion Memorandum or other audit work papers. The concurring reviewer's notes are discarded when the concurring reviewer is satisfied that questions raised are satisfactorily resolved.

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**5.5 Preparing audit reports**

**Audit opinions**

**5.5.1** Unless there are other reasons for a qualified opinion, an unqualified opinion is appropriate when:

- the financial statements are prepared in accordance with acceptable accounting policies consistently applied or, if changed, the changes in accounting policies are presented appropriately;
- appropriate information is disclosed, classified, and described in accordance with acceptable accounting policies and, if applicable, legal requirements;
- information in the financial statements is consistent with the knowledge of the auditee's operations.

**5.5.2** Reasons for a qualified or adverse opinion or a disclaimer of opinion are as follows:

- there is a limitation on the scope of the audit work;  
*This may lead to a qualified audit opinion or a disclaimer of opinion.*
- the auditor disagrees with management in respect of the financial statements;  
*This may lead to a qualified audit opinion or an adverse audit opinion.*

**5.5.3** Whenever the auditor issues an audit opinion that is other than unqualified, the auditor includes a clear description of all the reasons in the audit report and, unless impracticable, a quantification of the possible effect(s) on the financial statements. This information is preferably set out in a separate paragraph, preceding the audit opinion or disclaimer of opinion. It may also include a reference to a more extensive discussion in a note to the financial statements.

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**Effect on the audit opinion of a limitation on the scope of the audit work**

**5.5.4** If, because of the circumstances, the scope of the audit is limited, the auditor attempts to carry out reasonable alternative audit procedures to obtain sufficient and appropriate audit evidence to support an unqualified opinion.

*For example,*

- *the auditee's accounting records may be inadequate.*
- *The auditor is unable to carry out an audit procedure that the auditor believes is required.*

**5.5.5** When the auditor considers that the limitation in the scope of the audit work prevents the auditors from issuing an unqualified opinion, the auditor describes the limitation in the audit report. The auditor indicates in the audit opinion that the qualification is in relation to the possible adjustments that might have been determined to be necessary had the limitation not existed.

**5.5.6** The auditor disclaims an opinion when the possible effect of a limitation on scope is so important that the auditor is unable to express an opinion on the financial statements.

**Effect on the audit opinion of a disagreement with the auditee's management**

**5.5.7** The auditor may disagree with the auditee's management as to:

- the acceptability of the accounting policies applied;
- the method of their application, including the adequacy of disclosures in the financial statements; and
- the compliance of the financial statements with relevant regulations and statutory requirements.

**5.5.8** The auditor expresses a qualified opinion when the auditor concludes there is a material misstatement in the financial statements as the result of the conditions on which the auditor disagrees with the auditee's management. A qualified opinion is expressed as "except for the effects of" the disagreement.

**5.5.9** The auditor expresses an adverse audit opinion when the effect of a disagreement is so important and affects the financial statements to such a degree that the auditor concludes that a qualification of the report is inadequate to disclose the misleading or incomplete nature of the financial statements.

**Paragraph emphasising an uncertainty**

**5.5.10** If a significant uncertainty, the resolution of which is dependent on future events, affects the financial statements, the auditor may add a paragraph (after the opinion paragraph) to the report that draws attention to the note to the financial statements that more extensively discusses the uncertainty.

**5.5.11** An auditor is not precluded from issuing a disclaimer of opinion in situations involving significant uncertainties.

## Peer review

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### **6.1 OAGN Policy on Quality Control - Peer Review**

**6.1.1** OAGN’s policy provides that, to ensure the maintenance of the highest quality of auditing services to its auditees, a system of quality control policies and procedures are established which includes a review of general quality control considerations and review of selected individual financial audit engagements.

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### **6.2 INTOSAI pronouncement on Quality Control Review**

**6.2.1** The twelfth Congress of the International Organization of Supreme Audit Institutions (INTOSAI) (Sydney 1986) recommended that the objective of quality assurance programmes of an audit institution is to satisfy its top management that:

- the audit work has been carried out to appropriate standards;
- the output has been presented in a satisfactory manner; and
- the work in general meets the legitimate needs and interests of the audited body and other users of output, including Parliamentary and supervisory authorities on the political level, the media and the public at large.

**6.2.2** In addition, the INTOSAI Auditing Standards state that the Supreme Audit Institutions (“SAI”) should establish systems and procedures to:

- confirm that integral quality assurance processes have operated satisfactorily;
- ensure the quality of audit report; and
- secure improvements and avoid repetition of weaknesses.

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### **6.3 Introduction**

**6.3.1** This section provides guidance on :

- basis of peer reviews;
- conduct of Quality Control Committee;
- performing peer reviews; and
- conclusion and reporting.

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## Chapter 6

### Peer review

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**6.3.2** The objectives of performing peer reviews are to:

- evaluate quality of performance on audits;
- provide reasonable assurance that the work performed conform to the generally accepted government auditing and accounting standards and OAGN's laid down policies and procedures;
- provide reasonable assurance that adequate work has been performed to support the reports issued and that the underlying working papers provide sufficient evidence of this;
- evaluate the performance of individual audit team or staff in relation to understanding and implementation of OAGN's policies and guidelines and to facilitate the process of educating the value of complying with such policies and guidelines;
- corroborate the implementation and effectiveness of action plans for correcting deficiencies;
- identify significant deficiencies in operations and quality assurance procedures; and
- provide constructive recommendation for improving the efficiency and effectiveness of OAG's peer reviews and enhancing service and satisfaction to the auditee.

