

## P R E F A C E

These “European Implementing Guidelines for the INTOSAI Auditing Standards” have been drawn up, at the request of the Contact Committee of the Heads of the Supreme Audit Institutions (SAIs) of the European Union, by a Working Group consisting of representatives of the following six National Audit Institutions and chaired by a representative of the European Court of Auditors:

Rigsrevisionen/Denmark  
Tribunal de Cuentas/Spain  
Corte dei Conti/Italy  
Algemene Rekenkamer/the Netherlands  
Riksrevisionsverket/Sweden  
National Audit Office/United Kingdom

The 15 guidelines presented here are an excellent example of the ever closer cooperation between the SAIs of the European Union in areas of common interest and I would like to express my sincere thanks to the Heads of the SAIs involved.

My special thanks are due to the members of the Working Group, whose expertise and commitment have produced a handbook which, I hope, will be of use to a growing number of auditors both within and outside the European Union.

Prof. Dr. Bernhard Friedmann  
President  
European Court of Auditors  
Luxembourg, 1998

**Contact Committee of Presidents of the  
SAIs of the European Union**

**Ad hoc Group on Auditing Standards**

**European Implementing Guidelines for  
the INTOSAI Auditing Standards**

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# TECHNICAL INTRODUCTION

## Background to the work of the Ad hoc Group

1. The Ad hoc Working Group on Auditing Standards was established by the Contact Committee of the Presidents of the Supreme Audit Institutions of the European Union at its meeting in Madrid on 24 - 25 September 1991. The Group initially consisted of representatives of the SAIs of Denmark, Spain, Italy and the Netherlands. The SAI of the United Kingdom joined the Group in 1994 and that of Sweden in 1996. The Ad hoc Group was chaired by the European Court of Auditors<sup>(1)</sup>.
2. The Ad hoc Group's work has focused upon the methodological aspects for the execution of audits of activities where the SAIs of the European Union countries concerned have a joint or common interest. The INTOSAI Auditing Standards provide a common methodological thread which runs through the rich diversity of public audit traditions in the EU Member States and the Ad hoc Group has sought to build upon this common thread by drawing up a series of fifteen guidelines. These describe how the INTOSAI Auditing Standards can be applied in the context of an audit of European Union activity. The Group has sought to develop guidelines in all major areas of the audit process. Thus, for example, the INTOSAI field standard on "evidence" is developed by means of four guidelines on "audit evidence and approach", "audit sampling", "using the work of other auditors and experts" and "other information in documents containing audited financial statements". Furthermore, in developing its guidelines, the Group has also taken cognizance of the International Federation of Accountants (IFAC) International Standards on Auditing.
3. Whilst the initial task of the Group was to provide a common methodology for joint or coordinated audits<sup>(2)</sup> carried out by EU SAIs, the Group is pleased to note that its draft guidelines have also found a use within some individual SAIs, particularly when they were carrying out fundamental reviews of their audit working methods - for example, in response to new national legislation. Further mention of the potential use of the guidelines in this way is made in paragraph 10 of this introduction.

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<sup>(1)</sup> The following people participated in meetings of the Ad hoc Group:

DK: Mr H Otbo; Mr M Levysohn  
ES: Mr J Corral, Mrs M-L Martin Sanz, Mr V Manteca Valdelande  
IT: Mr G Clemente, Mr E Colasanti, Mr C Costanza, Mr B Manna  
NL: Mrs M-L Bemelmans-Videc  
UK: Mr S Ardron, Mr J D Thorpe  
S: Mr F Cassel  
ECA: Mr N Schmidt-Gerritzen (Chairman), Mr T M James, Mr B Albugues, Mr J Eilbeck,  
Mr N Usher

<sup>(2)</sup> In a joint audit, the participating SAIs set the same audit objectives for examining, within their fields of responsibility, the same subject. In a coordinated audit, each participating SAI examines a common subject and, whilst the objectives of each participating SAI's audit may differ, there is a close cooperation between the SAIs concerned which permits exchanges of information, so enriching the individual audits of each participating SAI.

4. The full set of fifteen “European Implementing Guidelines” and their relation to the INTOSAI Auditing Standards are shown in the diagram at the end of this introduction. They are broken up into five groups:

Group 1 - three guidelines relevant to audit preparation;  
Group 2 - six guidelines relevant to obtaining audit evidence;  
Group 3 - two guidelines relevant to audit completion;  
Group 4 - one guideline on performance audit ; and .  
Group 5 - three guidelines dealing with other matters.

In carrying out its work, the Ad hoc Group has received comments and support from the Presidents and Liaison Officers of the EU SAIs and from audit staff within many of these organisations (and, in particular, from staff in the SAIs represented within the Ad hoc Group). The Group would like to take this opportunity to express their gratitude for this support. We hope that we have repaid all these colleagues for their efforts by producing guidelines that will prove useful in their work.

5. The Group would also like to acknowledge its appreciation of the hard work that has been put into translating its guidelines and other documents from its working language (English) into the other ten official EU languages. A large part of this task was carried out by the Translation Service of the European Court of Auditors but the Group would also like to record its thanks to the numerous experts in the Member State SAIs and in the European Court who assisted in this task.

#### A common methodological base

6. Whilst these guidelines are more detailed than the INTOSAI Auditing Standards, they still do not amount to detailed working procedures for individual auditors, as the Ad hoc Group considers that each SAI must decide upon its own detailed procedures, taking account of national circumstances, traditions and legislation. However, the guidelines do represent a common base that can be referred to and adopted on a facultative basis by all EU SAIs, within the framework of each one’s existing auditing methods, for any audits of EU activities - whether this is undertaken solely at the national level or, jointly or in coordination with other SAIs, at the international level. Use of these guidelines should assist SAIs in carrying out their responsibilities economically, efficiently and effectively.
7. A number of the SAIs of the EU Member States have adopted audit approaches based more closely or more explicitly upon national auditing standards than upon those of INTOSAI. These national auditing standards, in turn, are often closely related to the International Standards on Auditing issued by the International Federation of Accountants (IFAC). During its work, the Ad hoc Group has taken note of a comparison, carried out within the European Court of Auditors, of the INTOSAI and IFAC standards. This comparison revealed that, whilst the two sets of standards differ in terms of their levels of detail and their terminology, their differences have no material impact upon the underlying audit methodologies. The Ad hoc Group thus considers that the European Implementing Guidelines are compatible for use by all the SAIs of the European Union.

8. In two guidelines, glossaries are included to explain specific terms. For terms in more general use throughout these guidelines, the reader should refer to the glossary published in the INTOSAI Auditing Standards, which is reproduced at the end of the guidelines <sup>(3)</sup>.

#### A “European Union dimension”

9. The Ad hoc Group has particularly sought, in preparing these guidelines, to bring to the front a “European Union dimension”. On occasions when a particular European aspect might affect the way in which an individual auditor carries out his or her work, this is mentioned in the text of the guideline - for example, guideline # 52 on “Irregularity” contains a summary of relevant EU legislation.
10. The Group considers, however, that the main European Union dimension of the guidelines is that they present a common technical base that can be adopted by all the EU SAIs, on a facultative basis, within the framework of each SAI’s existing individual auditing methods. In other words, the Ad hoc Group considers that the most significant European Union dimension arises from the general acceptability of the guidelines to all of the seven SAIs that participated in the Group’s work and which, between them, broadly represent the main features of all the public auditing traditions and organisational structures amongst EU SAIs.

#### A wider role for the guidelines?

11. The basic work of drafting the fifteen guidelines was spread over years, with a further year to make final editorial changes and prepare the completed set for publication. Europe (and, indeed, the world) has not stood still during this period and there have been many developments that will affect state audit and the environment in which it is carried out in the European Union. Perhaps the most significant events are the steps towards enlargement of the EU and, in particular, the preparations being made in the countries of Central and Eastern Europe and in the Newly Independent States. The Ad hoc Group was pleased to learn that its guidelines, even though still only in a draft form, had been made available to the SAIs of these countries and it was delighted to receive positive feedback from some of these bodies. The Group believes that the guidelines could have a useful additional role - unforeseen in 1991 when it started its task - in helping the SAIs of these countries to prepare for adhesion to the Union and hopes that its work will make a useful contribution in this area.

#### The advisory nature of the guidelines

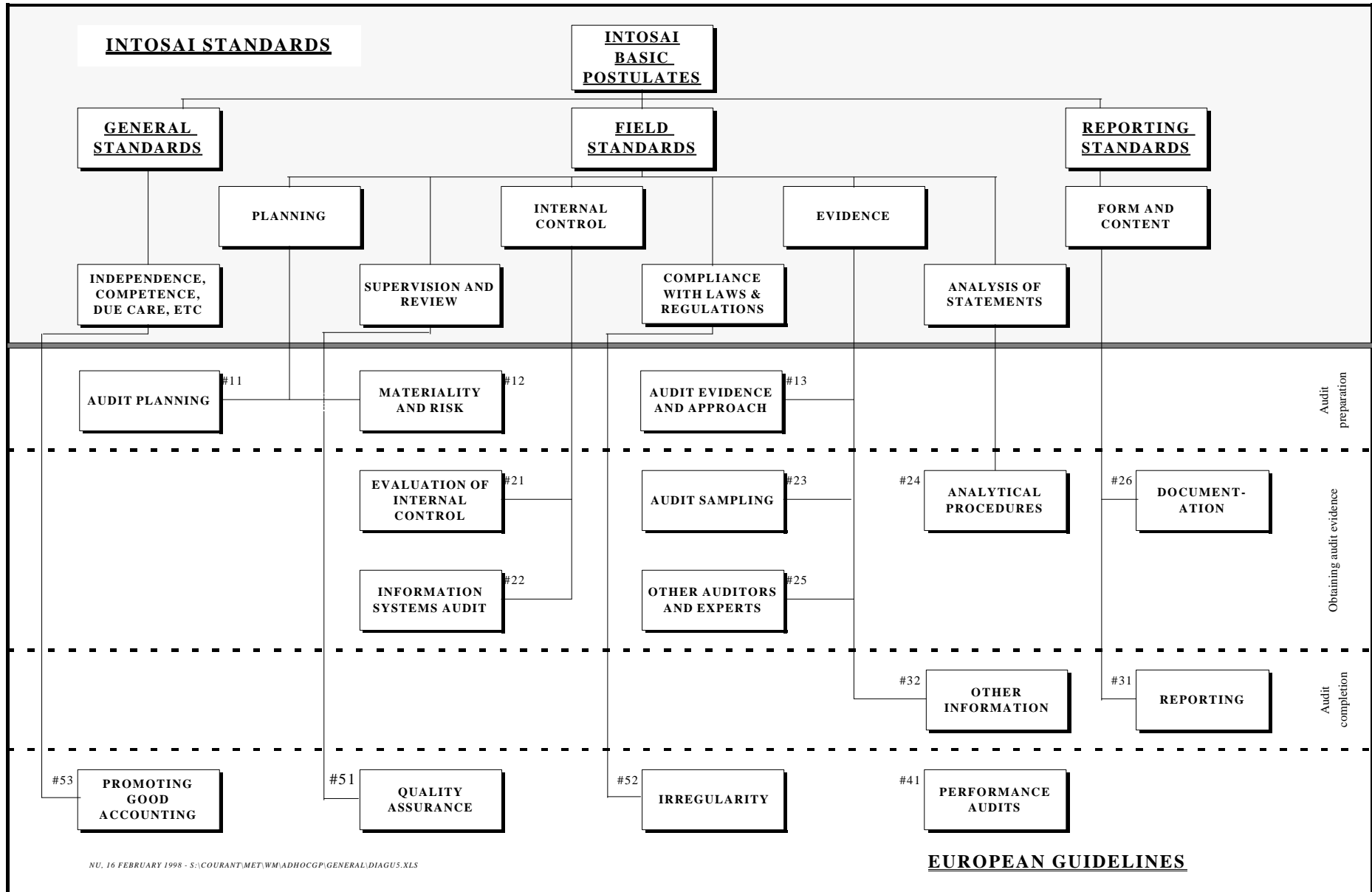
12. These guidelines are intended to be advisory and to be used by SAIs on a facultative basis. However, in the original English language version of the guidelines, the word “should” has often been used. In such cases, the Group has used the term to emphasize a practice or procedure that it recommends strongly.

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<sup>(3)</sup> Where official translations of the INTOSAI Auditing Standards exist, the INTOSAI glossary appears in the appropriate language version. For other languages, the English version is reproduced here.

## Comments

13. The Group will be pleased to receive feedback from users so that the guidelines can be updated and improved. Any comments should be sent to the working Methods team, ADAR Directorate, European Court of Auditors, 12 rue Alcide De Gasperi, L-1615 Luxembourg.



## GROUP 1 AUDIT PREPARATION

### EUROPEAN IMPLEMENTING GUIDELINES FOR THE INTOSAI AUDITING STANDARDS

N° 11

#### AUDIT PLANNING

#### CONTENTS

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#### 1. Reference to the INTOSAI Auditing Standards

1.1. Paragraph 132 of the INTOSAI Auditing Standards states that:



"The auditor should plan the audit in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way and in a timely manner"

## 2. The benefits and objectives of audit planning

2.1. Planning has three characteristics which benefit the Supreme Audit Institutions (SAI):

- (a) Rationality: the process and outputs of planning encourage a logical assessment of the tasks of the SAI and the setting of clear objectives;
- (b) Prospectivity: tasks are set into their time dimension, so that a clearer view can be gained of priorities;
- (c) Coordination: the coordination of the SAI's audit policies and actual audit work.

2.2. The objectives of audit planning are:

- (a) to set out the way in which legal obligations and other audit priorities will be achieved;
- (b) to identify the scope, objectives and anticipated outputs of audits;
- (c) to define how the audit evidence necessary to achieve the objectives will be obtained and analysed;
- (d) to identify the resources that will be needed and actually employed on audits and establish cost and time budgets;
- (e) to allow management to supervise and control individual audits, and the SAI overall.

## 3. Different levels of planning

3.1. Typically, there are more demands and expectations placed upon SAIs than there are resources available. Thus many SAIs have established hierarchical planning structures whereby plans for individual audit tasks over time are aggregated to give a global, long term view. This Guideline deals primarily with audit task planning. However, it is important that the individual auditor is conscious that any failure to meet budgets and targets at the task level has an impact not only upon that task, but also upon the other activities of the SAI. Conversely, when audit tasks can be completed to the desired standard below budget or before the target date (e.g. through improvements in efficiency) this increases the potential of the SAI to meet the other demands and expectations placed upon it.

## 4. Planning an audit task

4.1. An audit task is defined as a discrete and identifiable piece of audit work typically resulting in the issuing by the SAI of an opinion, statement, report or a distinct contribution to the SAIs annual report. Typically an audit task will have clearly identifiable objectives and pertain to a single or clearly identifiable group of activities, programmes or bodies (the "audited entity"). The objectives may be to undertake financial, legality and regularity or performance audit, or some combination of these.

4.2. Further guidance on planning an audit task is given in **ANNEX 1**.

4.3. To achieve improvements in its economy, efficiency and effectiveness, it is essential that the SAI evaluates its performance on each audit task against the audit objectives and plan, and draws from it any lessons. It will normally be a function of the responsible managers to carry out such a review and communicate the results to senior management. In some SAIs this function has been enhanced by the development of independent quality assurance or internal audit reviews (see the Guideline N° 51 "Quality Assurance").

## ANNEX 1: PLANNING AND AUDIT TASK

1. Regardless of its objectives, an audit task will typically include the following stages:
  - (a) Pre-planning stage:
    - . gathering and initial evaluation of information;
    - . preliminary evaluation of systems and controls;
    - . definition of detailed audit objectives;
    - . initial assessment of resource needs, and timetables;
  - (b) Planning stage:
    - . elaboration and review of the audit plan;
    - . liaison with the audited entity;
    - . preparation of audit programmes;
    - . approval of the plan;
  - (c) Fieldwork stage:
    - . collection and evaluation of audit evidence;
    - . drawing up of initial conclusions;
    - . interim review; identification and approval of any changes necessary to the audit plan;
  - (d) Reporting stage:
    - . drafting and review of conclusions, opinions, recommendations and/or reports ("outputs");
    - . review, approval and publication of outputs;
    - . internal reconciliation of resources used to those allocated in the audit plan;
    - . appraisal of audit staff performance;
  - (e) Post-reporting stage:
    - . monitoring of impact of the audit.

These stages are not necessarily distinct, and may overlap to some extent.

2. An effective audit plan is dependent upon the work undertaken at the pre-planning stage. Further guidance on this work is given at Appendix 1 to this Annex.
3. The audit task plan is, in effect, the report of the pre-planning stage. It is also the document that allows SAI management to review the pre-planning work, to approve the audit approach, budget and timetable for the audit and allocate the necessary resources. It also provides the basis for SAI management to control the audit as it progresses and to undertake an ex-post evaluation of its conduct. In addition, the audit task plan is one of many which in total contribute to the SAI's overall long-term resource planning and management.

4. The audit task plan is a key document. It must be prepared in a timely manner, and contain all the necessary information whilst remaining clear and concise. Whilst it is not possible to prescribe the exact contents of an audit task plan, certain features will be common to most plans - these are outlined at Appendix 2 to this Annex.
5. Audit planning is a dynamic process. To achieve audit objectives, it may be necessary to make changes to the original plan as the audit progresses. SAIs should have a procedure in place to review and approve such changes.

## **ANNEX 1: PLANNING AN AUDIT TASK**

### **Appendix 1: WORK AT THE PRE-PLANNING STAGE**

Frequently, much of the information needed at the pre-planning stage will be available within the SAI (e.g. in previous years' current files or in permanent files). In such cases, work at the pre-planning stage will involve updating this information and taking account of any major changes.

The following, in outline, is a summary of the work typically needed at the pre-planning stage:

#### 1. Understanding the audited entity

1.1. The auditor should identify important aspects of the environment in which the audited entity operates. This includes such considerations as:

- . objectives of the entity
  - . inputs
    - resources and funding;
    - legal framework,
    - personnel (quantity and quality);
  - . outputs
    - range and relative importance of outputs as compared to the entity's objectives;
    - time demands and constraints;
    - legal framework;
    - nature of the "market" in which the entity is operating;
    - intra/international comparisons;
    - statutory and non-statutory reports;
    - geographical and communications considerations.

1.2. The auditor must identify how the audited entity operates in its environment, including:

- . organisation
  - organigram and responsibilities
  - key management systems and controls;
  - key financial systems and controls

1.3. As part of gaining an understanding of the audited entity and its environment, the auditor will often use analytical review techniques (see Guideline N° 24 "Analytical Procedures") to analyse, compare and evaluate relevant data which are available.

#### 2. The impact of the audited entity upon the audit

2.1. The auditor must determine how the audited entity's operations and environment will affect the audit. In particular:

- . what are the inherent risks (see Guideline N° 12 “Materiality and Audit Risk”) associated with the activities arising from the entity's specific organisation and environment?
- . what are the inherent risks generally associated with this type of entity?
- . what controls have been put in place by the entity's management to guard against these risks; are they likely to be effective?
- . particularly in the European context, what special factors are there and what impact will these have upon the audit?

To answer these questions it is necessary to carry out a preliminary evaluation of key systems and controls (See Guideline N° 21 "Evaluation of Internal Control and Tests of Control").

### 3. The environment of the audit and the audit objectives

- 3.1. The auditor should consider the form, content and users of the outputs of the audit. He should then specify the audit objectives (for performance audits, in particular, it is important to do this in some detail: this allows the auditor to define the criteria against which the evidence obtained will be assessed and evaluated).
- 3.2. Clear objectives for the audit will assist the auditor in determining the materiality of matters to be considered (see Guideline N° 12 "Materiality and Audit Risk")

### 4. Audit evidence

- 4.1. The auditor must identify what audit evidence will be necessary to achieve the audit objectives. Consideration must be made of:
- . the competence of the evidence:
    - sufficiency;
    - reliability;
  - . the relevance of the evidence;
  - . the reasonableness of the evidence.<sup>(1)</sup>
- 4.2. This exercise should lead the auditor to define:
- . the audit approach to be adopted;

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(1)

Reasonable audit evidence is defined in the Glossary of the INTOSAI Auditing Standards as:

"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"

- . the sources of evidence to be used and the methods to be employed in obtaining it;
- . the tests necessary, and the extent of testing.

4.3. For further guidance in this area, see the Guideline N° 13 "Audit Evidence and Approach".

5. Audit Resources

- 5.1. When the auditor has defined the nature, type, quantity, sources and methods of obtaining the audit evidence, he can estimate the resources necessary to obtain and analyse it and prepare the audit outputs.

Considerations here include:

- . the audit skills necessary and thus the staff to be employed on the audit;
- . internal specialist skills (computer audit);
- . the possible use of external experts, the entity's internal auditor, other auditors (see Guideline N° 25 “Using the work of other auditors and experts”);
- . the geographical location of the audit evidence, the ease of access to it (and any potential problems) and the associated costs;
- . the audit timetable.

6. Documentation

- 6.1. The auditor should carefully document the results of the pre-planning work. Key conclusions arising from this work will provide the basis for the audit plan, and this documentation should be available to those responsible for reviewing and approving the plan.

7. Consultation with the audited entity

- 7.1. Depending on the policy and standard practice within the SAI, it may be considered worthwhile to discuss the findings of the pre-planning work with the audited entity.



## **ANNEX 1: PLANNING AN AUDIT TASK**

### **Appendix 2: TYPICAL CONTENTS OF AN AUDIT TASK PLAN**

1. Legal framework for the audit.
2. Brief description of the activity, programme or body to be audited (including a summary of the results of previous audits and their impacts).
3. Reasons for the audit.
4. Factors affecting the audit, including those determining the materiality of matters to be considered.
5. Risk assessment.
6. Audit objectives.
7. Audit scope and approach: what evidence is to be obtained to meet the audit objectives; where; when; how?
  - . materiality thresholds;
  - . systems to be evaluated and tested;
  - . sampling strategies;
  - . anticipated sample sizes;
  - . reliance on other auditors/experts;
  - . any special problems foreseen.
8. Resources required, and when:
  - . audit staff (in detail), responsibilities;
  - . specialist staff (who and when);
  - . external experts;
  - . travel requirements;
  - . time and cost budgets.
9. If appropriate, an estimate of the fee to be charged for the audit.
10. Details of those within the audited entity responsible for liaison.

11. Timetable for the audit, and date that draft report will be available for internal consideration.
12. Form, content and users of final output.

EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 12

**MATERIALITY AND AUDIT RISK**

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Materiality	Annex 1
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1. Reference to the INTOSAI Auditing Standards

1.1 The explanation of the INTOSAI Auditing Standards (paragraph 9) states that:

"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".

In the context of a financial audit the objective of the auditor is generally to estimate the level of overall error, misstatement or irregularity and, if this is deemed to be material, draw the matter to the attention of users of those financial statements.

2. Materiality and audit risk

2.1. Paragraph 152 of the INTOSAI Auditing Standards states that:

"Competent, relevant and reasonable evidence should be obtained to support the auditor's judgement and conclusions..."

2.2. Thus the auditor must obtain **assurance** that the financial statements being examined are not materially misstated.

- 2.3. The converse of assurance is **audit risk**. This is the risk that the auditor will reach the wrong conclusion regarding the financial statements being examined - i.e. that the auditor fails to express a reservation on financial statements that are in fact materially misstated.
- 2.4. Paragraph 132 of the INTOSAI Auditing Standard states that:
- "The auditor should plan the audit in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way and in a timely manner."
- 2.5. Thus, in planning the audit, the auditor must reach a judgement as to the level of overall errors or misstatements that is likely to influence users of the financial statements (the **materiality threshold**)<sup>(1)</sup>. Further the auditor must ensure that the audit risk taken does not compromise the quality of the audit.
- 2.6. Decisions regarding the materiality threshold and the acceptable audit risk will both have an impact upon the amount of work that is necessary to do, and thus upon the economy, efficiency and effectiveness of the audit.
- 2.7. Further guidance regarding materiality is given in **ANNEX 1** and an explanation of the significance of audit risk in planning and undertaking an audit is in **ANNEX 2**.

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<sup>(1)</sup> The Materiality threshold is also often known as the materiality **limit** or materiality **level**. The word threshold is preferred here as it better expresses the fact that it is a value at which the auditor must make a judgement as to the most appropriate course of action.

## **ANNEX 1 - MATERIALITY**

### **1. Introduction**

- 1.1. In carrying out a financial audit, the objective of the auditor is usually to obtain assurance that financial statements are correct and complete enough for the purposes of those who use them, in the public sector they are the budgetary authorities within the context of the discharge procedure. In doing this the auditor is seeking to ensure that the financial statements do not contain any material misstatement.
- 1.2. Errors or irregularities in financial statements may in total be considered material (i.e. significant) when the users of such statements, having had the errors brought to their attention, are likely to be influenced by them. The auditor has to decide what is the maximum tolerable amount by which the financial misstatements may be misstated but acceptable. This amount may be referred to as the "materiality threshold". Other things being equal, the higher the threshold, the lower the amount of audit testing necessary.
- 1.3. A materiality threshold for the examination of financial statements may be determined either directly by fixing an absolute sum of money or indirectly by using a percentage (e.g. X % of gross expenditure) to calculate such an amount. In addition to this concept of materiality by value, there are circumstances in which certain categories of accounts or transactions may be regarded as material by nature (where disclosure is particularly important) or material by context (e.g. where a misstatement which is otherwise too small to be significant converts a deficit into a surplus). Although the auditor should be alert to possible cases of materiality by nature or by context, these will generally be treated as special cases within the audit strategy. [Their specificity makes it difficult to lay down general rules.]

### **2. Using the materiality threshold**

- 2.1. At the planning stage the materiality threshold helps to determine the extent of testing needed to obtain sufficient audit evidence. At the reporting stage it is used to evaluate the importance of errors and irregularities uncovered by the audit and helps to determine whether or not the auditor expresses reservations about the financial statements.

### **3. Defining the materiality threshold**

- 3.1. When defining an appropriate overall materiality threshold, the public sector auditor has to consider his particular mandate and the fact that the users of public sector accounts have a generally high concern for matters of legality and regularity. Materiality thresholds for audit assignments tend to be on the conservative (low) side because of the public sector's particular interest in the examination of legality and regularity. An appropriate materiality threshold could be, for example, between 0,5% and 2% of that value which most reasonably reflects the level of financial activity of a body or a given audit subject. This basic figure will most often be total revenue or total expenditure but

may, in certain circumstances, be another figure, such as total assets or total borrowings - in which case a different percentage range may be appropriate.

- 3.2. Fixing the materiality threshold, whether it be a specific sum of money or a percentage, is a matter of judgement for the auditor and thus, for consistency of approach, an important policy matter for the SAI. The principal element to be taken into consideration is the political sensitivity of the area covered by the financial statements. An overall materiality threshold applicable to a complete set of financial statements or a large audit area may have to be accompanied by several specific materiality thresholds for areas/matters of greater political sensitivity.

#### **4. Technical considerations**

- 4.1. The materiality threshold should be set at the highest level of misstatement that users might find acceptable.
- 4.2. The materiality threshold should thus take account of the requirements of the budgetary authorities and the general public.
- 4.3. In exceptional circumstances, a part of a financial statement or audit area may be considered more sensitive by the user. In such cases, the auditor must judge whether it is more appropriate to set a lower materiality threshold and treat the part as a separate audit or undertake key item testing.
- 4.4. It may be necessary to revise the planned materiality threshold for an audit because of an change in political sensitivity or because the overall total value of the financial statements is significantly different from that assumed when setting the materiality threshold at the planning stage. The auditor must be properly aware of the need for such revision.
- 4.5. The determination of materiality thresholds is normally a matter of SAI policy, either as to the precise way in which the threshold is determined and approved as a basic element in audit planning or as to the actual threshold amount for a particular audit.
- 4.6. The materiality threshold is used to evaluate the importance of the impact of misstatements uncovered by the audit, by estimating from the audit results the likely overall error in the financial statements and comparing this with the materiality threshold.
- 4.7. If the estimate of overall error exceeds the materiality threshold the auditor should carefully re-examine all his evidence, including the possible range of error in statistical estimation procedures and extrapolations, with a view to qualifying his opinion on the financial statements covered by the audit.

- 4.8. As auditor judgements in relation to materiality thresholds, both prior to and throughout the audit, are fundamental to the conduct of the audit and to the final interpretation of its results, such judgements should be thoroughly documented in the working papers and subjected to careful management review and approval.

## ANNEX 2 - AUDIT RISK

### 1. Introduction

1.1. Audit risk (AR) is the risk that the auditor will fail to express a reservation on financial statements that are materially irregular or misstated. As it is almost always impractical to reperform all of the transactions underlying a set of financial statements, the auditor must accept some level of audit risk. It is for the SAI to determine, as a matter of policy, what this level should be. Given the expectations of users of financial statements produced by public bodies, particularly as regards legality and regularity, it is usual for SAIs to accept only very low levels of audit risk - frequently as low as one per cent.

1.2. There are three components of audit risk. These are:

Inherent risk (IR): the risk of material irregularity or misstatement occurring in the first place;

Control risk (CR): the risk that internal controls within the audited entity will fail to prevent or detect a material irregularity or misstatement;

Detect risk (DR): the risk that any material irregularity or misstatement that has not been corrected by the organisation's internal controls will not be detected by the auditor.

1.3. Inherent risk and control risk differ from detect risk in that they are determined within the audited entity. Detect risk, on the other hand, is determined by the auditor and is a function of the nature, extent and timing of the auditor's procedures. It is through his control of these determinants of detect risk that the auditor can seek to achieve an acceptably low level of audit risk.

1.4. The auditor must assess the inherent and control risks and, based on those assessments, design appropriate substantive procedures to reduce detect risk to a level which, in the auditor's judgement, results in an appropriately low level of overall audit risk.

1.5. There is a relationship between the auditor's assessment of inherent and control risk on the one hand and the acceptable level of detect risk on the other. The higher the auditor assesses the level of inherent and/or control risk to be, the greater the level of audit work that will be required to lower detect risk sufficiently to achieve the desired level of audit risk.

### 2. Inherent risk

2.1. Inherent risk depends upon the nature of both the item and the organisation being examined and the extent to which the item is susceptible to error. To assess inherent risk



the auditor must carry out an evaluation of the environment in which the organisation operates and of the characteristics of the items being audited.

2.2. It is normal to carry out the assessment of risk including inherent risk at the preliminary stage of the audit. Whilst this work needs to be done in sufficient depth to allow reasoned conclusions to be drawn, it need not be a lengthy process. Where the SAI carries out annual audits of the entity concerned the evaluation might be carried out in depth, say, every three years and a brief updating exercise done in the intervening years. The auditor should always to be into consideration the lessons to be learned from audits carried out in the past.

2.3. The objective of this preliminary assessment of risk is to allow the auditor to form a preliminary view about the entity and items being audited so as to inform the planning process. It is to be distinguished from the in-depth evaluation of internal controls that will be required if tests of control are undertaken as part of the overall audit approach.

### 3. **Control risk**

3.1. Control risk is assessed by carrying out an in-depth evaluation of the relevant systems of internal control and undertaking tests of control. Further guidance is given in the Guideline N° 21 "Evaluation of internal control and tests of control".

3.2. The initial risk assessment (see 2.2, 2.3 above) also permits a preliminary judgement to be made of the general quality of the control environment. Where control risk is likely to be high, the assurance that the auditor can obtain from tests of control designed to assess the effectiveness of internal controls will thus be low. The auditor may then decide that it is more economic to obtain the assurance he requires from other sources (and thus increase the amount of substantive testing undertaken).

### 4. **Detect risk**

4.1. The more substantive test procedures that the auditor carries out, the greater is the probability that he will detect any material error or irregularity in the financial statements being audited: thus the lower will be the detect risk. It is by reaching a judgement about the appropriate amount of substantive testing that the auditor seeks to reduce the detect risk to that level which brings the overall audit risk within the minimum set by the SAI.

4.2. The inverse of detect risk is the assurance that the auditor obtains from all of the substantive test procedures he undertakes: these include key item testing of high risk items or of items that are material by nature, testing of high value items, sample testing of other items and, in certain circumstances, analytical review procedures.

### 5. **Mathematical model**

- 5.1. An example to illustrate the audit risk model is given at the appendix to this annex.

Audit risk: illustration of the mathematical model

$$AR = IR \times CR \times DR$$

$$DR = AR / (IR \times CR)$$

The auditor carries out an initial assessment of inherent risk and judges it to be low. He therefore assigns a value of 20% to it, in accordance with the guidance issued by his SAI.

The in-depth evaluation of systems and tests of control reveal that a reasonable system of controls is in place and operating effectively, with no exceptions. Again in accordance with the policy of his SAI, he judges the systems to be "medium" and assigns a value of 40% to the control risk.

The policy of his SAI is to accept a maximum audit risk of 1%.

The auditor is thus able to calculate the assurance (or confidence level) required from substantive testing as follows:

$$AR = 1\% = 0,01$$

$$IR = 20\% = 0,20$$

$$CR = 40\% = 0,40$$

$$DR = 0,01 / (0,2 \times 0,4) = 0,125$$

As assurance is the inverse of detect risk, the assurance required from substantive testing is:

$$1,0 - 0,125 = 0,875 = \underline{87,5\%}$$

EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 13

**AUDIT EVIDENCE AND APPROACH**

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1. Reference to the INTOSAI Auditing Standards :

1.1. Paragraph 152 of the INTOSAI Auditing Standards states that:

"Competent, relevant and reasonable audit evidence should be obtained to support the auditor's judgement and conclusions regarding the organisation, program, activity or function under audit."

2. Competent audit evidence:

2.1. Competent evidence is information that is quantitatively sufficient and appropriate to achieve the auditing results; and is qualitatively impartial such as to inspire confidence and reliability.

2.2. Sufficient audit evidence will be obtained if the extent of tests (both compliance and substantive tests as relevant) is adequate. Further guidance on these matters is to be found in Guidelines on:

- Materiality and Audit Risk (N° 12) ;
- Evaluation of Internal Control and Tests of control (N° 21) ;
- Audit Sampling (N° 23) ;
- Analytical Procedures (N° 24).

2.3. Reliable audit evidence is evidence that is impartial. The reliability of audit evidence is dependent upon its nature, its source and the method used to obtain it. The auditor is frequently confronted with a choice of alternative forms of evidence, sources and methods: **ANNEX 1** gives further guidance on their relative reliability, and the auditor should seek to ensure that the most reliable sources and methods are employed within the time and cost constraints imposed upon the audit.

### 3. Relevant audit evidence

3.1. Relevant audit evidence is information that is pertinent to the audit objectives.

3.2. To ensure that audit evidence is relevant, the objectives of the audit must be clearly defined at the planning stage: for further guidance the auditor should refer to the Guideline N° 11 "Audit Planning".

3.3. Once the objectives for the audit have been clearly defined, the question of relevance (in conjunction with the question of reasonableness - see below) should lead the auditor to a consideration of the audit approach to be adopted. Further guidance on the audit approach is given in **ANNEX 2**.

### 4. Reasonable audit evidence

4.1. Reasonable audit evidence is information that is economical in that the cost of gathering it is commensurate with the result that the auditor or the Supreme Audit Institutions (SAI) is trying to achieve.

4.2. Ensuring that sufficient, relevant and reliable evidence is obtained to achieve the audit objectives at the least possible cost requires the auditor to evaluate, at an early stage in the audit process, the alternative audit approaches (Annex 2) and to judge which of these will achieve the desired results most economically.

### 5. Summary and impact on the management of an audit

5.1. A consideration of the competence (sufficiency and reliability), relevance and reasonableness of audit evidence to be obtained should assist the auditor to determine, at the planning stage, the following key elements of any audit:

- Sufficiency : type and extent of audit tests;
- Reliability : sources of, and techniques used to obtain evidence;
- Relevance : objectives of the audit;
  
- Relevance )
- ) audit approach
- Reasonableness )

5.2. At the planning stage, the reviewer/manager will be concerned to ensure that the judgements made by the auditor in drawing up the plan are sound and that the plan provides the basis for obtaining competent, relevant and reasonable evidence in support of the audit objectives.

5.3. At the final stages of the audit, the reviewer/manager will be concerned to ensure that the audit plan has been carried out in so far as competent, relevant and reasonable evidence has been obtained, that the conclusions of the audit are supported by this evidence and that any eventual report reflects these conclusions (see Guideline N° 31 “Reporting”).