#### *Overview of Peer Review*

**6.3.3** Across the globe, government, industrial and commercial enterprises are trying to embrace corporate governance- Good Business Practices- with transparency. As a result of corporate governance and good business practices- management expects that their auditors will also provide good quality and value added services and, therefore, contribute to corporate governance. This is achieved by conducting "Peer Reviews", a concept which is being widely recognised as the tool to assess and improve the quality of audit service.

**6.3.4** OAG has the responsibility of providing high quality (reliable, relevant and sufficient) information to the auditee. For this, it needs to establish its own quality review system to ensure the best product that meets the information needs of the auditees and offers opinions and recommendations that are professionally sound and relevant. It involves evaluating the effectiveness of the systems and controls used during the audit process, to determine whether the audit work was conducted in a professional manner and reports were prepared and distributed in accordance with OAG's strategy and policy.

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## Chapter 6 Peer review

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### *Basis of Peer Review*

**6.3.5** Peer Review programmes are based on the following considerations on the part of the reviewer :

- ***Independence, Integrity and Objectivity*** : The Peer Review team should maintain independence, perform all responsibilities with integrity and maintain objectivity in performing the review. The review team needs to be impartial, it should recognise an obligation for fairness, and intellectual honesty and it should be free from any conflict of interest;
- ***Competence*** : A Peer Review should only be carried out by a team possessing full knowledge of these guidelines, current government auditing and accounting standards, an understanding of the OAG's staff profile and the procedures related to its management and supervision;
- ***Due Professional Care*** : Peer Reviews are sensitive and confidential in nature. The peer review team needs to take due professional care in carrying out the review; and
- ***High Standards of Review Administration*** : To gain the maximum out of the reviews, it should be carried out under certain specific administrative standards supervised by a Quality Control Committee.

### *Conduct of the Review*

**6.3.6 Review by in-house team** : As OAG is an independent constitutional body, no outside authority is authorised to supervise its work and monitor its performance. An in-house team from OAG shall carry out the peer review. The members of the team shall be drawn from different divisions within OAG.

The review shall cover the overall quality and technical standards and also selected audit engagements to ensure that specified professional standards are actually followed.

**6.3.7 Quality Control Committee constitution and responsibility:** (To confirm with OAGN) The AG shall constitute a Quality Control Committee ("QCC") to develop and maintain policies and procedures. This committee will provide reasonable assurance as to the quality of financial auditing services and that it is rendered in compliance with this Guide, government auditing and accounting standards and such further audit guidelines as are established by OAG from time to time.

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## Chapter 6

### Peer review

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**6.3.8** The chairperson and the members of the committee shall be designated by the AG which may include DAG, selected AAG's, Directors and professional peer from among the private firm. The committee shall have a maximum of five members.

**6.3.9** Responsibility of QCC shall include but not be limited to:

- select audit engagements to be reviewed;
- designate an individual or a team to be responsible for the review of general quality control policies and also the individual audit engagements;
- approve questionnaires/checklists prepared for the review and to prepare necessary instructions for conducting the review;
- supervise and monitor the review assignment; and
- prepare summarised results for presentation to the AG and the follow-up suggestions for improvement which should include whether, in the opinion of the Committee :
  - the review programme met the review objectives and was carried out in a manner consistent with OAG's policies;
  - the review conducted have been appropriately documented;
  - the review report fairly reflects the review results; and
  - the indicated follow-up actions to be taken appear appropriate in the circumstances.

The report should also contain:

- details of timing of the review and the names of review team members; and
- a description of the scope of the review (general approach, extent of coverage of the general quality control aspects and the description of individual audit engagement)

**6.3.10 *Frequency of coverage*** : It is recommended that at least 10% of the audit engagements be reviewed each year. However, it is also recommended that no more than 10% of the relevant engagement hours be spent on peer review work.

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## Chapter 6

### Peer review

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**6.3.11** The sample of individual engagements selected must be sufficient to constitute a representative sample of all financial audit engagements conducted by OAG, and should include :

- engagement of every AAG/Director and, to the extent practicable, every auditee in-charge being reviewed at least once every 3 years;
- large and complex engagements, as well as a sample of smaller engagements;
- engagements in specialised sectors, e.g- public health, education, rural housing,
- new engagements; and
- special studies/engagements e.g- auditees where budgetary involvement is insignificant but is a matter of public concern.

**6.3.12** Consideration should be given to biasing the sample towards the review of those audited entities which the AAG regards as having critical significance.

#### *Performing the Review*

**6.3.13** The review shall be conducted in the following steps:

- **Planning** : The planning process involves the following :
  - A detailed planning for conducting the review in an organised manner is essential. A team with the right mix of people shall be formed and a team leader from amongst them chosen. The team should then plan for the review considering the nature of the review, inherent risk in the assignment, best practices available for the assignment, etc.
  - Every review team member should have questionnaires or checklists for use both in the review of general quality control policies and procedures and also in the review of individual audit engagements consistent with guidelines given in this Guide.
- **Reviewing** : The review of the specified engagements should be carried out in accordance with the detailed checklists prepared for the review. During the review process, the deficiencies in the quality control system and its compliance would be established.

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## Chapter 6

### Peer review

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**6.3.14** The objectives of review at the level of individual audit would normally cover:

- **Overall management of audit** - Audit is a specialised work that is to be performed with certain standard practice. The peer review assesses the performance of audit considering general practices that focuses on integrity and diligence of the auditor. It includes that the staff:
  - possess the technical standards and professional competence required for fulfilling their responsibilities;
  - the audit personnel are directed in the appropriate manner. It is important for completing the engagement efficiently and effectively;
  - the work is adequately supervised, which involves monitoring the progress of the assignment.
- **Documentation** - Proper documentation of evidence is very important from the viewpoint of justifying audit findings.
- **Compliance with audit plan** – The audit plan is the major guiding force in financial auditing. Auditors are required to follow audit plan. Peer review focuses on adherence to the audit plan. Any deviation from audit plan has to be properly justified and approved by the appropriate authority.