## **ANNEX 1: RELIABILITY OF AUDIT EVIDENCE - SOURCES, METHODS AND NATURE**

### **A. SOURCES OF EVIDENCE**

Audit evidence can be generated directly by the auditor, or obtained from third parties or the audited entity.

Generally speaking, evidence generated directly by the auditor will be more reliable than that obtained from others.

Evidence obtained from third parties may be more reliable than that obtained from the audited entity if that evidence is truly independent and complete.

The auditor may gain increased assurance when audit evidence obtained from different sources is consistent.

### **B. METHODS OF OBTAINING EVIDENCE**

Evidence may be obtained by one or more of the following methods.

- Inspection of documents or assets;
- Observation of processes or procedures;
- Inquiry and confirmation;
- Computation;
- Analysis of financial statements and interrelationships or comparisons between elements of relevant information

The auditor must make a judgement regarding which method of obtaining evidence will be suitably reliable and balance reliability of evidence against the cost of obtaining it.

### **C. NATURE OF AUDIT EVIDENCE**

Audit evidence may be documentary, visual or oral.

The reliability of documentary evidence depends upon its source (see above).

Visual evidence is highly reliable for confirming the existence of assets, but not their ownership or value.

Oral evidence must be considered as the least reliable. Whenever feasible, auditors should attempt to obtain documentary confirmation of oral evidence (e.g. agreed written records of interviews). When this is not feasible, oral evidence might be corroborated by interviewing separately more than one person.



## **ANNEX 2: AUDIT APPROACH**

### 1. Introduction

- 1.1. The audit approach is the combination of different types of audit tests that are employed to obtain the evidence necessary to achieve the objectives of an audit.

### 2. Audit objectives

- 2.1. In general terms, the objectives of an audit will be:

(a) for financial audits:

- to assess the accuracy and completeness of the financial statements of the activity, programme or body being audited; and/or
- to ascertain whether the transactions underlying the financial statements are legal and regular.

(b) for performance audits:

- to assess whether the activity, programme or body has been managed economically, and/or efficiently and/or effectively.

- 2.2. The INTOSAI standards apply equally to performance audits as to financial audits. Thus the auditor must seek to obtain competent, relevant and reasonable audit evidence. Similarly, it is generally possible to adopt either a systems-based or direct substantive testing approach: however, because of the different objectives, different systems may need to be studied in a performance audit to those examined in a financial audit (see paragraph 6 below).

### 3. The Systems Based Approach (SBA)

- 3.1. Entities subject to Supreme Audit Institutions (SAI) audits will typically establish systems of control designed to assure the accuracy and completeness of financial statements, the legality and regularity of underlying transactions and the economy, efficiency and effectiveness of operations. Generally speaking, if the auditor can satisfy himself as to the adequacy of these controls, substantive checking of financial statements, transactions or the performance of the organisation can be reduced accordingly.

- 3.2. The approach whereby the auditor relies upon the entity's system of internal control is known as the Systems Based Approach (SBA). It has the following distinct stages:

- (a) the identification and in-depth evaluation of relevant key controls, and assessment of the extent to which (if any) the auditor can rely upon these controls provided that they are found to be operating effectively;

- (b) the testing of the operation of those key controls to establish whether they have operated effectively throughout the period under examination;
  - (c) the evaluation of the results of the tests of control to establish whether the degree of reliance foreseen can be taken from the examination of the controls;
  - (d) substantive testing of a number of transactions, account balances, etc. to determine (as relevant to the audit objectives) whether, irrespective of the entity's system of controls, the financial statements of the entity are accurate and complete, the underlying transactions were legal and regular and/or the economy/efficiency/effectiveness criteria have been achieved.
- 3.3. Further guidance on stages (a)-(c) above is given in the Guideline N° 21 "Evaluation of Internal Control and Tests of Control", and on substantive testing ((d) above) in the Guideline N° 23 "Audit sampling". The relationship between tests of control and substantive testing is further explained in Annex 2 of the Guideline N° 12 "Materiality and Audit Risk".

#### 4. The Direct Substantive Testing (DST) approach

- 4.1. When the auditor has no specific requirement to assess the operation of organisations' systems of control, it may be that the audit objectives can be achieved without relying on these systems, and thus without undertaking tests of control. This is known as the Direct Substantive Testing approach (DST). It is to be noted that, as no assurance can be taken under the DST approach from the operation of controls (as under this approach they are not being tested and, thus, no evidence is being obtained as to their effectiveness), the amount of substantive testing necessary will be greater than under the SBA approach. It is for the auditor to judge in such circumstances which will be the most cost-effective method of obtaining the evidence necessary to achieve the audit objectives.
- 4.2. Paragraph 141 of the INTOSAI Auditing Standard States that:

"The auditor, in determining the extent and scope of the audit should study and evaluate the reliability of internal control".

Thus, even when a DST approach is adopted, the auditor must carry out some examination of the major systems, even if this study is preliminary in nature. Thus the DST approach is, in effect, a form of SBA, whereby examination of systems is minimised.

#### 5. Considerations in deciding which approach to adopt

- 5.1. When the auditor is not specifically required to adopt an SBA approach, the choice of SBA or DST will usually be based upon an assessment of the audit resources, and thus

the cost of obtaining competent and reliable evidence. The following factors will be significant in making that judgement:

- (a) where controls are geographically dispersed or when it is otherwise difficult to test their operation, SBA may not be feasible given the resources available. Similarly, where the results of a preliminary evaluation of the reliability of internal controls suggest these are weak, the auditor may not be able to rely upon them. Thus a DST approach might be adopted regardless of the relative costs.
- (b) whilst it is possible to adopt a DST approach for the examination of legality and regularity, this type of audit lends itself particularly well to an SBA approach.
- (c) The SBA approach has the particular advantage that it often allows the auditor to establish a direct link between individual errors and weaknesses in the system of control and thus focus on these weaknesses. By indicating such weaknesses to the entity's management, the auditor can help the entity to achieve improvements in control for the future.

## 6. Performance audit

- 6.1. Performance audit (see Guideline N° 41 “Performance Audit”) is concerned with the economy and/or efficiency and/or effectiveness of the activity, programme or body being examined:

Economy: minimising the cost of resources used for an activity, having regard to the appropriate quality;

Efficiency: the relationship between the outputs, in terms of goods, services or other results, and the resources used to produce them;

Effectiveness: the extent to which the objectives are achieved and the relationship between the intended impact and the actual impact of an activity.

A particular performance audit will not necessarily seek to reach conclusions about all three aspects above: it should be clear from the audit objectives which need to be examined. When carrying out audits of economy or efficiency, however, the auditor does need to make a general consideration of the effectiveness of the audited entity: it may be better that the entity does the right thing badly rather than doing the wrong thing well.

- 6.2. For the examination of effectiveness, it is generally necessary to assess the outcome or impact of an activity. Thus, whilst an SBA approach may be useful (for example, to assess how the audited entity measures and monitors its impact), the auditor will also have to obtain sufficient substantive evidence of the outcome and impact of the activity, programme or body.

7. Environmental aspects

- 7.1. Increasingly SAIs are being required to provide assurance that the activities they audit are being carried out in conformity with environmental criteria and requirements. In principle, the audit approach to such requirements is the same as for legality and regularity audits: both SBA and DST approaches may be applied, but an SBA approach may be particularly appropriate.

**GROUP 2 OBTAINING AUDIT EVIDENCE**

**EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS**

N° 21

**EVALUATION OF INTERNAL CONTROL AND TESTS OF CONTROL**

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1. Reference to the INTOSAI Auditing Standards

1.1 Paragraph 141 of the INTOSAI Auditing Standards states that:

"The auditor, in determining the extent and scope of the audit, should study and evaluate the reliability of internal control."

## 2. Internal control

- 2.1. Internal control is established by, and the responsibility of, the management of an audited entity. Internal control is defined as all the policies and procedures conceived and put in place by an entity's management to ensure:
- the economical, efficient and effective achievement of the entity's objectives;
  - the adherence to external rules (laws, regulations, ...) and to management policies;
  - the safeguarding of assets and information;
  - the prevention and detection of fraud and error; and
  - the quality of accounting records and the timely production of reliable financial and management information.
- 2.2. The concept of internal control extends beyond strictly accounting and financial considerations and includes two elements:
- a. the **control environment**, which means the overall attitude, awareness and actions of senior and line management regarding internal control and its importance within the entity.
  - b. **internal control procedures** are the procedures in addition to the control environment put in place by the entity's management which contribute to the achievement of the entity's objectives
- 2.3 The control environment (which could also be described as the "control culture" within the organisation) has an influence upon the effectiveness of specific systems of internal control procedures. For example, a control environment in which the management shows its interest of control related activities and functions can reinforce specific systems of internal control procedures. However, a strong control environment is not sufficient in itself to ensure that the systems of internal control procedures are effective. The auditor can assess the quality of control environment of an entity or activity by examining indicators corresponding to best organisational and management practice.
- 2.4 These procedures may include the preparation and management review of reconciliations, the establishment of procedures and responsibilities such that key duties are separated, limiting physical access to assets and accounting records, etc. It is for the auditor to determine, in the context of each individual audit task, those internal control procedures within the overall system put in place by management that are relevant to the audit objectives.

- 2.5 When an auditor evaluates the control environment he/she is seeking to assess management's awareness of the significance of internal control and management's commitment to ensuring that activities are properly controlled. On the other hand, when evaluating control procedures, the auditor is assessing whether the necessary procedures are in place and operating effectively, continuously and consistently.
- 2.6. A description of the types of controls that an auditor might find in an audited entity is given at **ANNEX 1**.
3. Evaluation of internal control
- 3.1. The auditor should, as a minimum, undertake a preliminary evaluation of the internal controls relevant to the audit. This evaluation should be sufficient to allow the auditor to:
- (a) make an initial assessment of the inherent and control risks associated with the activity under examination (see Annex 2 of Guideline N° 12 "Materiality and Audit Risk").
  - (b) assess whether the controls appear, at this early stage, to be sufficiently effective that a Systems Based Audit approach (SBA) can be adopted. In these circumstances further in-depth testing of the controls must be carried out and, if the results are satisfactory reliance can be placed upon the system. This allows the auditor to reduce the amount of substantive testing: for further guidance on the audit approach, see Guideline N° 13 "Audit Evidence and Approach".
- 3.2. When an SBA approach is chosen, the auditor must then carry out an in-depth evaluation of the relevant internal controls. The objective of this evaluation is to determine:
- (a) which of the controls within the system are key controls - i.e. controls that should, if operating effectively:
    - . prevent or detect material misstatements, or safeguard the organisation's assets (financial audits: reliability of the accounts);
    - . ensure compliance with laws and regulations (financial audits: legality and regularity of the underlying transactions) or;
    - . ensure that there are no major failures in the economy, efficiency or effectiveness of the activities being audited (performance audits);
  - (b) the overall quality of the system of controls relevant to the audit, and thus the degree of reliance that the auditor can place upon it if subsequent tests of control provide evidence that it has operated effectively on a day-to-day basis.
- 3.3. It is important to note that, at this stage, the auditor is reaching a judgement as to the potential effectiveness of the control system that, according to the policy decisions and instructions of the audited entity's management, should be in place. Before actually placing reliance upon this system it is necessary to evaluate its effectiveness in practice i.e. carry out tests of control.



3.4. Further guidance on carrying out an evaluation of internal control is at **ANNEX 2**, and guidance concerning tests of control is at **ANNEX 3**.

4. Relationships with the management of the audited entity

4.1. It is usually normal practice to inform the management of the audited entity of any weaknesses identified in their systems of internal control. The timing and form of this communication will depend upon the nature and seriousness of the weaknesses discovered, the channels of communication that are available, and the legal framework of the audit. It is normal practice for the auditor to record in the working papers any such communications, so that they might be referred to at a later date if necessary (see Guideline N° 26 "Documentation").

## ANNEX 1: TYPES OF INTERNAL CONTROLS

The following is a description of some of the types of controls which the auditor may find in many organisations and on some or a combination of which he may seek to place some degree of reliance.

1. Organisational. Audited entities should have a plan of their organisation, defining and allocating responsibilities and identifying lines of reporting for all aspects of the entity's operations, including the controls. The delegation of authority and responsibility should be clearly specified.
2. Segregation of duties. One of the prime means of control is the separation of those responsibilities or duties which would, if combined, enable one individual to record and process a complete transaction. Segregation of duties reduces the risk of intentional manipulation or error and increases the element of checking. Functions which should be separated include those of authorization, execution, custody, recording and, in the case of a computer-based accounting system, systems development and daily operations. Internal audit and financial control (as applicable) should be independent of day-to-day management of activities.
3. Physical. These are concerned mainly with the custody of assets and involve procedures and security measures designed to ensure that access to assets is limited to authorised personnel. This includes both direct access and indirect access via documentation. These controls assume importance in the case of valuable, portable, exchangeable or desirable assets.
4. Authorization and approval. All implementing decisions and transactions should require authorization or approval by an appropriate responsible person. The limits for these authorizations should be specified.
5. Arithmetical and accounting. These are the controls within the recording function which check that the transactions to be recorded and processed have been authorised, that they are all included and that they are correctly recorded and accurately processed. Such controls include checking the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliations, control accounts and trial balances, and accounting for documents.
6. Personnel. There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. Inevitably, the proper functioning of any system depends on the competence and integrity of those operating it. The qualifications, selection and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.
7. Supervision Any system of internal control should include the supervision by responsible officials of day-to-day transactions and the recording thereof.

8. Management. These are the controls exercised by management outside the day-to-day routine of the system. They include the overall supervisory controls exercised by management, the review of management accounts and comparison thereof with budgets, the internal audit function and any other special review procedures.
9. Financial Controller. In some member states, the Financial Controller acts as an autonomous control. In these cases, the Financial Controller will have a wide range of duties, including giving his approval in advance to all propositions to enter into transactions.

Normally, the Financial Controller will only approve a transaction when he is satisfied that, amongst other things, it is legal and regular, and that sufficient funds are available.

## ANNEX 2: CARRYING OUT AN EVALUATION OF INTERNAL CONTROL

1. The following steps might usefully be followed in carrying out an evaluation of a system, whether this evaluation is preliminary or in-depth:
  - (a) identify the risks relevant to the audit objectives against which an effective control system should provide protection;
  - (b) by examination of procedure manuals, instructions to staff, and by interview, etc. identify the controls that have been put in place to guard against the identified risks. (For an SBA approach, it is also necessary to identify which of these controls are the key ones);
  - (c) document the results of this examination (flow diagrams, written descriptions...);
  - (d) the auditor can usefully check his understanding of the system by following a small number of transactions through the system ("walk-through test");
  - (e) on the basis of the controls that have been identified, evaluate their likely effectiveness in respect to the risks inherent in the activities concerned.
  
2. It is common practice for Supreme Audit Institutions (SAIs) to develop internal control questionnaires (ICQs) or key control questionnaires (KCQs) to assist the auditor in carrying out evaluations of this type.
  
3. In the SBA approach, the auditor must complete the in-depth evaluation by establishing the degree of reliance that might be placed upon the system if it is later found to be operating efficiently in practice. As a general rule, the system will be judged as:

<u>Excellent</u>	-	if all risks are adequately addressed by controls which are likely to operate effectively;
<u>Good</u>	-	if all risks are adequately addressed by controls which are likely to operate effectively with only minor exceptions
<u>Fair</u>	-	if all risks are addressed to some extent by controls which may fail occasionally
<u>Poor</u>	-	not all risks are addressed by controls and/or there are likely to be frequent control failures.

## ANNEX 3: TESTS OF CONTROL

### 1. Carrying out tests of control

- 1.1. When following the SBA approach it is not adequate just to carry out the in-depth evaluation of the internal controls. The auditor must also establish whether the controls have actually operated effectively and consistently throughout the period under audit: it is necessary to undertake tests of control.
- 1.2. Typically the key controls that have been identified should be tested by examining a sample of transactions or operations that have been subject to those controls. As the auditor is seeking to assess the practical effectiveness of the controls, the sample selection method and the nature of the tests performed should ensure that:
  - (a) evidence is obtained of the consistent operation of the control over time (n.b. periods of absence of key staff, etc);
  - (b) evidence is obtained of the consistent operation of the control upon all types of transaction processed through the system (n.b. high volume, low value transactions; unusual transactions; transactions being re-processed following earlier rejection by the system, etc.).
- 1.3. It is for the auditor to judge how many transactions should be examined to obtain sufficient evidence as to the satisfactory operation of a control. Typically, the minimum sample size is 30 and in some cases more than 100 transactions will be necessary. The following points need to be considered in making this judgement:
  - (a) the significance of the control within the overall system;
  - (b) the extent to which the auditor wishes to place reliance upon the satisfactory operation of the control and the length of time concerned;
  - (c) the range and nature of the transactions being processed through the system;
  - (d) the fact that most tests of control provide evidence not that the control has operated, but that it has not failed ("negative" evidence).
- 1.4. Whilst most tests of control give "negative" evidence the auditor also needs to be alert to possibilities of obtaining positive evidence of the effective operation of controls. This can be done by seeking examples where controls have detected errors or exceptions.
- 1.5. The timing of tests of control poses particular problems: the auditor must seek evidence of the effective operation of controls throughout the period in which he wishes to rely upon them. This must be taken into consideration in designing and carrying out the compliance tests.

### 2. Evaluating the results of tests of control

- 2.1. When tests of control are completed, the auditor must reach a final judgement as to the extent of reliance he can place upon the system of controls, and thus upon the amount of substantive testing that it will be necessary to undertake to obtain the overall level of assurance required (see Guideline N° 12 "Materiality and audit risk").
- 2.2. The level of assurance that can be taken within the Systems Based Approach will depend firstly upon the auditor's initial evaluation of the system. The results of tests of control provide the auditor with additional evidence regarding the operation of that system, which allows him to confirm or re-evaluate his original judgement. General guidance on the level of assurance that can be taken is given at the Appendix to this Annex.
- 2.3. The relationships between degrees of assurance and statistical confidence levels for substantive audit tests are normally a matter for SAI policy.
3. Joint tests of control and substantive testing
  - 3.1. There is no objection in principle to the auditor carrying out simultaneous tests of control and substantive testing on a particular sample. Whilst recognising that this might be an efficient use of audit resources, care must be taken however to clearly distinguish between the two types of tests which have widely differing objectives. Care must also be taken to document the results properly in such circumstances (see Guideline N° 26 "Documentation").