#### *Conclusion and Reporting*

**6.3.15** The primary objective of the review is to formulate recommendations which address the cause of any shortcoming in quality to ensure that appropriate corrective action is taken. The objective is achieved through the process of concluding the review. The findings of the review should be formally tabulated and communicated by way of a report.

**6.3.16** The following factors should be considered in concluding the review:

- at the end of the review visit, the reviewers should prepare an overall summary report for the AAG responsible for the audit;
- the reviewer's report on individual engagements should be discussed with the relevant Audit Director and the summary report with the AAG prior to finalisation;
- upon completion of the review, every team should submit a report to the chairperson of QCC.

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## Chapter 6

### Peer review

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- information about the scope and extent of the reviews, including but not limited to:
    - details of timing of the review and the names of review team members;
    - a description of the scope of the review (general approach, extent of coverage of the general quality control aspects and the description of individual audit engagement);
    - time spent on engagement reviews and on the review of general quality control aspects; and
    - name and designations of reviewers involved including professionals/ specialists from outside OAG.
  - the reviewer may highlight other pertinent issues that may be of interest to all other Audit Divisions.
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# Debrief

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## 7.1 Introduction

7.1.1 This section provides guidance on:

- definition of debriefing;
- importance of debriefing; and
- how the auditor debriefs

### *Definition*

7.1.2 Debriefing involves considering the quality of delivery of the audit. OAG analyses the audit team's performance in the current year to identify successes, areas where improvements are possible and recommendations for the following year's audit. Either the auditee or the audit team may suggest ideas for improvement.

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## 7.2 Importance of debriefing

7.2.1 Debriefing is important in the aim to achieve continuous quality improvement. Debriefing provides a link between the current year's audit and next year's audit. The main benefits of debriefing are:

- to provide improved service in the future by repeating this year's successes, eliminating defects and making more efficient use of both the OAG's and the auditee's resources; and
- to enhance the responsiveness to the auditee's needs.

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## 7.3 How the auditor debriefs

7.3.1 Debriefing usually involves:

- considering events during the audit;

*OAG discusses factual and technical information about the auditee, the auditee's operations and the audit team. This is a useful forum for receiving ideas from, and providing constructive comments to, members of the audit team.*

*Debriefing provides an opportunity for members of the audit team to learn more about the entirety of the audit beyond their individual roles.*

- considering important judgements;

*OAG may identify the important audit decisions and factors entering into them. This is important to develop the judgmental skills of the audit team.*

- analysing the activities within the audit;

*The auditor considers the activities that were successful and those for which improvements are possible. The auditor set criteria against which the auditor judges the effectiveness and quality of delivery or cost effectiveness of the audit team. The auditor also takes account of comments received from the auditee's management.*

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## Chapter 7

### Debrief

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- producing recommendations;  
*The audit team participates in a discussion to produce constructive recommendations to improve the quality of delivery or cost effectiveness of the audit.*

*The auditor may also prepare an action plan, setting out the issues identified, the action to be taken, the persons responsible and a timetable. Notes prepared during debriefing are not considered to be audit work papers. Debriefing notes are discarded when the audit plan for the following year's audit is complete.*

- monitoring the implementation of recommendations.  
*The auditor incorporates recommendations into the following year's audit strategy and planning, as appropriate.*

**7.2.4** The AAG is responsible for leading debriefing and setting the direction for improvement of both individual and team performance in the future. The AAG is also responsible for follow-up in developing the subsequent year's audit strategy and planning.

**7.2.5** The auditors may debrief continuously throughout the audit, identifying strategies for improving the audit. In addition, the auditor may conduct debriefing meetings, as appropriate, with members of the audit team, management and other relevant parties. These meetings are normally held soon after completion of the audit.

<b>Audit programme</b>
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Client.....

Year/ Period ended.....

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**OBJECTIVES :**

- 
- 
- 

	Audit procedures	Completed by and date	Ref
1.			
2.			
3.			
4.			
5.			

*(AUDITEE)*

Audit strategy and planning  
memorandum  
for the year ended

.....

## 1.0 Introduction

This Audit Strategy and Planning Memorandum (“ASPM”) serves to provide general information on (auditee) and to outline the proposed audit approach and reporting and other requirements in connection with the examination of the financial statements of the (auditee) for the year ended XXX.

The purpose of this ASPM is summarised as follows:

- 
- 
- 

## 1.1 Background information



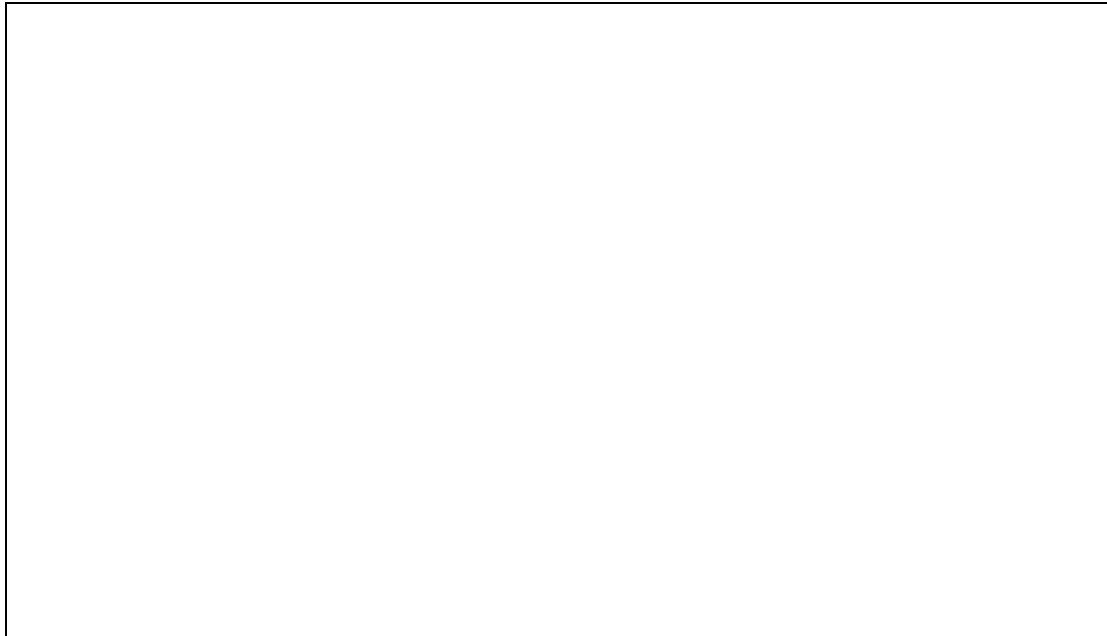
## **1.2 Audit objective**

The overall objective of our audit is to enable us expressing an opinion on following matters based on our examination of books of accounts and other related documents and records provided by (auditee) for the year ended XXX:

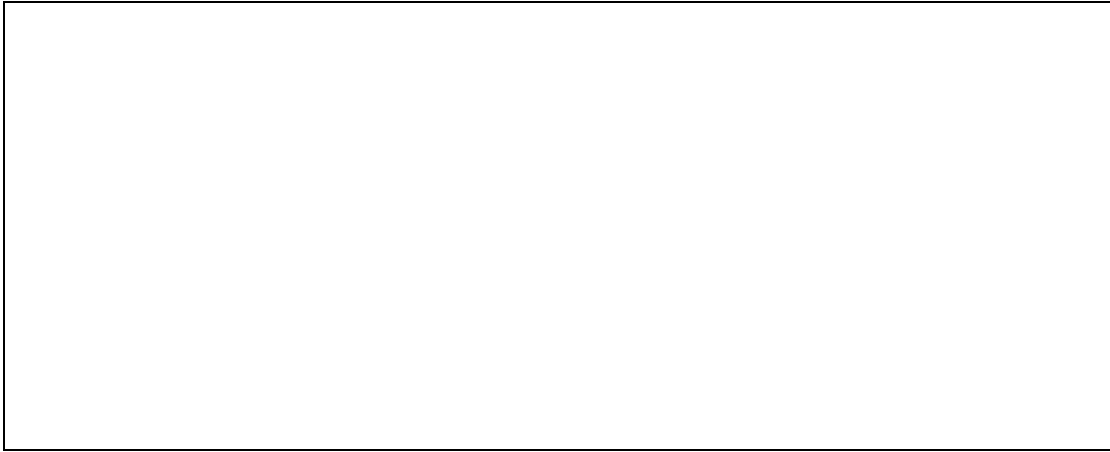
Our audit is to be performed in accordance with INTOSAI and ISA and based on the guidance set forth in the Government Auditing Standards (GAS) Part 2. During the course of our review, we may make recommendations via Management Letter to improve control weaknesses and enhance operational and administrative efficiency. However, our audit should not be relied upon to identify all such weaknesses or inefficiencies, which may exist.