**ANNEX 3, Appendix: LEVEL OF ASSURANCE TO BE TAKEN FROM EVALUATIONS OF INTERNAL CONTROL AND TESTS OF CONTROL UNDER THE SYSTEMS BASED APPROACH**

Conclusions of the in-depth evaluation of the system of internal control before tests of control	Final evaluation and degree of reliance			
	Tests of control reveals no exceptions	Tests of control reveals only some minor exceptions	Tests of control reveals some major exceptions	Tests of control reveals widespread failures
Control system seems excellent. All major risks addressed and controls likely to be effective  = Excellent	High	Medium	Low/Nil	Nil
Control system seems reasonable. Most major risks addressed and/or controls likely to be generally effective  = Good	Medium	Medium/Low	Low/Nil	Nil
Control system seems generally reasonable, but danger of some control failures  = Fair	Low	Low/Nil	Low/Nil	Nil
Control system seems unsatisfactory. Risks not addressed and/or control failures likely.  = Poor	Nil	Nil	Nil	Nil





EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 22

**INFORMATION SYSTEMS AUDIT**

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- 1      Reference to the INTOSAI Auditing Standards
- 1.1    The explanation of the INTOSAI Auditing Standards (Paragraph 51 (b)) states that:
- "The auditor and the SAI must possess the required competence."
- 1.2    The explanation of the INTOSAI Auditing Standards (Paragraph 86) states that:

" ... The SAI should equip itself with the full range of up-to-date audit methodologies, including systems-based techniques, analytical review methods, statistical sampling, and audit of automated information systems."

1.3 The explanation of the INTOSAI Auditing Standards (Paragraph 144) states that:

"Where accounting or other information systems are computerized, the auditor should determine whether internal controls are functioning properly to ensure the integrity, reliability and completeness of the data."

1.4 The explanation of the INTOSAI Auditing Standards (Paragraph 153) states that:

" ... When computer-based system data are an important part of the audit and the data reliability is crucial to accomplishing the audit objective, auditors need to satisfy themselves that the data are reliable and relevant."

## 2. Scope of this guideline

2.1 Most administrative and financial functions are now carried out with the aid of computer systems. The term *information systems* (IS) has come into general use for all such systems, as not prejudging the amount or type of technology concerned.

2.2 This guideline deals with the methodology for audit of such information systems. It is intended to provide guidance at the level required by the generalist auditor who is familiar with the issues and methods of IS audit, can undertake simple IS audit tasks, and can use IS audit specialists to serve general audit objectives<sup>(1)</sup>. The guideline does not attempt to present detailed specialist information on the highly technical areas of the subject. The scope of IS audit work needed in any particular case is discussed in paragraphs 4.5- 4.7 below and must be decided in the light of the general objectives of the audit being undertaken.

2.3 Information systems may be of particular significance in audits of European Union activities where they have been explicitly established by regulation. Such systems may be prescribed to facilitate an important element of EU policy (e.g. the VAT Information and Exchange System (VIES) established by Regulation (EEC) No 218/92). In some cases regulations prescribe certain aspects of IS control (e.g. for the accreditation of paying agencies (Regulation (EEC) 1663/95); in others (e.g. the integrated administration and control system for agricultural payments (Regulation (EEC) 3508/92)) the computer system established is itself a vital control over EU payments.

## 3. Basic concepts and definitions

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<sup>(1)</sup> skill level 1, using the definitions in the paper IT audit curriculum for INTOSAI

- 3.1 The presence of information technology has no direct effect on the objectives of an audit, but it introduces specific control concerns and may mean that there have to be changes in the audit approach.
- 3.2 Information technology brings two particular problems for management and auditors:
- computers and networks, like any technology, are vulnerable to *breakdown and damage*. As soon as an organisation or a function becomes dependent on information technology, therefore, contingency planning becomes more important than before and must take sufficient account of technical matters.
  - *data and programs held in computer systems are invisible and intangible*, and they can be accessed or changed without leaving a trace. Management and auditors alike need to take special measures to be sure of the reliability, integrity and confidentiality of any data resulting from computers.
- 3.3 Generally-recognized control techniques have been developed accordingly. IS audit deals with the evaluation of these controls. Different components of IS audit should be distinguished because they require differing skill levels, techniques and timing; and because they make different contributions to audit work as a whole. Each of these components is discussed at greater length later in this guideline.

#### General (installation) controls audit

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- 3.4 General controls are the controls in place over a whole computer installation or network. The quality of these controls has a pervasive effect on all applications run in that environment: for example, if there are weaknesses in access control at the installation level or for a whole network, it is most likely that all applications will be vulnerable to unauthorized access, regardless of any specific access controls in the applications themselves.
- 3.5 Most auditors need support from IS specialists to carry out a full general controls audit. However, full audits are not always necessary. Generalist auditors may be able to obtain sufficient assurance that data are complete and correct, and that internal controls covering the computer are functioning adequately so far as they affect a particular audit, without a full review of general controls.
- 3.6 In some cases generalist auditors may rely on third party statements (TPS) given by specialist IS auditors. These TPS usually cover the general controls regarding computer centres and/or applications. On the implications of using such evidence, see Guideline N° 25 “Using the Work of Other Auditors and Experts”. Should TPS not be available, generalist auditors should nevertheless always evaluate certain non-technical general controls: see paragraph 5.1 below.

#### Application audit

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3.7 An application audit evaluates the internal controls specific to the input, processing, data files and output of a defined function. All auditors carrying out systems-based audits of administrative functions where information technology is used need to address this aspect of IS audit.

3.8 Applications audits are not necessarily highly technical. Generalist auditors will need to call on IS specialists where the application controls are exceptionally complex or technical, and there are no satisfactory compensating controls in the user area. But many applications are designed so that they give definite assurance to user managers that data and processing are in order without requiring them to be IS experts. In such cases, checks and procedures (including manual procedures) routinely carried out by user staff may give satisfactory assurance that data and output are reliable. In many audit situations this level of assurance will also be adequate for the auditors.

#### Computer-assisted audit techniques (CAATs)

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3.9 The term CAATs is used for a wide range of programmed procedures and packages which auditors may use to make tests on controls or (much more commonly) to sort, compare or extract data for further testing. It is essential when using CAATs to ensure that the data being used by the auditor are in fact complete and correct - see paragraph 7.2.

3.10 Specialist help may be needed with CAATs. Whilst some CAATs products on the market can be used relatively easily by generalist auditors, where the task is complex, or where the data are not available to a package in the form it requires, more advanced programming skills are needed. In such cases CAATs can be an expensive use of audit resources; the decision on whether they are needed, and the design of the procedures, should depend closely on the objectives of the audit.

#### Audit of developing systems

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3.11 Audits of developing systems cover two main aspects:

- the *management* of the development work. This may be the subject of a performance audit (see Guideline N° 41 “Performance Audit”);
- the adequacy of the *system design* for achieving the internal control requirements of the function (these should normally be defined by user management).

3.12 In addition, and whether or not they carry out formal audits of developing systems, SAIs need to ensure that new applications subject to their audit are designed so that they are efficiently auditable.

#### 4. Planning and staffing information systems audits

##### Staffing and training

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- 4.1 Since there are now few functions without some computer component, all auditors need to know how the presence of computers influences the evaluation of internal control. Training programmes should reflect this general requirement.
- 4.2 Auditors need additional training to become specialists in IS audit. And IS professionals usually do not have training in control evaluation which equates to that of an auditor. Care must be taken therefore that staff who are to be IS audit specialists acquire and maintain an appropriate body of both IS and audit knowledge. Specific qualifications exist which can provide a measure of this. IS audit specialists are often a scarce resource, use of which must be focused on the points where it is of greatest benefit. When this is so, it follows that IS specialists must only be called on when the objectives of the audit and the complexity of the information systems make their expertise necessary. The following section, on planning, gives guidance on this.
- 4.3 Generalist auditors can be trained in the use of CAATs products without having to become full IS specialists.

##### Planning and use of specialists

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- 4.4 Standards of IS security and control are not absolute. Too high a level of control (“over-engineering”) is expensive and usually inefficient. The set of controls in place should reflect the purpose and use of each system, and is usually a mixture of technical and manual procedures. Efficient controls over computer processing may be found in manual procedures in user areas, or in user management activities. Information systems should, therefore, not be examined in isolation, but as part of the general audit of the whole administrative or financial function of which they are part. Only in this way can the auditor realistically assess the appropriate control standard and evaluate the interaction of technical and user controls.
- 4.5 At the planning stage, information should be gathered to decide on the scope of the IS audit to be carried out. It may be useful to consult an IS auditor at this stage to help decide on priorities. In particular, a decision should be made on whether a general controls review is necessary, and the extent to which CAATs will need to be used. Since both of these can represent an expensive demand on specialist resources, it may be necessary to apply strict priorities in the use of IS auditors.
- 4.6 *In the light of the general objectives of the audit*, the following factors should be taken into account:
- the extent to which the function concerned uses computer processing or data held on computers;

- the extent to which the correctness of processing and data is proved, to the degree necessary for the function, by controls in the user area, including user management procedures;
- the complexity of the computer processing, specifically the extent to which the function uses data *generated* by computer programs (as opposed to data which are simply recorded, sorted or analysed by the application);
- the size of the installation: for example, it may be intrinsically impossible to have good general controls because there are not enough staff to provide sufficient separation of duties. This will be the case, for example, if a full separation of duties cannot be made between programmers, operators and access administration;
- the sensitivity of the data and data protection obligations<sup>(2)</sup>;
- any special difficulties in the management/audit trail. In older or poorly-designed systems there may be problems, for example in tracing the underlying details for data which are accounted for in aggregate, or in getting assurance that totals include all relevant transactions. These will increase the need for the auditor to use CAATs simply to establish that data are correct.

4.7 Where the correctness of data and processing is proved, to the extent required for the audit being undertaken, by compensating controls carried out in the user area (including user management procedures), a technical general controls review as part of the audit may be unnecessary. In such cases, the generalist auditor should nevertheless obtain TPS or himself cover the IS management questions indicated in paragraph 5.1.

## 5. General (installation) controls audits

5.1 The areas covered by general controls audits are set out below. The first four are general management issues which should be addressed by generalist auditors even when the technical aspects are not being examined.

### General management issues

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- organisational: strategic planning, structure and reporting lines of the IS department, adequate segregation of duties within the department
- IS security policy: exists, is adequate, communicated and followed
- continuity: back-up and standby arrangements
- management of IT assets

### Specialist technical issues

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<sup>(2)</sup> For the EU generally, European Parliament and Council Directive 95/46/EC of 24.10.1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data, Official Journal L 281, 23.11.1995, p.31

- logical and physical access controls: detailed execution
- operations: all jobs submitted to the computer are properly authorized and are completely, accurately and promptly processed
- systems software (including specific access restrictions)
- programs maintenance and development procedures
- data/database management
- data communication
- (local) networks

5.2 **ANNEX 1** gives guidance for generalist auditors on the first four subjects above.

## 6. **Application audits**

6.1 As has been indicated, an application audit is not normally free-standing, but part of a systems-based audit of a business or administrative function. In any particular case, the objectives and key control questions will therefore be modified and often made more specific in accordance with the scope and subject of the whole audit.

6.2 The aspects which must always be addressed can be summarized in a generally-applicable form as follows:

- Organisation and Documentation

Management responsibility for every aspect of maintaining and running applications should be properly allocated.

The costs of running applications should be identified and kept under review.  
All necessary documentation should exist considering the type of application concerned and the organisation's needs.

- Input

Only authorized items, and all authorized items, should be input.

Data input to applications should be accurate and complete. (Input comprises both transaction and permanent/reference data.)

- Processing

Processing of transactions should be complete and arithmetically accurate, and the results (including generated data) should be correctly classified and recorded properly in the computer files.

Other processing activities should be carried out on time and give correct results.

- Data transmission

Data should be transmitted accurately and completely.

- Standing data

The continued correctness of stored data should be ensured.

- Output

Output released whether on paper, via screens, on magnetic media, or through electronic links, should be correct and complete.

Output should reach all those, and only those, for whom it is intended.

6.3 **ANNEX 2** presents these headings together with illustrations of control techniques or procedures which might be found. It is important that each phase should include appropriate error-handling procedures, and references to these are made in annex 2.



6.4 In deciding which controls he needs to rely on, the auditor should bear in mind that tests of control will need to establish, among other things, that the control operated correctly throughout the period subject to audit (see the guideline on Evaluation of internal control and tests of control). It will usually favour good use of audit resources if, where he has a choice, the auditor seeks by preference to rely on controls in the user area which can be tested readily, provided that these give sufficient assurance about the control objective concerned. The use of CAATs may help to increase assurance. If there has to be reliance on the more technical controls, it will often make a general controls audit necessary. For example, to be certain that validation checks made by a program always operated, the auditor would need to obtain definite evidence that controls over program changes were effective throughout the period - a question which would involve a full general controls audit.

## 7. Computer-assisted audit techniques (CAATs)

7.1 The phrase CAATs most commonly refers to the use of retrieval software to identify transactions with particular characteristics for more detailed audit, or to make samples. Examples of CAATs tests and procedures are:

- identifying erroneous values;
- identifying exceptional values;
- testing the posting or summarizing of transactions;
- re-performing computerized processing (e.g. foreign currency conversions);
- comparing data on separate files;
- producing aged analysis of accounts;
- stratification.

7.2 CAATs are the means to an end, not an end in themselves. The use of CAATs needs to be planned and they should only be used where they produce added value or where manual procedures are not possible or less efficient. The functions to be carried out should be documented in advance and the actual use made of CAATs should be recorded. Normal rules of audit evidence must be applied. The CAATs documentation should include details of all settings, queries etc. that were used to produce the results. In all cases, it is important to be able to show that the CAATs program operated on the complete and correct set of underlying records.

## 8. Audits of developing systems

8.1 It is important that new information systems should be designed in such a way that they are auditable and that there is sufficient internal control. Since making changes to the design becomes progressively more expensive in the later stages of development, auditors must consider carefully both the timing and the nature of their approach to new information systems. If no audit action is taken, there is a risk that systems may be introduced which lack important controls or are unnecessarily difficult to audit. On the other hand, any audit contribution must be made in such a way that audit independence is retained. The possibilities are:

- (a) carrying out a audit of the developing system;
- (b) being directly involved as a user of the developing application; in such cases, audit independence should be reserved, for example by arranging that other audit staff will be available to review the system independently;
- (c) ensuring that the project owner or another principal user represents auditability requirements as a management requirement of the system (in accounting systems it is quite logical for the accountant to do that, in consultation with both internal and external auditors);
- (d) ensuring that the audited organisation has general application design standards that provide for auditability and that its quality control assures this (in addition, internal audit should have arrangements for keeping an eye on auditability generally).

8.2 Of these possibilities, (a) and (b) both demand considerable resources and may give little or no reportable audit result. It is therefore normally preferable to work through (c) and (d).

8.3 In order to foster (c), auditors should always take the opportunity of reminding management of the need to ensure that adequate management/audit trails are specified in new applications, and should invite consultation at the planning stage for important new financial systems. **ANNEX 3** presents a note of generally-applicable application control requirements, which may be useful in discussions with user management of developing systems.

8.4 The general standards can be checked by an examination of the systems development methodology applied by the IS division of the auditee, and a dialogue with the IS standards branch and the internal auditors to ensure that it is executed properly.

## GLOSSARY

### **Application**

A set of programs, data and clerical procedures which together form an information system designed to handle a specific administrative or business function (e.g. accounting, payment of grants, recording of inventory). Most applications can usefully be viewed as processes with input, processing, stored data, and output.

### **Back-up**

Relating to the recovery of data and programs, and the provision of alternative operational capabilities, in the event of damage or loss.

### **Back-up copy**

Duplicate of data or software maintained up-to-date and available for use in case of damage to or loss of the original.

### **CAATs (Computer-assisted audit techniques)**

Computer programs for carrying out audit tests, retrieving, sorting or selecting data, or obtaining evidence on the correctness of processing.

### **Contingency planning (also called Business continuity planning, Disaster planning)**

Plans and procedures to ensure that information systems (hardware, software, data and telecommunications) can be restored to availability at the level and in the time required after a disaster whereby the equipment and/or site become unusable.

### **Developing system**

An application which is at any stage of preparation and not yet in live running (production). The preparation stages may include: proposal, feasibility study, user specification, design, prototyping, programming, program and system testing, user testing, conversion, pilot running.

### **Information systems (IS)**

Systems which record, distribute or process information, generally with the use of information technology.

### **Information technology (IT)**

Machinery, including computers, used for data handling and processing.

## **Logical access control**

The use of software to prevent unauthorized access to IT resources (including files, data, and programs) and the associated administrative procedures.

## **Owner**

The individual (or unit) responsible for particular (IS or IT) assets, including their security and correctness.

## **Program**

The complete set of instructions necessary to solve a particular problem or carry out a particular (set of) procedure(s) on a computer.

## **Software**

Computer instructions generally.

## **System software**

A collection of programs used to control and manage the operation of a computer and the allocation and use of computer resources. (System software includes programs which can modify data or other programs without following the normal processes established in the application concerned; therefore access to system software should be very restricted and staff who have this access should be separate from the programming staff - and preferably also from the operations and access management functions.)

## **Third party statements (TPS)**

Statements given by specialist IS auditors working for an organisation other than the SAI. TPS usually cover the general controls regarding computer centres and/or applications. See paragraph 3.6.

## **User**

Individual or unit that makes use of information systems. Specifically, in business and administration, a department which uses information systems to carry out the functions for which it is responsible in the organisation.

ANNEX 1

GENERAL (INSTALLATION) CONTROLS -  
GENERAL MANAGEMENT ISSUES  
CONTROL OBJECTIVES AND EXAMPLES OF CONTROL TECHNIQUES

**CONTROL OBJECTIVES**

Possible procedures or controls

Note: These are, in each case, a range of possibilities given for illustration; they do not all have to be present to meet the control objective, and the objective may be met by other means. The auditor needs to make a judgment on the overall effectiveness of the mix of controls actually present, bearing in mind the size, complexity and importance of the system concerned.