## **2.0 Methodology: Government Auditing Standards Guidelines**

### **2.1 Audit Approach**

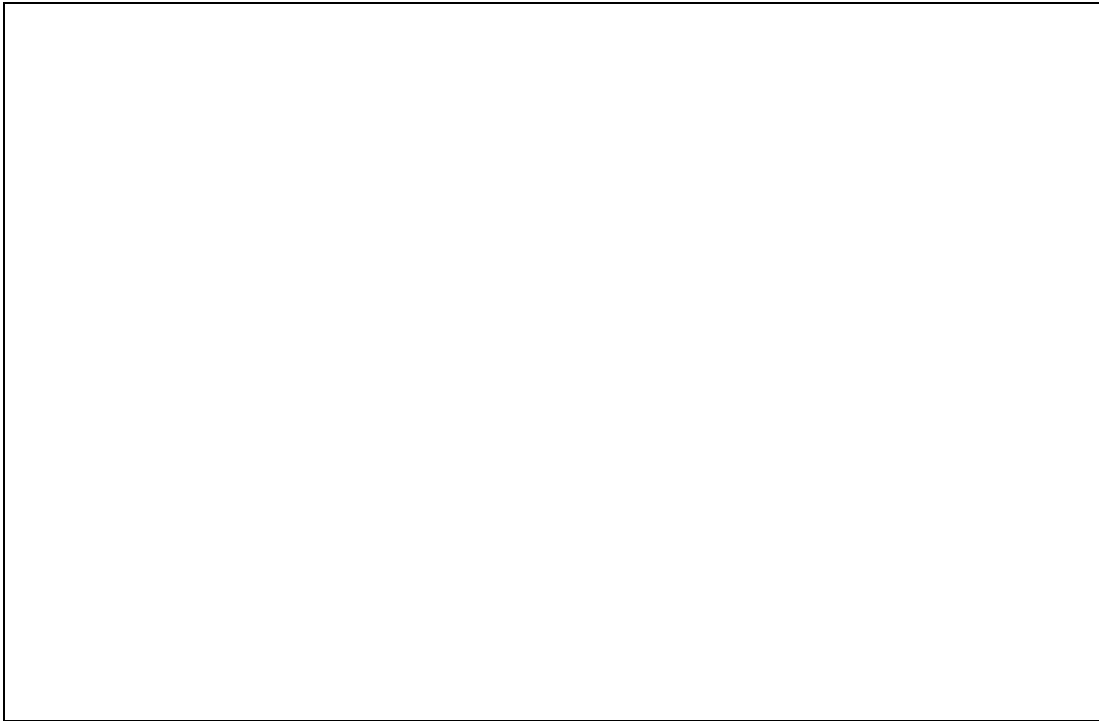


## **2.2 Business activities and risk issues**



## **2.3 Assessment of inherent risk and rationale**

There are various factors over which (auditee) has no or minimal control but these factors have significant influence on its financial results. The factors are as follows:



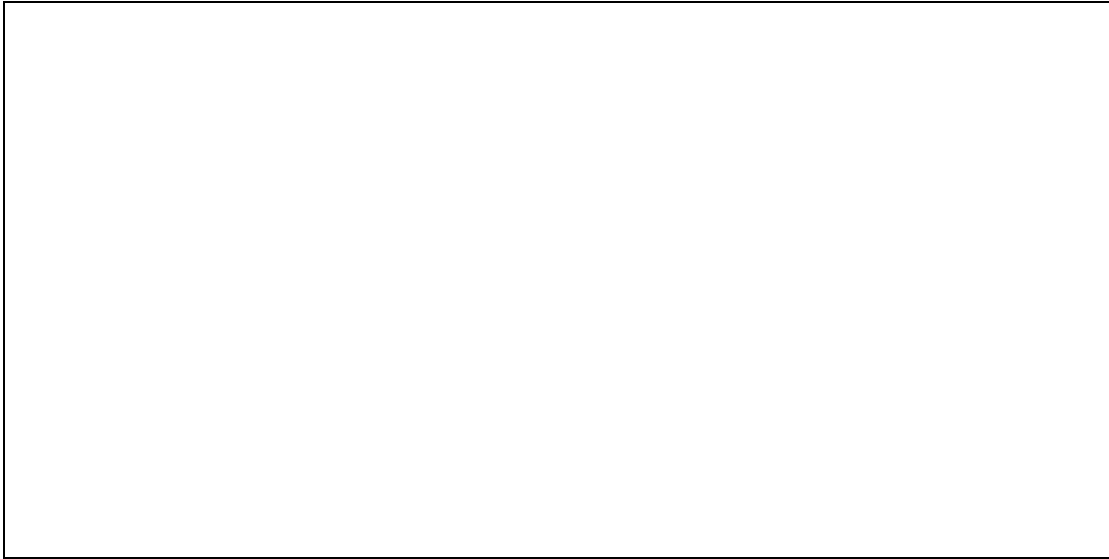
## **2.4 Critical audit objective and specific procedures**

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### **3 Internal controls and review approach**

#### **3.1 Assessment of control risk and rationale**

The areas of review of controls being performed are:



#### **3.2 Internal audit reliance**

Apart from the above specific review, we will also perform an overall assessment on the DTCCO audit function during your system review. The assessment will include the following:



## **4 Practical aspects**

### **4.1 Schedules required**

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### **4.2 Follow-up on previous year's findings (to identify and list the previous year's follow-up matters, if any)**

During the course of our audit, we shall also review the status of previous years audit findings and report the current status.

## **5 Engagement team**

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## 6 Primary client contact

<i>Name</i>	<i>Position</i>

## 7 Principal reporting deadlines

The principal reporting dates is subject to approval by OAGN and (auditee's) management. Tentatively, principal reporting dates for the audit for the year ended XXX are as follows:-

## 8 Budget and time summary

### 8.1 Budget

No.	Activity	Estimated Budget Rs.
	<b>Total Estimated Budget for the assignment</b>	

### 8.2 Time Summary

No.	Engagement Team Member	February	March	April	Total
	<b>Total man days for the assignment</b>				

## 9 Amount considered as insignificant misstatement

Any item of simple noncompliance with statutory provisions not exceeding \_\_\_% of total allocation to that particular budget allocation head which has not caused any loss to HMG/N shall be considered as insignificant misstatement. However, all items of misappropriation, fraud and misuse which have incurred loss or additional financial burden to HMG shall be considered as significant and shall be reported accordingly.

# Glossary

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<b>Access controls</b>	Access controls are procedures designed to restrict access to on-line terminal devices, programs and data. Access controls consist of "user authentication" and "user authorization". "User authentication" typically attempts to identify a user through unique logon identifications, passwords, access cards or biometric data. "User authorization" consists of access rules to determine the computer resources each user may access.
<b>Account balance</b>	An account balance is a component of the financial statements. It is the accumulation of accounting entries arising from classes of transactions and presentation and disclosure decisions.
<b>Accounting estimate</b>	An accounting estimate is an approximation of the amount of an item in the absence of a precise means of measurement.
<b>Accounting policies</b>	The principles, bases, conventions, rules and procedures adopted by management in preparing and presenting financial statements.
<b>Accounting system</b>	An accounting system is the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.
<b>Adverse opinion</b>	An adverse opinion is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. The auditor may issue an adverse opinion due to a disagreement with management.
<b>Analytical procedures</b>	Analytical procedures are the analysis of plausible relationships among both financial and non-financial information. They include the investigation of fluctuations and relationships that are inconsistent with our expectations.
<b>Appropriateness</b>	Appropriateness is the measure of the quality of audit evidence and its relevance to a particular assertion and its reliability.