**GA. ORGANISATION AND MANAGEMENT**

**GA1. Planning, staffing, reporting and segregation of duties**

**To ensure that the IT department is correctly placed in the organisation and is adequately staffed, and that incompatible duties are separated.**

1. The head of IT is of an appropriate rank in view of the importance of IT for the organisation and the position of the IT department within the overall organisation is consistent with the responsibilities and objectives assigned to it.
2. IT strategic plans are made and reviewed annually, and they receive senior management (direction or board) attention and approval.
3. IT personnel and user staff are separate: IT staff cannot initiate or approve transactions and user staff cannot write programs which would change data.
4. An IT organisation chart is published and kept up to date.
5. An IT personnel policy exists which will ensure recruitment, training and retention of staff with the necessary types of expertise and which provides for succession planning.
6. Adequate supervisory and approval levels exist in each functional area within the IT department.

7. Formal job descriptions exist in the IT department and are kept up to date.
8. Operations and programming staff are separate: operators may not write programs and programmers may not operate the computer.
9. If the IT department is large enough, staff who have access to system software should be separate from both programmers and operators.
10. Logical security (access rights and passwords) is administered by staff who are not responsible for programming.
11. Regular liaison is maintained with user departments.
12. There is a change management policy which governs the development and enhancement of applications and ensures that new programs are fully tested and are accepted by the user.

## **GB. SECURITY POLICY**

### **GB1. Security awareness and policy**

**To define and communicate information security policies and procedures and to ensure that management, users and IS personnel are aware of security matters and follow security procedures consistently.**

1. A policy for access, both logical and physical, to computer resources exists, is communicated and is adhered to by management and employees.
2. A physical security policy covering:
  - access restrictions to buildings, computer rooms, IT storage areas,
  - fire and other disasters,
  - contingency planningexists, is communicated and is adhered to by management and employees.
3. All staff who use PCs are required to sign a statement of the security and other practices they must follow, including physical security rules, use only of authorized (and licensed) software, and anti-virus measures (restrictions on importing dangerous data and programs).
4. Access to IT resources is controlled by individual userIDs and confidential passwords.

5. UserIDs and passwords are set up by specific staff and only on the written authority of the manager of the person who needs access.
6. A policy on access by staff to outside resources including the Internet is defined and announced.
7. A security officer with appropriate technical expertise is nominated and is involved in the approval of access control schemes implemented.
8. Security procedures are periodically tested.
9. The security officer makes formal reports periodically on the state of security procedures and these reports are followed up by management.
10. Management has formal reviews of IS security carried out from time to time by specialists (either external consultants or internal audit).
11. If the network is open to access from outside (e.g. Internet), a firewall has been set up.
12. The firewall's effectiveness has been reviewed by a specialist consultant.

## **GC. CONTINUITY AND DISASTER RECOVERY**

### **GC1. Backup, off-site storage, recovery and disaster plan**

**To provide security against loss/damage of data and to ensure continuity of operations.**

1. A detailed policy and procedure covering back-up of data and programs has been established.
2. File back-up routines are scheduled as part of the normal daily activities (especially important for distributed systems with remote input etc).
3. Back-up copies of key master files are made on an appropriate schedule and stored off-site.
4. Back-up copies of key application programs and documentation are made and stored off-site.
5. Back-up copies of operating system programs are made and stored off-site.



6. Off-site application and operating system programs are updated or replaced whenever significant changes are made to the programs. Access to the off-site master files, application programs and operating system programs is restricted to authorized personnel.
7. Recovery and restart procedures, including rapid restoration of corrupted or lost files, exist and are tested on a recurring basis.
8. A disaster (business continuity) plan exists which enables ongoing operations, at the level required by users, in the event of the IT department inability to maintain the normal service.
9. The disaster plan is regularly tested (for example, annually). Formal reports on the tests exist and necessary action is taken by management.
10. Copies of the disaster plan are stored in a remote location.

**GD. MANAGEMENT OF IT ASSETS AND USE OF EXTERNAL SERVICE PROVIDERS**

**GD1. Responsibilities for the organisation's IT assets**

**To ensure that responsibility for management of IT assets is assigned.**

1. Organisational ownership of every IT asset (hardware, software, applications and data) is defined.
2. Personnel and machine activity are accounted for.
3. Users are the owners of their data and applications.
4. Inventories of hardware exist and are regularly checked.
5. A reliable inventory of software (including software on PCs) exists and is regularly checked.
6. Responsibility for ensuring compliance with the terms of software licences is allocated and measures are carried out.
7. A clear policy exists on the management of and responsibility for end-user computing, covering among other things:
  - security (see GB1.3);

- back-up requirements;
  - the extent to which programs may be developed by end-users;
  - the documentation and other standard requirements for such local programs and for spreadsheets which are part of business functions.
8. The status and ownership of e-mail messages has been defined and announced to staff.

**GD2. Use of external service providers (e.g. outsourcing of specific services, use of external computer bureaux)**

**To ensure that the use of external service providers is managed effectively.**

1. Access by the auditors is provided for.
2. The contract or service level agreement specifies requirements including, as appropriate:
  - performance;
  - security;
  - data ownership and access to data;
  - service availability;
  - contingency arrangements (e.g. if service provider ceases operations).
3. Management actively monitors performance against the requirements specified.

## ANNEX 2

### APPLICATION AUDITS - CONTROL OBJECTIVES AND EXAMPLES OF CONTROL TECHNIQUES

#### CONTROL OBJECTIVES

Possible procedures or controls

Note: These are, in each case, a range of possibilities given for illustration; they do not all have to be present to meet the control objective, and the objective may be met by other means. The auditor needs to make a judgment on the overall effectiveness of the mix of controls actually present, bearing in mind the size, complexity and importance of the system concerned.

#### AA. ORGANISATION AND DOCUMENTATION

##### AA1. **Responsibility for applications**

**To ensure that management responsibility for every aspect of maintaining and running applications is properly allocated.**

1. The user (or a principal user) is defined as owner of the application.
2. Maintenance of the application and decisions on its future development are formally managed, preferably by the owner.
3. The application's performance and its contribution to the operational function of which it forms a part are actively managed, preferably by the owner.
4. Ownership of the data used by the application is specified.
5. The duties of the computer centre, and of any third parties (e.g. software houses) for operating and supporting the application are covered by service level agreements (contractually in the case of third parties).
6. All the departments responsible for input or for handling output are known and their responsibilities (for timing, quality, security etc) are formally agreed.

7. The division of responsibility for the accuracy and continued integrity of stored data is clear (ultimate responsibility should normally lie with the user).
8. Responsibility for deciding, and for executing, the security and control requirements of the application is assigned, taking account of the organisation's general security policy and of the IT department's standard security measures.
9. Responsibility for providing and for maintaining documentation, including user manuals, is defined.

**AA2. Cost allocation**

**To ensure that the costs of running applications are identified and that they are kept under review.**

1. Computer running costs are logged and the application's share identified.
2. IT department overheads and staff costs are identified and allocated to the applications.
3. Running costs are reported to the owner of the application and to those responsible for resource management, and reviewed in accordance with the organisation's policy.
4. Costs of maintenance and enhancement of the application are identified and reported.
5. Estimates are made for development and maintenance tasks, are approved by the owner or resource manager, and are used to control the work.

**AA3. Documentation**

**To ensure that all necessary documentation exists in the light of the types of application concerned and the organisation's needs. (Documentation may be kept on media other than paper provided that availability and reliable storage are assured.)**

1. A SYSTEMS SPECIFICATION describes the data and processing of the application in terms which allow it to be an effective medium of communication between the users and the IT providers.
2. The systems specification is kept up to date.
3. It meets the organisation's documentation standards and systems development methodology.

4. It includes (or a separate document sets out) the user's control needs and any other special requirements for the application.
5. Structured PROGRAM DOCUMENTATION including comprehensible source listings is available and is kept up-to-date.
6. The organisation's rights to obtain documentation and source listings developed by outside contractors are guaranteed even if the supplier becomes bankrupt (for example by depositing them in escrow).
7. OPERATORS' INSTRUCTIONS are up-to-date and cover any special action required e.g. response to error messages, abnormal termination, etc.
8. USER MANUALS fully describe responsibilities and procedures and are systematically kept up to date.

**AB. INPUT**

**AB1. Authorization**

**To ensure that only authorized items, and all authorized items, are input.**

1. Access controls ensure that only those authorized have access to input processes.
2. Input is from authorized documents, which are checked for the authority (usually a signature) by the person doing the input, or in a preliminary clerical checking stage.
3. Documents used for input are serially numbered and there is a check for validity and for completeness of sequence either by the computer or clerically.
4. Input other than transcription of authorized documents receives authorization in accordance with its significance before being processed. (This may be on a statistical basis where appropriate.) Methods include:
  - holding input in a special computer file until released interactively by a supervisor;
  - flagging recent input for supervisory check;
  - post-input authorization of print-outs before further processing.
5. Transmission of authorized and checked documents is controlled by batching.
6. Confirmatory prints of input are sent to authorizing officers, who sign for approval.
7. Changes to permanent data are properly authorized.

8. Programmed checks prevent validation and processing of input which logically cannot have been authorized, e.g. payments in excess of available budget.

**AB2. Completeness and accuracy**

**To ensure that data input to applications is accurate and complete. (Input comprises both transaction and permanent/reference data.)**

1. Batch controls including (hash) totalling of all sensitive fields are used, and a positive check is made that required totals match.
2. Validation checks are carried out by program to ensure that the data entered:
  - have the format expected for each field;
  - are within appropriate ranges (e.g.. not negative where logically impossible; do not exceed pre-determined reasonable amounts; are within the known sequence of items of their kind (cheque numbers, etc).
3. Double-keying is used for sensitive data.
4. For on-line entry, input reports are produced showing aggregated totals, which are checked or matched with totals established separately for the session.
5. Check digits are used with reference numbers and validation actually checks them.
6. Validation includes tests of self-consistency of the data input (e.g. debits = credits, reference numbers match related descriptive material).
7. Logical checks are made with accessible existing records e.g. account balances.
8. Permanent data (and other key data) are printed out and positively approved by the responsible user before being used in processing.
9. Error handling - clerical or computer suspense files of input rejected by the system during validation or processing are maintained, and procedures ensure that suspense data is promptly corrected and reinput (without bypassing normal authorization and other input checks), or cancelled.

**AC. PROCESSING**

**AC1. Transaction processing**

**To ensure that processing of transactions is complete and arithmetically accurate, and that the results (including generated data) are correctly classified and recorded properly in the computer files.**

1. Batch or session control totals are matched to the aggregate change in appropriate control records in computer files. (It is important that the structure of batch types and control records should be such that significant mis-classification would be detected by this control.)
2. Where the program generates data (ie carries out arithmetical operations such as currency conversion, or looks up and writes data which has a logical but not arithmetical connexion with the input, for example pay), the user makes checks either against a separately-made forecast of the aggregate amount or of a sample of transactions.
3. Output includes control prints or screens on which responsible users must positively check and accept key control totals.
4. Validation controls within the programs include:
  - (1) ensuring that (batch) totals established before the processing remain completely accounted for at each stage;
  - (2) consistency checks where input handled recapitulates information already held (e.g. when account number and name are both given);
  - (3) range checks on amounts generated (calculated, looked-up) by program.
5. Control counts and totals are maintained on each of the data files accessed by the application.
6. Control counts and totals are maintained for each transaction type.
7. "Success units" are used to ensure that complex transactions are entirely posted to all appropriate files, or else backed out completely.
8. Separate control files held on a different device are used to check that appropriate file versions have been loaded.
9. Manual control totals are maintained and reconciled on a timely basis to the totals produced by the system.
10. Error handling - clerical or computer suspense files of input rejected by the system during validation or processing are maintained, and procedures ensure that suspense data is promptly corrected and reinput (without bypassing normal authorization and other input checks), or cancelled.

**AC2. Other processing**

**To ensure that other processing activities (including data re-organisation such as year-end/month-end procedures, routine data integrity checks, production of reports and analyses not directly related to input, supply of data to other applications, and enquiry facilities) are carried out on time and give correct results.**

1. The timetable for regular processing of this type is controlled by the user, and runs are initiated on his instructions.
2. User procedures lay down responsibility for the checks to be made on the results of such processing (e.g. checking that amounts reported as processed match those expected, that new aggregate figures in control records reflect the adjustments forecast, that management information reports indicate by control totals that they include the whole body of the data intended).
3. Where data belonging to the application are available to an enquiry facility, the appropriate degree of check is built into the processing which produces responses (e.g., where this is important, proving that all relevant records have been read, by aggregating and showing the total for the records within the same control account which were not selected).
4. Users of enquiry facilities and owners of other applications using the data are aware of the level of reliability of the data as such and of the programmed procedure through which they obtain them.

#### **AD. DATA TRANSMISSION**

##### **AD1. Data should be transmitted accurately and completely**

**To ensure that all data transmitted, whether through a network or by disks or tapes, is received in a complete and accurate state, and that there is no loss or disclosure of data in transit (see also section AF1).**

1. Use of check digits, and hash and other control totals.
2. Use of digital signatures.
3. Use of data encryption.
4. Use of passwords.
5. Sequential message numbering, sequencing of transactions.



6. Reports confirming receipt are sent and are reconciled promptly to records of data transmitted.

**AE. STANDING DATA**

**AE1. Continued correctness of standing data**

**To ensure that all data stored in the system as a permanent record or for reference remains correct and complete.**

1. Responsibility for checking the continued correctness of data is allocated either to a database administrator or to appropriate users.
2. Control totals or hash totals are used to monitor the state of files containing permanent data.
3. Print-outs of standing or reference data are checked periodically to source documents by the responsible user. This can be done on a cyclical or statistical basis, depending on the risk represented by incorrect data.

**AF. OUTPUT**

**AF1. Correctness of output**

**To ensure that output released whether on paper, via screens, on magnetic media, or through electronic links, is correct and complete.**

1. Validation and range etc. checks are carried out by the program on records output. Warning messages are given if the output does not comply. There is a user procedure for handling such warning messages.
2. There are procedures in place to give an appropriate degree of reasonableness check to printed output (may range from none for internal paper which is not a base for decisions, to 100% read-through against supporting documents (e.g., perhaps, for large cheques)).
3. For transmissions of payment instructions to banks:
  - the responsible user uses both control totals and spot checks (such as sample tests from time to time on the disk to be despatched or browsing and sampling the messages transmitted) to obtain reasonable assurance that the information actually sent is identical with that authorized;
  - despatch of tapes or disks by a secure messenger service;
  - prepared disks or tapes are stored securely up to despatch;
  - pre-established limits are agreed with the bank on the total amount and on individual transactions;
  - acceptance reports are reconciled promptly (in time to recall payments)
  - post-payment reconciliation is done promptly.
4. Output reports include totals which are reconciled by the user to totals established before input. Detailed prints of input are available to investigate differences when necessary.

**AF2. Correct distribution of output**

**To ensure that output reaches all and only those for whom it is intended.**

1. Output produced by the computer center is kept under surveillance, and distributed with appropriate security/privacy.
2. Mailing lists for output are regularly reviewed and unnecessary or incorrect addressees removed.
3. Superfluous copies of output for which there is no addressee are not produced.

4. The general security rules applied to PCs, terminals and printers located with end-users ensure sufficient privacy for output, taking into account the level of building security and the quality of password etc controls.
5. The person responsible for security decisions for the application has a clear picture of the various user groups with access to output in any form and makes decisions on control accordingly (see point AA1.8 above). In particular, logical access controls for the application take account of possible approaches through all networks in which the installation is involved.
6. All expected output is accounted for (e.g. use of serial numbering to detect unauthorized suppression of exception reports).
7. Reports are regularly produced even if there is no problem to report (recipients should then become used to receiving a report and less likely to overlook a report that is suppressed by someone who does not want the report's contents known).
8. Negotiable, sensitive or critical forms (for example cheques) should be properly logged and secured to provide adequate safeguards against theft or damage. The forms log should be routinely reconciled to inventory on hand and any discrepancies should be properly investigated.

## ANNEX 3

## APPLICATION CONTROL REQUIREMENTS

The following requirements are expressed in general terms. In general the requirement is that evidence should be provided at suitable intervals (for example, daily) to user managers to enable them to be assured that the data and processing in the application are correct. Specific solutions (for example aggregations and control totals, serial numbers, reports for reconciliation or reasonableness checking, supervisor/manager consultation and recorded approval of control data on screen) need to be defined in the early stages of the project.

It is assumed in what follows that general installation controls satisfactory to the users are in place in the systems/networks which will run this application. Such controls should cover, for example, physical access, logical access generally, separation of IT staff duties, back-up, disaster recovery, (software) changes, and should include performance indicators to measure the efficiency of the system.

1. **Access** The application should prevent access to programs except by authorized staff, and should provide for access to user resources (processes or data) to be managed by (a) senior user(s) and to be restricted as may be required to reflect differing patterns of work and separations of duties in user divisions (for example, by account codes, by values, by functions, etc.). All access should be controlled and logged on an individual basis and the system should prevent and report all unauthorized access attempts.
2. **Input of data**

The system should provide evidence permitting user managers to be sure that data input, including standing data, is complete, is validated in accordance with user requirements, and is correctly written to the correct files.
3. **Integrity of data**

The system should be organized so as to provide regular evidence to user managers that standing and stored data remains complete and correct.
4. **Transaction processing**

The system should provide regular evidence that transactions are, in aggregate, correctly processed and written to the correct files.
5. **Changing data and programs by emergency routes**

So far as they are within the application, the use of any emergency data change facilities or processes, which allow data to be changed without passing through normal validation, should be capable of being heavily restricted and logged.



**6. Management (audit) trail**

All transactions should be traceable forwards and backwards through the system. A trail should be maintained of data which is aggregated at various reporting levels, so that component transactions can be identified.

**7. Records** All actions on each transaction record should be stamped with the logged-in identity concerned, and the machine time and date (and an action code). Full records of every change should be retained (no overwriting).

**8. Output** Outputs should be dated and timed, and (where necessary for control) serially numbered. There must be appropriate controls (and evidence to the accountant that they have operated) over electronic transfer of payment data to ensure that only - and all - authorized transactions are timeously executed.

EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 23

**AUDIT SAMPLING**

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1. Reference to the INTOSAI Auditing Standards

1.1 The explanation of the INTOSAI Auditing Standards (Paragraph 153) states that:

"The audit findings, conclusions and recommendations must be based on evidence. Since auditors seldom have the opportunity of considering all information about the audited entity, it is crucial that the data collection and sampling techniques are carefully chosen".

2. Factors affecting the decision to sample.

2.1. Audit evidence can be obtained using various techniques which fall into the broad categories of inspection, observation, enquiry and confirmation, computation and analysis (see Annex I of Guideline N° 13 "Audit Evidence and Approach"). The auditor

can apply such techniques to an entire set of data (100% testing) or may choose to draw conclusions about the entire set of data (the population) by testing a representative sample of items selected from it: this latter procedure is audit sampling.

2.2. The auditor must make a judgement as to whether sampling is an appropriate way of obtaining some of the audit evidence required. Amongst the factors that must be considered are:

- . the number and relative sizes of the items in the population;
- . the materiality of, and inherent risk of error in, the items concerned;
- . the relevance and reliability of evidence produced by alternative tests and procedures, and the relative costs and time involved in each.

2.3. Sampling will frequently be appropriate when undertaking both tests of control and substantive testing. However, as the objectives of these types of testing are different, different sampling approaches may need to be used.

### 3. Basic concepts and definitions

3.1. As the auditor is seeking to draw conclusions about a whole population by testing a sample of items selected from it, it is essential that the sample is representative of the population from which it is drawn.

3.2. There is a risk that the conclusions the auditor reaches after testing a sample are different to those that would have been reached had the whole population been tested: this is known as sampling risk. The auditor must use judgement in planning, carrying out and evaluating the results of sampling work in order to reduce sampling risk to an acceptable level.

3.3. A sample may be statistical or non-statistical. Both require the use of professional judgement in the planning, testing and evaluation stages. In addition, statistical sampling demands the use of random selection methods, and uses probability theory. This allows the auditor to:

- . determine the sample size;
- . evaluate the results quantitatively; and
- . estimate the sampling risk, and thus draw conclusions regarding the whole population.

This Guideline does not seek to provide detailed guidance in the area of probability theory: if necessary the auditor should obtain expert advice in order to reach sound judgements in this area.

3.4. Even when the auditor decides to take a non-statistical sample, consideration should be given to using random selection methods. This would normally increase the likelihood



of the sample being representative of the population. The auditor must always carefully consider whether a non-statistical sample provides a reasonable basis for drawing conclusions about the population from which it was drawn.

4. The stages of audit sampling

- 4.1. For both statistical and non-statistical samples, the sampling process can usefully be broken up into four distinct stages: planning the sample; selecting the items to be tested; testing; evaluation of results. The following paragraphs deal briefly with each of these.

Planning the sample  
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- 4.2. The first stage in planning the sample is to define exactly the population. For statistical samples it is important that the population is homogenous. That is to say that the population should consist of broadly similar items that are processed by similar or common systems and thus exposed to similar risks. The items to be sampled should also be defined: it may be, for example, a transaction, an account balance, or perhaps a monetary unit.
- 4.3. It is essential that the auditor clearly defines the specific audit objective that the testing of the sample is designed to achieve. This process should include the definition of an error (in substantive testing) or an exception (in tests of control).
- 4.4. The sample size should also be determined at this planning stage. A major factor is that a larger sample is more likely to be representative of the population than a smaller one. However, if the area being tested is judged to be relatively insignificant in terms of the overall financial statements, the auditor may be willing to accept a higher degree of sampling risk.

Selecting the items to be tested  
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- 4.5. Throughout the selection procedure, the auditor should regularly review whether the sample selected is likely to be adequately representative of the population. This is particularly important when a non-statistical sample is taken, and especially when selection is not random.
- 4.6. The auditor should guard against the risk of omitting part of the population when selecting the sample. For example, it is often necessary, particularly in computerised environments, to carry out and document a reconciliation between the file used for extracting the sample and the population as recorded in the entity's accounts.

Testing  
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- 4.7. As far as possible, testing should follow a pre-determined questionnaire. In exceptional cases this may not prove to be possible, in which case alternative procedures should be carried out to obtain equivalent evidence for the items concerned.

- 4.8. The auditor should consider the time at which it is appropriate to carry out the testing. This is particularly the case for tests of control where the objective is usually to assess whether controls have operated effectively over a period of time.

#### Evaluation of results

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- 4.9. As errors or exceptions are found it is necessary to consider their cause and nature. This allows the auditor to assess their potential impact upon both the financial statements being audited and the audit itself.
- 4.10. Having evaluated the errors or exceptions found in the sample, the auditor should estimate the "most likely error or exception level" in the population as a whole. This is done by extrapolating from the "known error/exception level" in the sample.
- 4.11. The third step is to build on to this extrapolation an allowance for sampling risk<sup>(1)</sup>. This estimate of the "upper error/exception level" can now be compared to the maximum error/exception level that can be tolerated for the audit. If the estimated total error/exception level exceeds that tolerable the auditor should consider:
- . requesting the audited entity to investigate the errors/exceptions found and the potential for further errors/exceptions. This may lead to agreed adjustments in the financial statements;
  - . carrying out further testing with a view to reducing the sampling risk and thus the allowance that has to be built into the evaluation of results;
  - . using alternative audit procedures to obtain additional assurance.
- 4.12. The final conclusion of the sampling work taken together with the results from other audit procedures should allow the auditor to reach a judgement as to whether the financial statements are acceptable and report accordingly.
- 4.13. This evaluation procedure (as applied to the results of substantive testing) is illustrated by the diagram at **ANNEX 1**.

#### 5. Documentation

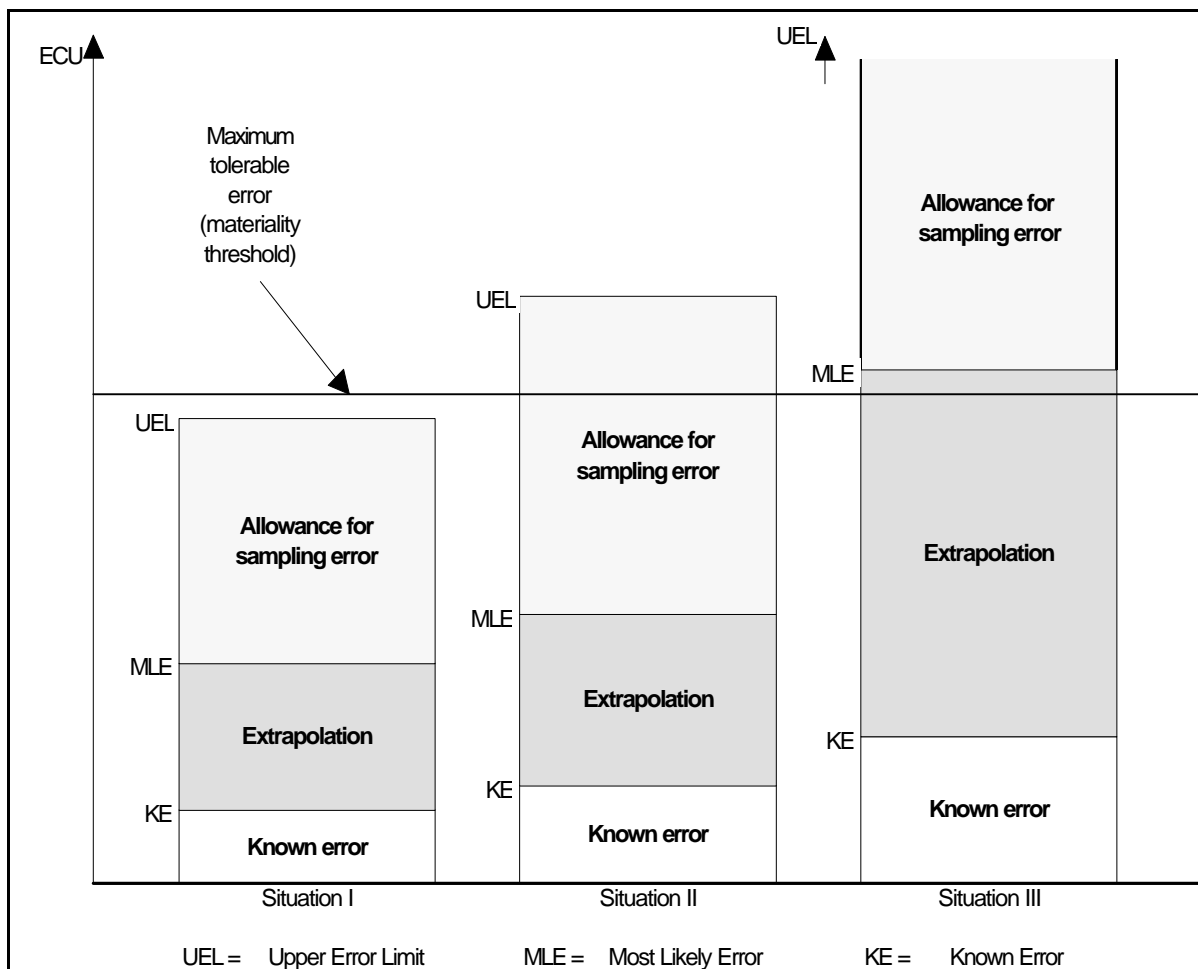
- 5.1. The auditor is required, throughout the sampling process, to make numerous judgements. It is essential that these are carefully documented (see Guideline N° 26 "Documentation") so that supervisors can carry out review procedures.

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<sup>(1)</sup> As noted in paragraph 3.3., it is only possible to calculate this allowance when a statistical sampling technique is used.

6. Performance audit

- 6.1. The above paragraphs have given guidance on the use of audit sampling in financial audits (including examinations of legality and regularity). It is to be noted that audit sampling is often used to obtain evidence in performance audits (see Guideline N° 41 “Performance Audit”). Whilst the specific objectives of the sampling exercise may be different, the underlying principles are the same.



## ANNEX 1: EVALUATION OF THE OVERALL RESULTS OF SUBSTANTIVE TESTING

Conclusions to be drawn:

**Situation I:** The upper error limit is less than the tolerable error. This is an acceptable result.

**Situation II:** The upper error limit exceeds the tolerable error but the most likely error is lower than the tolerable error. See paragraph 4.11.

**Situation III:** The most likely error exceeds the tolerable error. The financial statements are unacceptable.

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N° 24

**ANALYTICAL PROCEDURES**

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1. Reference to the INTOSAI Auditing Standards

- 1.1 The explanation of the INTOSAI Auditing Standards (Paragraph 86) recommends the use of analytical procedures in the following terms:

*"...The SAI should equip itself with the full range of up-to-date audit methodologies, including systems-based techniques, analytical review methods, statistical sampling and audit of automated information systems."*

Meanwhile, paragraph 160 of these explanatory notes explains the objective of analytical procedures in the audit of financial statements:

*"Financial statement analysis aims at ascertaining the existence of the expected relationship within and between the various elements of the financial statements, identifying any unexpected relationships and any unusual trends..."*

1.2 Analytical procedures have been defined as follows<sup>(2)</sup>:

*"Analytical procedures means the analyses of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts."*

1.3 In addition, some of the methods that may be used as part of analytical procedures have been described as follows<sup>(3)</sup>:

*"Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components ... and individual elements of financial information. The auditor's choice of procedures, methods and level of application is a matter of professional judgement."*

## 2. Introduction

2.1 The purpose of this Implementing Guideline is to provide the external auditor ("auditor") of European Community activities with guidance on the use of analytical procedures. Analytical procedures assist the auditor in:

- understanding the organisation to be audited and in planning the audit (paras 3.1 - 3.9);
- carrying out the substantive audit procedures (paras 4.1 - 4.12); and
- reviewing the results at the end of the audit (paras 5.1 - 5.2)
- Auditors may use analytical procedures in performance audits as well as in the examination of financial statements. The use of analytical procedures in performance audit is considered briefly in para 6.1.

### Nature of Analytical Procedures

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2.2 Analytical procedures include a variety of techniques used by the auditor to study relationships between data and to test their plausibility. The data may be non-financial as well as financial and may arise from internal and external sources. In broad terms,

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<sup>(2)</sup> *International Standard on Auditing 520*, paragraph 3 (IFAC Handbook, 1996)

<sup>(3)</sup> *International Standard on Auditing 520*, paragraph 6 (IFAC Handbook, 1996)

analytical procedures involve looking at figures in the financial statements to see if they are consistent with each other and with the auditor's knowledge of the organisation and its activities.

2.3 The auditor can employ analytical procedures where it can be assumed that there are relationships between items in the financial statements, and between items in the accounts and non-financial data. Analytical procedures include a range of specific techniques:

- the study of changes in account balances over prior periods leading to a prediction for the current period (e.g. the regular repayment of a loan over x years)
- the comparison of financial information with anticipated results (e.g. examining outturn variances against budgets and forecasts);
- the study of relationships between account balances over time (e.g. interest receivable or payable against loans or borrowings);
- the computations that give a prediction of a given account balance (e.g. (a) using independent data on staff numbers and average pay rates to predict the total staff costs for the period; (b) using farm data to predict per hectare payments to farmers);
- the study of relationships between financial and non-financial information, which may confirm the auditor's understanding of the financial information or direct his/her attention towards unusual or unexpected account figures (e.g. (a) licence income against the number of licences; (b) import duties against data on physical imports; (c) agricultural storage costs against records of physical stocks)

2.4 Analytical procedures fall into three broad categories: trend analysis, ratio analysis and predictive analysis. These procedures are outlined in **ANNEX 1**. Analytical procedures based on trend analysis or ratio analysis are most useful at the planning and final review stages to help auditors to direct and conclude their work. Predictive analytical procedures are more commonly employed to obtain audit evidence as part of the substantive testing.

#### Viability of Analytical Procedures

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2.5 The extent to which the auditor can use analytical procedures will depend on a number of factors including:

- the nature of the organisation and its operations;
- the extent to which account balances and transactions can be predicted with reasonable accuracy;
- the knowledge of the organisation gained from previous audits;
- the availability of appropriate financial and non-financial information;
- the reliability of the various forms of information available; and
- the compatibility and independence of information from different sources.



### 3. Analytical Procedures in Planning the Audit

3.1 Auditors may apply analytical procedures at the planning stage to:

- confirm and improve their understanding of the organisation's activities;
- identify areas of potential audit risk;
- identify any significant non-routine or unusual transactions and/or account balances; and
- assist in planning the nature, timing, and extent of substantive procedures - including substantive analytical procedures.

3.2 The knowledge which the auditor gains from analytical procedures at the planning stage can be used to support the rest of the planning process and the development of the audit approach for the examination of specific account balances. Where analytical procedures used for planning reveal significant departures from expectations the auditor will need to develop specific procedures to discover the cause of these fluctuations.

3.3 Analytical procedures at the planning stage may also involve a preliminary analysis of the available data in order to assist the auditor to decide whether substantive analytical procedures could be used to provide the required audit evidence at a reasonable cost. The auditor may, for example, carry out initial data analysis to assess the structure and quality of data and to investigate possible relationships between different variables.

3.4 The auditor will usually consider information from various sources, both internal and external to the organisation, when undertaking analytical procedures at the planning stage. Typically the auditor may consider information such as:

- prior year financial statements;
- appropriate external reports, e.g. performance and statistical reports;
- relevant non-financial information e.g. staff numbers, claims processed;
- interim financial statements, reports and other analyses by the organisation's management comparing the current period results with prior periods and with current period budgets and forecast; and
- data on significant ratios and achievement against performance targets.

In many cases, auditors should be able to obtain much of this information from the organisation's management.

3.5 The sophistication and extent of the analytical procedures applied at the planning stage are matters for the auditor's judgement and will vary depending on the size of the organisation, its complexity and the availability of information. For some organisations the procedures may be limited to reviewing changes in account balances between the prior year and the current year. In other organisations the procedures might involve more extensive analysis of monthly financial statements and comparisons with non-financial data.

- 3.6 Analytical procedures used in planning should result in a better understanding of the organisation's activities. The procedures may involve:
- a review of the significant financial statement account balances and classes of transactions;
  - a review of the organisation's budgets and forecasts;
  - a discussion on performance and future plans with finance and operational departments;
  - an examination of statistics and other information about the organisation's activities; and
  - a review of achievement against budgets and performance targets.
- 3.7 These procedures will help the auditor to identify changes in the organisation's activities and operations which may affect its financial statements. They should also direct the auditor's attention to specific areas of the financial statements which require particular consideration.
- 3.8 The auditor will need to assess the organisation's budget setting procedures before placing too much reliance on them. In particular, the auditor should consider the pressures which may be placed on individual departments to conform to the budget and the risk that results may be manipulated, for example, by the misallocation of expenditure between individual budget lines to ensure that appropriations are not exceeded.
- 3.9 Other analytical procedures that the auditor may employ as part of planning are profiling and ratio analysis. Profiling involves plotting the results from monthly management accounts to identify non-routine transactions and unexpected fluctuations which require explanation. Ratio analysis may also highlight trends of possible concern. Examples of these techniques include:
- comparing commitments entered into as a percentage of total commitment appropriations made available, to check the level of execution of the budget (ratio analysis)
  - comparing actual monthly budgetary expenditure to budget, which may show that a significant part of the expenditure is incurred during a holiday period, thereby indicating the possible existence of a problem (profiling).

#### 4. Analytical procedures as substantive procedures

- 4.1 When using analytical procedures to obtain substantive audit evidence the auditor should take account of the audit objective for which these procedures are performed, the nature of the account balance/transactions being audited, and the quality of the available data. The auditor should bear in mind that analytical procedures are more reliable in a strong control environment with effective internal controls and good external data. Substantive analytical procedures are also more likely to be effective in providing audit evidence on the completeness and measurement of account figures.

They will normally not provide evidence as to the legality and regularity of transactions and ownership of the assets and liabilities recorded in the balance sheet.

4.2 Only tests which involve predicting a value which may be used in a comparison against an actual account balance are acceptable as a source of substantive audit evidence in financial audits. Predictive tests range from a simple computation of account balance to complex regression analysis. When performing a predictive test to obtain substantive audit evidence the auditor will need to:

- determine the maximum difference arising from the procedure he/she can accept by setting a level of precision;
- understand the relationship between the account balance and the variables used in the prediction;
- confirm the reliability of information being used;
- calculate the predicted amount;
- identify any significant differences between the account balance and the predicted amount;
- investigate any differences and obtain corroborative evidence; and
- evaluate the results.

These steps are considered further in the following paragraphs.