**Assertions**

Financial statement assertions are assertions by management that are embodied in the financial statements, as follows:

- completeness  
There are no unrecorded assets, liabilities, classes of transactions or undisclosed items.
- existence  
An asset or liability exists at a given date and recorded transactions or events pertain to the entity and occurred during the period covered by the financial statements
- accuracy  
Details of assets, liabilities and classes of transactions are correctly recorded, processed and reported with respect to party, allocation to the proper period, description, quantity and price.
- valuation  
Assets are recorded at an appropriate amount
- obligations and rights  
The entity has the appropriate right (such as the title) to the assets reflected in the financial statements. The liabilities reflect the operations obligations.
- presentation and disclosure  
An item is disclosed, classified and described in accordance with the applicable financial reporting framework.

**Assurance**

Assurance refers to the auditor's satisfaction as to the reliability of an assertion being made by one party for use by another party. To provide such assurance, the auditor assesses the audit evidence collected as a result of procedures conducted and expresses a conclusion. The degree of satisfaction achieved and, therefore, the level of assurance which may be provided is determined by the procedures performed and their results.

**Attendance**

Attendance consists of being present during all or part of a process being performed by others.

**Audit**

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrases used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects," which are equivalent terms. A similar objective applies to the audit of financial or other information prepared in accordance with appropriate criteria.

**Audit difference**

An audit finding in which the auditor does not agree with the amount, classification, presentation or disclosure of items or totals in the financial statements, including related notes.

<b>Audit evidence</b>	<p>Information that forms the foundation which supports the auditor's or SAI's opinions, conclusions or reports.</p> <p><b>Competent:</b> information that is quantitatively sufficient and appropriate to achieve the auditing results; and is qualitatively impartial such as to inspire confidence and reliability.</p> <p><b>Relevant:</b> information that is pertinent to the audit objectives.</p> <p><b>Reasonable:</b> information that is economical in that the cost of gathering it is commensurate with the result which the auditor or the SAI is trying to achieve.</p>
<b>Audit firm</b>	<p>Audit firm is either a firm or operations providing audit services, including if appropriate its partners, or sole practitioner.</p>
<b>Audit mandate</b>	<p>The auditing responsibilities, powers, discretions and duties conferred on a SAI under the constitution or other lawful authority of a country.</p>
<b>Audit objective</b>	<p>A precise statement of what the audit intends to accomplish and/or the question the audit will answer. This may include financial, regularity or performance issues.</p>
<b>Audit procedure</b>	<p>The application of an audit technique to obtain audit evidence. Audit procedures may include:</p> <ul style="list-style-type: none"> <li>▪ test of control;</li> <li>▪ analytical procedures;</li> <li>▪ tests of details.</li> </ul>
<b>Audit programme</b>	<p>An Audit Programme sets out the nature, timing and extent of planned audit procedures required to implement the overall audit plan. The Audit Programme serves as a set of instructions to assistants involved in the audit and as a means to control the proper execution of the work.</p> <p>An Audit Programme includes:</p> <ul style="list-style-type: none"> <li>▪ a description of the audit objective;</li> <li>▪ an assessment of the risk of significant misstatements, and any revisions from our preliminary assessment;</li> <li>▪ a record of the nature, timing and extent of tests of control and other procedures performed to respond to the assessment of the risk of significant misstatement;</li> <li>▪ a record of the nature, timing and extent of substantive procedures performed to respond to the assessment of the risk of significant misstatement;</li> <li>▪ an indication as to who performed the audit procedures and when they were performed;</li> <li>▪ a conclusion as to whether the auditor has obtained sufficient appropriate audit evidence for the audit objective.</li> </ul>
<b>Audit risk</b>	<p>Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.</p>
<b>Audit scope</b>	<p>The framework or limits and subjects of the audit.</p>

<b>Auditing standards</b>	Auditing standards provide minimum guidance for the auditor that helps determine the extent of audit steps and procedures that should be applied to fulfill the audit objective. They are the criteria or yardsticks against which the quality of the audit results are evaluated.
<b>Audit techniques</b>	We obtain audit evidence by performing an appropriate mix of audit procedures, including tests of control, analytical procedures and tests of details. Such audit work involves one or more of the following techniques: <ul style="list-style-type: none"> <li>▪ inspection;</li> <li>▪ observation;</li> <li>▪ inquiry and confirmation; and</li> <li>▪ computation.</li> </ul>
<b>Auditor</b>	The auditor is the person with final responsibility for the audit.
<b>CAATs</b>	Applications of auditing procedures using the computer as an audit tool are known as Computer-Assisted Audit Techniques (CAATs).
<b>Classes of transaction</b>	Classes of transaction refers to set of transactions having common features, properties or qualities. A class of transactions may relate to non-routine transactions.
<b>Concurring review</b>	A review of significant accounting, auditing and financial reporting considerations that is performed before certain audit reports are issued by a partner not otherwise involved with the engagement.
<b>Confirmation</b>	Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records.
<b>Constitutional</b>	A matter which is permitted or authorized by the fundamental law of a country.
<b>Control environment</b>	The control environment comprises the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity.
<b>Control procedures</b>	Control procedures are those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives.
<b>Control risk</b>	Control risk is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material, individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.
<b>Critical audit objectives</b>	“Critical” is a term used to designate the audit objectives that an audit team determines benefit from the judgements of the most experienced members of the audit team, for instance the AAG/Director.
<b>Database</b>	A collection of data that is shared and used by a number of different users for different purposes.