#### Setting a Level of Precision

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4.3 The auditor should set a level of precision for substantive analytical procedures. This precision is the maximum difference between the auditor's prediction and book value which is still acceptable for the purpose of the test. The range within which the account balance can fall is called the zone of reasonableness.

4.4 The auditor should state a tolerable difference (and thus define the zone of reasonableness) for a substantive analytical procedure before making a prediction of the account balance. The tolerable difference provides the benchmark against which to evaluate the results of substantive analytical procedures. The method of calculating the tolerable difference should take account of the materiality of the account balance being tested. The more material an account balance is, the smaller the tolerable difference as a percentage of the account figure being tested should be.

#### Understanding the relationship

-----

4.5 The auditor's understanding of the relationship between the account balance predicted and other variables is the key to effective substantive analytical procedures. The relationship needs to be understood in terms of:

- **Plausibility** - The auditor needs to be satisfied that the assumed relationship is plausible. For example, it would be reasonable to assume that there is a relationship between staff numbers and total payroll costs. On the other hand, it would not necessarily be reasonable to assume a relationship between staff numbers and other operating costs.
- **Relevance** - A particular variable may be subject to several influences. The auditor needs to ensure that all of these, or at least the most significant, are built into the model used for prediction. A simple computation of payroll costs based on previous years' audited figures and changes in employee numbers and average pay increases would not be appropriate, for example, where there had been significant changes in the mix of staff grades between periods.
- **Consistency** - Relationships observed in the past cannot always be expected to carry on into the future. For example, relationships between account balances which may have been comparatively stable in previous years may change as a result of changes in the underlying business. The auditor should consider the possibility of changes in relationships when designing substantive analytical procedures.
- **Frequency of measurement** - The more frequently a set of variables is measured, the better the information about the relationship between the variables is likely to be.
- **Independence of source data** - Audit evidence from substantive analytical procedures is very limited if two variables, both derived from the same source, are being compared. The procedure is only effective where information from different sources is used.

#### Reliability of the information being used

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- 4.6 Before placing reliance on the results of analytical procedures as a substantive procedure, the auditor must obtain relevant and reasonable evidence as to the reliability of the information used. The auditor should consider whether:
- the information has been verified by audit procedures
  - the information was generated independently of the accounts/finance department (for example, by an external source)
  - the system used for generating the information was subject to effective internal controls.

#### Identifying significant differences

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- 4.7 The difference between the predicted and recorded amount is significant if it exceeds the tolerable difference (i.e. the prediction is outside the zone of reasonableness). A difference below tolerable difference may still be significant if any of the following conditions apply:

- it is only marginally below tolerable difference;
- it could change a surplus into a deficit or vice versa;
- it could lead to appropriations used exceeding appropriations available;
- it is material in the context of measuring performance against a target. Such differences may be particularly significant when they relate to the payment of performance bonuses.

#### Investigating differences and obtaining corroborative evidence

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4.8 When substantive analytical procedures give rise to significant differences between predicted and recorded amounts, it is essential that the auditor investigates these differences by obtaining explanations. All explanations of differences should be documented and backed by corroborative evidence. No assurance should be taken from substantive analytical procedures if significant differences cannot be supported by proper explanations and corroborative evidence.

4.9 The auditor should be aware that significant differences may occur as a result of the following:

- errors in the recorded amount;
- simplifications or errors in the auditor's assumptions;
- important variables not built into the model for prediction.

The auditor should always consider the extent to which errors in the assumptions or variables supporting the prediction may explain significant differences. Where the auditor identifies errors or omissions in the model for prediction it may be necessary for the model to be revised.

4.10 When investigating significant differences arising from substantive analytical procedures the auditor should in the first instance seek explanations from the management of the audited entity. Management explanations of significant differences should be quantified and documented. The auditor should also ensure that the whole of the difference between the predicted amount and account figure is investigated and explained.

4.11 The auditor will use his/her judgement and experience to decide whether management's explanations appear to be acceptable and what corroborative evidence is needed and from whom it will be sought. The auditor must also be satisfied that the explanations and corroborative evidence obtained are reasonable and consistent based on his/her knowledge of the organisation.

#### Evaluating the results

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4.12 If the difference cannot be adequately explained and corroborated the auditor will usually need to perform detailed testing of transactions to seek the necessary assurance. The failure of the analytical procedure may indicate that there is a material error in the account balance or class of transactions.

5. Analytical procedures at the completion stage of the audit

5.1 When completing the audit, the auditor should apply analytical procedures in forming an overall conclusion as to whether the financial statements as a whole are consistent with his knowledge of the organisation's activities. The analytical procedures used at the final review stage are often the same as those used during the planning stage of the audit.

5.2 It is important that auditors read the final financial statements (including disclosures) and consider:

- the adequacy of the audit evidence gathered in respect of unusual or unexpected balances identified at the planning stage or during the course of the audit;
- unusual or unexpected balances or relationships that have not previously been identified;
- whether the current year's financial statements are reasonable in the light of their knowledge, in comparison to the prior year.

In considering the above matters the auditor must decide whether enough audit evidence has been obtained to support the opinion on the financial statements.

6. The Use of Analytical Procedures in Performance Audit

6.1 Analytical procedures can be used extensively in the planning stage of performance audits and as a means of obtaining substantive evidence. For example, the analysis of costs over time may help the auditor to identify areas where poor economy is being achieved, which merit further examination during the audit. The use of benchmarking techniques (comparing the costs of performance of the audited entity against similar organisations) and the analysis of performance indicators are generally recognised forms of analytical procedures used within some performance audits to obtain substantive evidence. For further guidance, see Guideline N° 41 "Performance Audit".

## **Annex 1 - Types of Analytical Procedure**

### **Trend Analysis**

Trend analysis is the analysis of changes in a given account balance or financial statement line over past accounting periods. A diagnostic approach may be used at the planning or review stages, where the auditor simply compares the actual current year value with the past trend to determine if it appears to be out of line.

A predictive approach may be used for substantive purposes, where the auditor seeks to predict a current year value based on the trend.

A number of trend analysis techniques exist. More complex techniques are capable of giving more accurate predictions and may be particularly suitable for substantive testing. However, as techniques increase in complexity, more audit effort is usually required to perform them. A balance has to be struck between the cost and the benefits of each technique.

Trend analysis techniques include:

- graphical methods;
- period-to-period comparisons;
- weighted averages;
- moving averages;
- statistical time-series analysis;
- Multiple variable techniques such as regression analysis.

Graphical methods and period - to-period comparisons are more appropriate at the planning and review stages of the audit.

### **Ratio Analysis**

Ratio analysis is any method that involves comparing relevant relationships between financial statement figures. This isolates stable (over time) or common relationships between account balances. Ratio analysis is particularly useful where the ratios can be calculated for a sufficient number of years to allow trends to be properly recognised and evaluated.

The two most commonly used ratio analysis methods are:

- common base indexation ; and
- financial ratio analysis.

#### ***Common Base Indexation***

Common base indexation involves the comparison of income and expense items to total income or balance sheet items to total assets e.g. by comparing interest received or paid to loans and borrowings. It is particularly useful when comparing income and expense items to total income from period to period.

### ***Financial Ratio Analysis***

Financial ratio analysis involves comparing balances within financial statements to understand the relationship between those balances and help identify changes in the relationship over time. Investigating the relationships between account balances can help auditors to understand the information contained in financial statements.

A wide range of financial ratios can be employed by the auditor depending on the nature of the organisation and its financial statements. Gross profit margin (operating profit against sales), stock turnover (cost of sales against stock values), and debtor days (trade debtors against total credit sales) are three important ratios commonly examined in a trading organisation. Certain financial ratios which involve the measurement of an entity's current assets against its current liabilities can provide a useful measure of its ability to meet its short term obligations and may direct attention to liquidity problems.

Ratio analysis can be an effective technique provided the following conditions apply:

- the ratios to be compared must be calculated using the same methodology;
- the account figures included in the ratio to be compared are calculated using the same accounting policies;
- the ratio is expected to be relatively stable between periods.

### **Predictive Analysis**

Predictive analysis is an analytical procedure which uses computations or series of computations that develop a prediction of an amount based on an understanding of plausible relationships through the use of relevant financial and operating data.

Predictive analysis is usually the most powerful analytical procedure. However, its effectiveness is based on the following factors:

- the plausibility of the relationships involved;
- the inclusion of relevant predictors;
- the omission of irrelevant predictors;
- the use of non-financial operating data and relevant external data as well as financial data.

### ***Examples of predictive testing***



Predictive testing can, for example, be used by the auditor to check the accuracy and completeness of payroll expenditure. The auditor may employ simple modelling techniques or more complex statistical methods to develop a prediction depending on the nature and quality of information available.

- i) **Simple modelling approach.** A modelling approach to the prediction of payroll expenditure may be effective where reliable data about staff numbers and grades are available from personnel systems which are maintained independently of data on pay. As a first approximation, the auditor may try to predict total payroll costs in the period by multiplying numbers in each grade by the mid-point of the pay scale for the grade. However, such a method fails to take account of the numbers of staff in each grade at different points on the pay scale. The auditor may be able to use data on lengths of time in the grade to refine the procedure by using a weighted average pay rate for each grade, rather than simply the mid-point of each scale. Further refinements might take account of other variables, such as annual performance bonuses, which may also be significant in the context of account figures being audited.
  
- ii) **Formal statistical methods.** Where the auditor has good quality historical data on payroll expenditure and relevant predictor variables, it may be worthwhile to use formal statistical techniques such as multiple regression. For example, the auditor may have reliable monthly payroll expenditure, together with corresponding monthly figures for average numbers of staff in post, for the past few years. It would then be possible to develop a statistical model for the prediction of payroll expenditure in terms of staff numbers and time, and to use this model to predict expenditure in the current period from the corresponding staff numbers.

EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 25

**USING THE WORK OF OTHER AUDITORS AND EXPERTS**

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1      Reference to the INTOSAI Auditing Standard

1.1    Paragraph 132 of the INTOSAI Auditing Standards states that:

“The auditor should plan the audit in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way and in a timely manner.”

The explanation of this Standard states (para 134) that:

“In planning an audit, the auditor should:

...

- (g) review the internal audit of the audited entity and its work programme;
- (h) assess the extent of reliance that might be placed on other auditors, for example, internal audit”.

1.2    In addition, paragraph 152 of the INTOSAI Auditing Standards states that:

“Competent, relevant and reasonable evidence should be obtained to support the auditor’s judgement and conclusions regarding the organisation, program(*me*), activity or function under audit.”

## 2 Scope of this guideline

2.1 This guideline covers the use by European SAIs of the work of other auditors and experts:

- by auditors, the guideline includes the work performed by auditors internal to the audited entity and external auditors of third parties (such as the external auditors of economic operators entering into relationships with the audited entity including, where appropriate, SAIs of countries that are not Member States of the European Union) . However, this guideline does not cover the relationships between the European Community Supreme Audit Institutions;
- by experts, the guideline includes the work performed by professionals other than auditors. This may include experts employed directly by the SAI, consultants employed by the audited entity or experts operating on an independent basis (eg. academic researchers). Experts might include (for example):
  - economists;
  - lawyers;
  - architects, valuers, surveyors and insurance assessors;
  - statisticians;
  - social scientists and opinion surveyors;
  - scientific, technical and industrial experts;
  - management consultants.

## 3 Introduction

3.1 The work of other auditors and experts can be used in three ways in the context of the SAIs audits:

- at the task planning stage, reports prepared by other auditors and experts may provide the auditor with information about potential strengths and weaknesses in systems of control and about any history of serious errors that have arisen in the audit field.
- during the testing stage, the work of other auditors and experts can be used to provide a part of the audit evidence deemed necessary to achieve the audit objectives. By using the work of other auditors, it may be possible to reduce the amount of work undertaken by the SAI and thus release resources for other audit tasks.

- at the end of the audit, the reports of other auditors and experts can provide information to corroborate or cast doubt upon the findings obtained or preliminary conclusions that the auditor has reached on the basis of the evidence gathered during the audit testing stage;

This guideline is largely concerned with using the work of other auditors and experts at the testing stage as part of obtaining the necessary audit evidence. This is covered in paragraphs 6 to 8 below. Before dealing with this, however, it is necessary to briefly consider the use of the work of other auditors and experts at the planning stage (paragraph 4) and at the end of the audit (paragraph 5).

- 3.2 SAI's are often in a position to rely upon the work of **internal auditors** and thus reduce the amount of detailed testing that the SAI's themselves have to undertake. Such reliance often requires planning and close cooperation before or at the earliest stages of the audit. Thus, if any preliminary assessment of internal auditing is positive (see points 7.3 - 7.6 below), the SAI has the opportunity to consider and discuss with the internal auditor the extent to which the internal auditing work programme might be adapted to better take account of the needs of external audit. This may both minimise duplication of effort and maximise the scope for the SAI to use the work of internal auditing.

#### 4 Using the work of others at the planning stage

- 4.1 The work of other auditors and experts can be useful to the auditor at the planning stage. However, caution must be exercised in its use. Whilst the auditor may, as part of the planning process, take account of any available reports of other auditors and experts, he/she will always need to consider the reliability and appropriateness of these reports before determining their influence upon the audit testing to be carried out. This involves ensuring that the other auditor or expert that carried out the work was independent of the audited entity or activity and was objective in carrying out the work. In addition, the auditor needs to consider whether the objectives of the work and methods used by the other auditor coincide sufficiently closely with those for the audit task, whether the conclusions reached by the other auditor or expert were based upon sufficient evidence and whether the other auditor or expert concerned was professionally and technically competent.

#### 5 Using the work of others at the end of the audit

- 5.1 When the work of other auditors or experts corroborates the findings obtained or conclusions reached by the SAI's audit, then the auditor concerned can draw some comfort from that fact. However this comfort is additional to, and cannot be in place of, the competent, reasonable and relevant evidence<sup>(1)</sup> that the auditor must obtain to achieve the objectives of the audit.

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<sup>(1)</sup> see Guideline N° 13 "Audit evidence and approach"

5.2 When there is a discrepancy between the findings or conclusions arising from an audit of the SAI and those presented in the report of another auditor or expert, this may point to a weakness either in the work carried out by the SAI or in that done by the other auditor or expert. Alternatively, an apparent discrepancy may arise because the objectives of the two pieces of work were different. As far as is possible and cost-effective, the auditor needs to:

- investigate the cause of any such discrepancy;
- reconsider whether the analysis and interpretation of the audit evidence obtained was adequate and reasonable.

5.3 In cases where the findings or conclusions of other auditors or experts are not consistent with those obtained or reached by the SAI, and where the reports of those auditors or experts are or may become available to the audited entity, the possibility arises that the audited entity will question the SAI's findings or conclusions.

## 6 Obtaining audit evidence from the work of other auditors

Objective

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6.1 The work of other auditors can be used to obtain part of the audit evidence that is necessary to achieve the objectives of the audit task. The aims of so doing are to reduce the SAI staff resources that are necessary to carry out the audit task, to avoid unnecessary duplication of audit work and to minimise disruption imposed upon the audited entity.

Conditions for using the work of other auditors as audit evidence

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6.2 When using the work of another auditor or expert, it is important for the SAI to consider carefully whether:

- it has an adequate knowledge of the audit field to be able to make an informed assessment of the impact of the work of the other auditor or expert;
- the other auditor or expert has the required professional competence in the context of the specific assignment;
- the work of the other auditor or expert is adequate and the working methods are suitable for the SAI's purposes in the context of the objectives of the audit task concerned.

6.3 The SAI's relationships with other auditors and experts can be complex. Thus, it may prove difficult to carry out the assessment necessary to be able to use their work as audit evidence. This problem can be addressed at the planning stage of the audit so that, if

such use proves not to be possible, alternative audit procedures can be planned to ensure that competent, reasonable and relevant audit evidence is obtained.

- 6.4 As well as considering at the planning stage the factors listed in points **6.2 - 6.3** above, the auditor who is using the work of another auditor or expert as audit evidence must also reconsider them when analysing and interpreting the results of that work. In addition, the auditor needs to consider the impact upon the opinion that is to be expressed of the findings of the other auditor or expert. In cases where these findings are significant to the opinion, the auditor of the SAI should normally discuss these findings with the other auditor or expert and consider whether it is necessary to carry out any additional audit testing him/herself.
- 6.5 All aspects of the process of reliance on other auditors and experts outlined in points **6.2 - 6.4** above need to be fully documented in the audit task working papers (for further guidance, see Guideline N° 26 “Documentation”).

## 7 Special considerations concerning the work of internal auditors

### Definition

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- 7.1 “Internal auditing” means an appraisal activity established within an audited entity as a service to the audited entity. Its functions may include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of the accounting and internal control systems. In the Community context, “internal auditing” may include specialised functions such as that of the Financial Controller.
- 7.2 The role of internal auditing is determined by management and its objectives may thus differ from those of the external auditor. Nevertheless, there may be an overlap in the type and scope of work carried out by internal and external auditors.

### Understanding, assessing and promoting internal audit

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- 7.3 The auditor of the SAI needs to obtain an understanding of the structure and functioning of internal auditing and carry out a preliminary assessment of its work. To do this, the auditor needs unrestricted access to the reports and working papers of the internal auditor.
- 7.4 The preliminary assessment of internal auditing should normally cover the following:
- its operational status: the level to which the internal auditor reports and the action taken by management upon its reports; any restraints or constrictions imposed upon the internal auditor (especially in its communications with the external auditor);
  - the scope of its work;

- its technical competence, including the appointment, training, experience and professional qualifications of the internal audit staff;
- the conduct of its work: this covers whether internal auditing is properly planned, supervised, reviewed and documented as well as the existence of adequate audit manuals, work programmes and working papers.

7.5 In the absence of internal auditing or where the preliminary assessment of internal auditing reveals inadequacies, the SAI auditor needs to consider drawing these weaknesses to the attention of the management of the audited entity<sup>(2)</sup>.

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<sup>(2)</sup> In many cases, the SAI auditor may be in a position to provide advice to management on improvements in internal auditing (eg. recommendations of suitable training schemes and reporting structures). However, this needs to be done in such a way that the independence of the external audit function is not compromised.