<b>Disclaimer of opinion</b>	A disclaimer of opinion is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly are unable to express an opinion on the financial statements. The auditor may also issue a disclaimer of opinion in extreme cases involving multiple uncertainties that are significant to the financial statements.
<b>Documentation</b>	Documentation is the material (working papers) prepared by and for, or obtained and retained by the auditor in connection with the performance of the audit.
<b>Due care</b>	The appropriate element of care and skill which a trained auditor would be expected to apply having regard to the complexity of the audit task, including careful attention to planning, gathering and evaluating evidence, and forming opinions, conclusions and making recommendations.
<b>Economy</b>	Minimising the cost of resources used for an activity, having regard to the appropriate quality.
<b>Effectiveness</b>	The extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.
<b>Efficiency</b>	The relationship between the output, in terms of goods, services or other results, and the resources used to produce them.
<b>Error</b>	<p>An error is an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as:</p> <ul style="list-style-type: none"> <li>▪ a mistake in gathering or processing data from which financial statements are prepared;</li> <li>▪ an incorrect accounting estimate arising from oversight or misinterpretation of facts; and</li> <li>▪ a mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.</li> </ul>
<b>Expert</b>	An expert is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.
<b>External confirmation</b>	External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements.
<b>Financial statements</b>	The annual financial statement (which is supported by the SOE) and explanatory material which are identified as being part of the financial statements.
<b>Findings, conclusions and recommendations</b>	Findings are the specific evidence gathered by the auditor to satisfy the audit objectives; conclusions are statements deduced by the auditor from those findings; recommendations are courses of action suggested by the auditor relating to the audit objectives.

<b>Fundamental</b>	A matter becomes fundamental (sufficiently material) rather than material when its impact on the financial statements is so great as to render them misleading as a whole.
<b>General controls</b>	The establishment of a framework of overall control over the computer information systems activities to provide a reasonable level of assurance that the overall objectives of internal control are achieved.
<b>General standards</b>	The qualifications and competence, the necessary independence and objectivity, and the exercise of due care, which shall be required of the auditor to carry out the tasks related to the field and reporting standards in a competent, efficient and effective manner.
<b>Governance</b>	Governance describes the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.
<b>Higher risk engagement</b>	<p>The following are examples of situations that should be considered in the context of an operation's industry when deciding whether the engagement is a higher risk engagement:</p> <ul style="list-style-type: none"> <li>▪ the financial statements are expected to be widely distributed; and</li> <li>▪ there is a high level of public, media or regulatory interest in the operations.</li> </ul> <p>Risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor exercises professional judgement when considering risk factors individually or in combination and whether there are specific controls that mitigate the risk. The size, complexity, and ownership characteristics of the entity have significant influence on the consideration of relevant risk factors.</p>
<b>Independence</b>	The freedom of the SAI in auditing matters to act in accordance with its audit mandate without external direction or interference of any kind.
<b>Inherent risk</b>	Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
<b>Inquiry</b>	Inquiry consists of seeking information of knowledgeable persons inside or outside the entity.
<b>Inspection</b>	Inspection consists of examining records, documents or tangible assets.

<b>Internal audit</b>	The functional means by which the managers of an operations receive an assurance from internal sources that the processes for which they are accountable are operating in a manner which will minimise the probability of the occurrence of fraud, error or inefficient and uneconomic practices. It has many of the characteristics of external audit but may properly carry out the directions of the level of management to which it reports.
<b>Internal control</b>	The whole system of financial and other controls, including the organizational structure, methods, procedures and internal audit, established by management within its corporate goals, to assist in conducting the business of the audited operations in a regular economic, efficient and effective manner; ensuring adherence to management policies; safeguarding assets and resources; securing the accuracy and completeness of accounting records; and producing timely and reliable financial and management information.
<b>International Organization of Supreme Audit Institutions (INTOSAI)</b>	An international and independent body which aims at promoting the exchange of ideas and experience between Supreme Audit in the sphere of public financial control.
<b>International Standards on Auditing (ISA)</b>	International Standards on Auditing, developed International Standards on Auditing, developed by the International Federation of Accountants (IFAC), contain basic principles and essential procedures together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application.
<b>Knowledge of the operations</b>	Knowledge of the operations includes the auditor's general knowledge of the economy and the industry within which the operations is in and a more particular knowledge of how the operations operates.
<b>Known errors</b>	Known errors are audit findings the auditor has objectively determined or quantified.
<b>Limitation on scope</b>	A limitation on the scope of the auditor's work may sometimes be imposed by the operations (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary). A scope limitation may be imposed by circumstances. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed desirable.
<b>Management</b>	Management comprises officers and others who also perform senior managerial functions. Management includes directors and the audit committee only in those instances when they perform such functions.
<b>Management representations</b>	Representations made by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries.

<b>Management audit</b>	Analysis of public expenditure in the light of general principles of sound management.
<b>Material weaknesses</b>	Material weaknesses in internal control are control deficiencies that could have a material effect on the financial statements.
<b>Materiality and significance</b>	In general terms, a matter may be judged material if knowledge of it would be likely to influence the user of the financial statements or the performance audit report. Materiality is often considered in terms of value but the inherent nature or characteristics of an item or group of items may also render a matter material--for example, where the law or some other regulation requires it to be disclosed separately regardless of the amount involved. In addition to materiality by value and by nature, a matter may be material because of the context in which it occurs.
<b>Misstatement</b>	A mistake in financial information which would arise from errors or fraud.
<b>Most likely errors</b>	Most likely errors are audit findings the auditor has estimated, or subjectively quantified.
<b>Non-routine transactions</b>	<p>Transactions not in the ordinary course of business or infrequent or infrequent in occurrence. Management intervention may be required for such transactions to be processed. The risk of significant misstatement for audit objectives relating to non-routine transactions may be high as:</p> <ul style="list-style-type: none"> <li>▪ inherent risk may be high           <ul style="list-style-type: none"> <li>There may be:               <ul style="list-style-type: none"> <li>- greater management intervention to specify accounting;</li> <li>- greater manual intervention for data collection and processing;</li> <li>- greater judgement required in determining amounts;</li> <li>- complex calculations or accounting principles;</li> <li>- the nature of non-routine transactions may make it difficult for management to implement effective controls to prevent or detect and correct a significant misstatement as compared to routine transactions.</li> </ul> </li> </ul> </li> </ul>
<b>Observation</b>	Observation consists of looking at a process or procedure being performed by others, for example, the observation by the auditor of the counting of inventories by the entity's personnel or the performance of internal controls that leave no audit trail.
<b>Opinion</b>	The auditor's written conclusions on a set of financial statements as the result of a financial audit.
<b>Period</b>	Period refers to the length of time covered by the financial statements for which the auditor expresses an opinion. An entity usually issues financial statements annually.

<b>Planning</b>	Defining the objectives, setting policies and determining the nature, scope, extent and timing of the procedures and tests needed to achieve the objectives.
<b>Population</b>	The population is the entire set of data from which the auditor wishes to sample in order to reach a conclusion.
<b>Principles</b>	Basic assumptions, consistent premises, logical principles and requirements which represent the general framework for developing auditing standards.
<b>Professional skepticism</b>	An attitude of professional skepticism means making a critical assessment, with a questioning mind, of the validity of audit evidence obtained and being alert to audit evidence that contradicts or brings into question the reliability of documents or management representations.
<b>Qualified opinion</b>	A qualified opinion is expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or disclaimer of opinion. A qualified opinion should be expressed as being “except for” the effects of the matters to which the qualification related.
<b>Reasonable assurance</b>	In an audit engagement, the auditor provides a high, but not absolute, level of assurance, expressed positively in the audit report as reasonable assurance, that the information subject to audit is free of material misstatement.  Absolute assurance in auditing is not attainable as a result of such factors as the application of judgment, the use of testing, the inherent limitations of any accounting and internal control systems and the fact that most of the evidence available to the auditor is persuasive, rather than conclusive, in nature.
<b>Report</b>	The auditor's written opinion and other remarks on a set of financial statements as the result of a financial audit.
<b>Reporting Standards</b>	The framework for the auditor to report the results of the audit, including guidance on the form and content of the auditor's report.
<b>Representative sampling</b>	A selection of less than every item in a population for the purpose of evaluating some characteristic (by applying one or more audit techniques to the sample items) and reaching a conclusion about the population as a whole on the basis of the sample items. The sample is selected in such a way that it is likely to be representative of the population. A representative sample may be statistical or non-statistical.
<b>Risk of significant misstatement</b>	The audit combines the inherent risk and control risk assessments through the concept of the risk of significant misstatement.

<b>Routine transactions</b>	<p>Routine transactions record the operation's day-to-day business transactions, such as its ordinary purchases, cash payments and cash receipts. Routine transactions are likely to be:</p> <ul style="list-style-type: none"> <li>▪ numerous;</li> <li>▪ recurring;</li> <li>▪ objectively measurable, requiring little or no judgement in determining the amount to be recorded; and</li> <li>▪ processed in a similar way each time they occur.</li> </ul>
<b>Sampling risk</b>	<p>Sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.</p>
<b>Significant misstatement</b>	<p>A significant misstatement is a misstatement that, when accumulated with others, could cause the financial statements to be materially misstated.</p>
<b>Strategy</b>	<p>Strategies are the operational actions by which management aims to achieve its business objectives.</p>
<b>Substantive procedures</b>	<p>Substantive procedures are tests performed to obtain audit evidence to detect material misstatements in the financial statements, and are of two types:</p> <ul style="list-style-type: none"> <li>▪ tests of details of transactions and balances; and</li> <li>▪ analytical procedures.</li> </ul>
<b>Sufficiency</b>	<p>Sufficiency is the measure of the quantity of audit evidence.</p>
<b>Supervision</b>	<p>An essential requirement in auditing which entails proper leadership, direction and control at all stages to ensure a competent, effective link between the activities, procedures and tests that are carried out and the aims to be achieved.</p>
<b>Supreme Audit Institution (SAI)</b>	<p>The public body of a State which, however designated, constituted or organised, exercises by virtue of law the highest public auditing function of that State.</p>
<b>Test of control</b>	<p>Tests of control are performed to obtain audit evidence about the effectiveness of the:</p> <ul style="list-style-type: none"> <li>▪ design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and</li> <li>▪ operation of the internal controls throughout the period.</li> </ul>
<b>Transactions</b>	<p>A transaction is an event involving the exchange of value between the entity and another party that is required to be recognized in financial statements. The other party may be external to the entity or not, as in the case of inter-company transactions. A transaction may be routine or non-routine.</p>
<b>Uncertainty</b>	<p>An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.</p>

**Unqualified opinion**

An unqualified opinion is expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with the identified financial reporting framework. An unqualified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

**Working papers**

Working papers are a record of the auditor's planning, nature, timing and extent of the auditing procedures performed; and results of such procedures and the conclusions drawn from the audit evidence obtained. Working papers may be in the form of data stored on paper, film, electronic media or other media.

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