## Using the work of internal auditing as part of the external audit evidence

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7.6 The considerations at points **6.2 - 6.3** and **7.3 - 7.4** above apply when using the work of internal auditing as part of the external auditor's evidence. In addition, the SAI auditor needs to consider whether:

- the evidence obtained through internal auditing is adequate in quality and quantity for the specific needs of the SAI, taking into account that objectives may be different. Examination by the SAI auditor of this question will normally include consideration of the nature, timing and extent of internal audit work;
- the conclusions reached by internal auditing are appropriate, given the audit evidence that has been obtained;
- all exceptions or unusual matters detected by internal auditing have been properly resolved;

7.7 In some situations written agreements are concluded between the SAI and audited bodies in order to ensure that the SAI can use the work of internal auditors to maximum benefit.

## 8 Special considerations when employing experts

### Objective

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8.1 The purpose of using other experts is to make available to the audit team technical knowledge or skills that are essential to the achievement of the audit objectives and that would not otherwise be available. Generally, experts are directly employed by the SAI on a contract basis and selected by the team responsible for the audit task.

### Conditions for appointing and using experts

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8.2 Experts are employed to assist the audit team in obtaining competent, reasonable and relevant audit evidence to achieve the audit objectives. To achieve this, the following conditions must be met:

- the scope and nature of the expert's work and the way in which the expert is to report need to be clearly defined at the earliest possible stage: this is essential to identify an expert who has the appropriate technical knowledge and skills;
- the SAI needs to assure itself that the expert is independent of the audited entity (usually, this means that the expert has not recently been employed by the audited entity or related organisations). SAIs may also need to consider whether the nature and scope of other work undertaken by the expert is such that the expert's



independence is compromised (for example, when the expert is largely dependent upon contracts with a third party whose interests may overlap with the area to be studied by the expert on behalf of the SAI);

- the auditor must assure him/herself of the professional competence of the expert, of the objectivity of the work produced by the expert, of the suitability of the working methods employed and of the competence, reasonableness and relevance of the audit evidence that the expert produces. Where necessary, the auditor should carry out additional testing work to obtain this assurance.

These conditions imply that the expert, who may not necessarily have experience in working in an audit environment, should be closely managed and guided by the audit task team leader. Detailed terms of reference can make this management and guidance easier.

- 8.3 The report that is issued as a result of an audit task in which an expert is employed remains a report of the SAI. The role of the expert is, typically, to assist the audit team, who remain responsible for forming and putting to the SAI an audit opinion. Thus, it is usually inappropriate to refer specifically to any opinion of the expert in the report arising from the audit.

#### Confidentiality

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- 8.4 Experts employed by SAIs are normally bound by requirements of confidentiality. Auditors who are working with experts need to make themselves familiar with these requirements and be prepared to advise experts accordingly. It may be appropriate to systematically insert confidentiality clauses in experts' contracts.

#### 9 Further reading

- 9.1 The Public Sector Committee of the International Federation of Accountants (IFAC)<sup>(3)</sup> published in October 1994 its Study #4 entitled "Using the work of other auditors - a public sector perspective" This provides further guidance to which readers of the present guideline may wish to refer.

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<sup>(3)</sup> International Federation of Accountants, 535 Fifth Avenue, 26th Floor, New York, NY 10017, USA

EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 26

**DOCUMENTATION**

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The content of working papers	3
Current and Permanent Files	4
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Retention of audit documentation	6

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1. Reference to the INTOSAI Auditing Standards

1.1 The explanation of the INTOSAI Standards (Paragraph 156) states that:

"Auditors should adequately document the audit evidence in working papers, including the basis and extent of the planning, work performed and the findings of the audit".

2. The benefits of adequate documentation

2.1. Adequate documentation helps the Supreme Audit Institutions (SAI) to improve its efficiency and effectiveness in that it:

(a) facilitates planning;

(b) provides a record of weaknesses, errors and irregularities detected by the audit;

- (c) confirms and supports the auditor's judgements, opinions and reports;
- (d) serves as a source of information for preparing reports or answering enquiries from the audited entity or from any other party, and provides a record of work done for future reference;
- (e) shows compliance with Auditing Standards and Guidelines, and with the internal procedures of the SAI;
- (f) supports (or provides a defence against) claims, law suits and other legal processes;
- (g) helps and provides evidence of the auditor's professional development;
- (h) facilitates review, supervision and quality assurance (see below).

2.2. Adequate documentation is particularly important for review, supervision and quality assurance. This is because it:

- (a) helps the reviewer to:
  - . ascertain whether the audit objectives have been achieved;
  - . ensure that delegated work has been properly performed;
  - . assess the judgements made by the auditor during the course of the audit and identify areas where additional work may be necessary to obtain evidence required to reach conclusions or make recommendations;
  - . carry out the tasks of reviewing audit working papers and supervising audit staff more efficiently and effectively.
- (b) provides the basis for independent quality assurance reviews (see Guideline N° 51 "Quality Assurance").

### 3. The content of working papers

3.1. All audit steps must be carefully documented, as well as the resulting observations and conclusions. This documentation is collectively known as working papers.

3.2. Working papers are the auditor's principal record of the work performed and the conclusions reached on significant matters. Working papers provide evidence of the auditor's exercise of due care and help the auditor conduct and supervise the audit.

3.3. Working papers are essential to support the audit. All phases of the audit, from the basic planning to the preparation of the final draft of the report, should be in the working papers. Each SAI should develop its own techniques to prepare, review and file working papers, generally based on its experience and its particular needs and environment.

- 3.4. It is not possible to prescribe what working papers should or should not include. However, as a general principle, a well-documented set of working papers will be sufficiently complete and detailed to enable an experienced auditor having no previous connection with the audit to ascertain from them what work was performed to support the conclusions.
- 3.5. Working papers must have a series of physical qualities such as clarity, legibility, completeness, relevance, accuracy, conciseness, neatness and understandability. If computer evidence is used, there should be adequate identification that completely describes its origin, content and location.
- 3.6. Working papers should be planned and, in many cases, formatted at an early stage in the audit. Prior years' working papers, if available, might be used as a guide.
- 3.7. The auditor should use marks to indicate the origins of data (etc.), comparisons, agreements and processing. In some SAIs, standard marks have been established for this purpose. Where this is not the case, or when the auditor uses non-standard marks for any reason, the meaning of the marks should be clearly indicated on the papers concerned. This applies equally to symbols used in flow diagrams.
- 3.8. In order to facilitate review, and in particular, to assist the reviewer in finding and evaluating the audit evidence that supports conclusions, recommendations and reports it is essential that working papers are cross-referenced backwards and forwards. These cross-references should clearly show the source and destination. It is to be noted that good cross-referencing requires clear and logical initial referencing of all working papers.
- 3.9. Working papers should normally be prepared on the basis that, and to a suitable standard so that they might be used as evidence in any legal procedure that could arise. Thus, auditors should sign and date their individual working documents.
- 3.10. It should be clear from the examination of a completed set of working papers who they were reviewed by, when, and what was the outcome of the review. Notes of reviewers indicating agreement, incomplete or unclear items should be retained. These are essential for use by higher level reviewers.
- 3.11. The documentation should include a record of all contact with the audited entity on significant matters (e.g. weaknesses found during tests of control, assurances received from the entity's management, etc.).

#### 4. Current and permanent files

- 4.1. Working papers relating to individual audits are generally known as current files. In addition to these, permanent files are often established. These contain the information that will be used year after year in successive audits in a specific area. These files are fundamental for planning audit work and its subsequent execution. They should be updated regularly.

5. Confidentiality of audit information

- 5.1. SAIs frequently have access to information which may be considered sensitive from a commercial, political or security point of view. The SAI and its personnel must exercise due professional care to ensure that such information is properly safeguarded and thus should establish procedures and controls to assure the physical security of working papers. Similarly, it is normal to treat working papers, communications with audited entities and draft reports as confidential documents until recognised and established procedures for their release have been followed.
- 5.2. SAIs must balance the need for confidentiality of audit information with any legislation allowing freedom of information to citizens.

6. Retention of audit documentation

- 6.1. It is important that SAIs have a clear policy for the storage and retention of documentation which supports the conclusions reached in published reports. This policy should cover, amongst other things :
- length of retention before destruction;
  - transfer of files from audit units to central storage;
  - standard file contents, indexing and retrieval procedures.

## GROUP 3 AUDIT COMPLETION

### EUROPEAN IMPLEMENTING GUIDELINES FOR THE INTOSAI AUDITING STANDARDS

N° 31

#### REPORTING

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INTOSAI Reporting Standard	Annex 1

- 
1. Reference to the INTOSAI Auditing Standards
    - 1.1. This Guideline concerns the final reporting of audits carried out by SAIs to the relevant external bodies and, when applicable, to the public.
    - 1.2. Paragraphs 163 to 191 of the INTOSAI Auditing Standards give extensive guidance on Reporting. These are summarised at **ANNEX 1** to this Guideline.
    - 1.3. In addition to the guidance given in paragraphs 163 to 191 of the INTOSAI Auditing Standards, further guidance is also given in Guideline N° 41 : “Performance Audit”.

2. Reporting of Joint and Coordinated audits

2.1. The reporting of audits conducted jointly by two or more SAIs and of coordinated audits may pose particular difficulties. It is advisable that a reporting procedure is agreed between the participating SAIs at the planning stage, and that the process is carefully monitored at the reporting stage so that problems can be addressed promptly.

2.2. The reporting procedure should cover the following points:

- . the reporting timetable;
- . the precise responsibilities of each SAI for drafting reports;
- . the language in which reports are to be drafted, and translation arrangements;
- . clearance of draft reports within the participating SAIs and with the audited entities (correspondence, meetings, treatment of replies/comments);
- . publication arrangements, including communications with the press, etc.;
- . presentation of the reports to parliamentary and/or other authorities.

## ANNEX 1 : SUMMARY OF THE INTOSAI REPORTING STANDARDS

1. The expression "reporting" embraces both the auditor's opinion and other remarks on a set of financial statements and the auditor's final report on completion of a performance audit.
2. Paragraph 169 of the INTOSAI Auditing standards states that:
  - (a) At the end of each audit the auditor should prepare a written opinion or report, as appropriate, setting out the findings in an appropriate form; its content should be easy to understand and free from vagueness or ambiguity, include only information which is supported by competent and relevant audit evidence, and be independent, objective, fair and constructive.
  - (b) It is for the SAI to which they belong to decide finally on the action to be taken in relation to fraudulent practices or serious irregularities discovered by the auditors.

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

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

3. In the explanation of the INTOSAI Auditing Standards (Paragraph 170) a guidance is provided on the form and content of all audit opinions and other reports on financial audits. The auditor must have specific regard to the following aspects of the report:
  - Title
  - Signature and date
  - Objectives and scope
  - Completeness
  - Addressee
  - Identification of subject matters
  - Legal basis
  - Compliance with standards
  - Timeliness



4. The explanations of the INTOSAI Auditing Standards (Paragraphs 171-182) outline the usual format of audit opinions, including adverse and qualified opinions and the action necessary in cases where weaknesses, irregularities or non-compliance are detected by the auditor.
5. The explanations of the INTOSAI Auditing Standards (Paragraphs 183-188) give specific guidance on the reporting of performance audits, particularly with regard to the objectivity and fairness that the auditor should use in interpreting and presenting the evidence obtained. So far as possible, reports should be constructive and recommend improvements that are necessary to overcome weaknesses.
6. The explanations of the INTOSAI Auditing Standards (Paragraphs 189-191) provide guidance on what should be included in reports, having regard to the materiality of the matters concerned (including materiality by nature and context, as well as by value).

EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 32

**“OTHER INFORMATION IN DOCUMENTS CONTAINING  
AUDITED FINANCIAL STATEMENTS”**

CONTENTS

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1. Introduction

1.1. The purpose of this Implementing Guideline is to provide the external auditor (“auditor”) of European Community activities with guidance on the audit of other information in documents containing audited financial statements.

1.2 Because the constitutional mandates of the National Audit Institutions and the European Court of Auditors may impose different responsibilities for the audit of other information in documents containing audited financial statements, the guidance contained in this Implementing Guideline needs to be applied as appropriate for the particular circumstances concerned.

2. Scope of this guideline

2.1. Increasingly, documents presented by audited entities that contain audited financial statements also contain other information. Other information which may be both financial and non-financial, includes the analysis and review of operations and financial results,

performance measures, expenditure plans and future prospects (see paragraph 4.1. below).

2.2. Other information will often be read in conjunction with the audited financial statements. Users often attach great importance to other information because it contributes to establishing an understanding of the audited entity's operational and financial performance, its financial circumstances and resources, and its plans and future prospects.

2.3. The purpose of this implementing guideline is to:

- define other information in documents containing audited financial statements ; and
- provide guidance for the auditor when considering other information, including the course of action the auditor should follow regarding material misstatements and inconsistencies in other information.

### 3. Auditor's Responsibility and Other Information

3.1. An audit of financial statements is directed towards giving an opinion on those statements. An auditor will often have no responsibility to report that other information is properly stated. The auditor should be aware, however, that the credibility of the financial statements and his report thereon may be undermined by inconsistencies between the financial statements and other information, or by misstatements within the other information. The auditor should therefore normally review the accuracy and consistency of such other information.

3.2. Under the legislative requirements in individual countries or under the terms of his engagement, the auditor may be required to report the results of his review. Unless stipulated in statute or in the terms of engagement, the auditor must establish the extent to which such a report will include the results of his review or other information.

3.3. When reviewing other information published in documents containing financial statements it is important to establish that management of the audited entity is to be held responsible for the content. One of the basic postulates for the INTOSAI Auditing standards (INTOSAI Auditing Standards, paragraph 6 (d)) states:

“ Development of adequate information, control, evaluation and reporting systems within the government will facilitate the accountability process. Management is responsible for correctness and sufficiency of the form and content of the financial reports and other information.”

### 4. Basic Concepts and Definitions

4.1. The following are examples of other information that might appear in documents containing audited financial statements :

- the annual report of management
- reference to plans and budgets for future periods
- reference to ongoing or planned projects or activities
- reference to events occurring after the accounting period
- explanations as to how an account-related estimate has been calculated
- information on analysis of operating results, productivity and performance measures
- reference to organisational circumstances
- reference to relevant legislation and any changes thereto and
- reference to environmental circumstances.

It is important for the auditor to be aware of the limitations on the scope of his review of other information. For example, the auditor cannot confirm or approve plans and budgets of the audited entity but merely evaluate whether there is consistency between the bases and methods used in the determination of estimates.

4.2. When reviewing other information in documents containing audited financial statements, the auditor should consider:

- whether the other information is inconsistent with the audited financial statements and
- whether there are misstatements in references to the financial situation and future development which give an inaccurate, insufficient or misleading impression of the audited entity's circumstances.
- The auditor might also consider whether any information, which could be of importance to the users, has been omitted.

4.3. A misstatement or inconsistency will be material if it is likely to influence the users of the financial statements or other information that accompany them. More specifically:

- a material misstatement of fact exists when significant other information not related to matters appearing in the audited financial statements is incorrectly stated or presented and
- other information, or the manner of its presentation, is materially inconsistent when it contradicts information in the audited financial statements and is of such significance as to raise doubt about the basis of the auditor's reports on those financial statements.<sup>(1)</sup>

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1) The definitions of material misstatements and material inconsistency given here are derived from the New Zealand Society of Accountants Auditing Guidelines #8 (1986).

- 4.4. Whilst a major factor will be the financial importance (material by value) of the matters concerned, the auditor should also reach a judgement as to whether the misstatement or inconsistency is material because of the context in which it appears or because of its nature. For example, a minor misstatement or inconsistency in a management report that accompanies the audited financial statements may lead the reader to form an unrealistically optimistic view of the audited entity's performance or future prospects.
- 4.5. The auditor should always be particularly alert to the possibility that misstatements or inconsistencies (including omissions) in other information are made intentionally by the audited entity's management. Certain circumstances may be present that increase the inherent risk of such intentional misstatements or inconsistencies. For example, the management of the audited entity may be under political pressure to achieve certain levels of performance or the salaries of senior managers may be determined by the achievement of predetermined objectives or performance measures.

## 5. Audit Planning and Procedures

5.1. The auditor should review other information in documents containing audited financial statements regardless of whether the auditor is required to report on the review or not. When planning the review of other information, the auditor should be alert to the possible consequences of inconsistency or misstatements in this information. The review must be planned and performed in accordance with the auditor's estimation of risk and materiality.

5.2. Omissions might be identified by the auditor by comparing the current year's other information with that published in previous years and thus identifying any inconsistencies over time in the other information presented. Alternatively, omissions might be identified, for example by examining the minutes of meetings of the management board, etc.

5.3. An auditor will usually conduct the review of other information in conjunction with the audit of the financial statements.

5.4. If the auditor assesses that the other information together with the financial statements:

- give an incorrect or an inadequate impression of the audited entity's activities or general situation, or
- leave the reader in doubt about the content or the adequacy of the information in one or more areas

the auditor should seek to resolve the matter. This may involve interviewing management of the audited entity and examining additional documentation.

5.5. As for other audit procedures, the auditor should evaluate and independently assess the evidence supporting the disclosure within other information based on the auditor's knowledge of the area and the results of the examination.

## 6. Reporting

6.1. The auditor's reporting of the results of the review of other information depends on:

- whether he is obliged to report and
- whether he considers that the other information contains misleading or inconsistent information which is likely to be material to the user.

6.2. When the review of other information reveals cases of misstatements or inconsistencies, the auditor should normally draw all of these to the attention of the management of the audited entity. The auditor should request the management of the audited entity to make

an appropriate amendment to the financial statements or add information in order that any material inconsistencies or errors are satisfactorily resolved.

- 6.3. If the management of the audited entity do not agree to make any required amendments or cannot do so,<sup>(2)</sup> and the auditor considers the inconsistency or misstatements to be material, the auditor should consider the implications for his report on the financial statements. If material inconsistencies or misstatements are discovered after the auditor's reporting on the financial statements, then the auditor should consider taking appropriate further action (e.g. inform the relevant ministry).
- 6.4. The nature of the auditor's report may differ according to the legislative requirements in individual countries and the terms of the engagement. However, where the auditor is obliged to report or where he decides to do so, it is often appropriate, as a minimum, for the auditor to give a brief description of the work performed as well as the results including material misleading or inconsistent disclosures.

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2) For example, in the European Community the financial statements and accompanying information is made available to the European Court of Auditors in its final form and is forwarded to the discharge authorities at the same time that it is made available to the Court.

## GROUP 4 PERFORMANCE AUDIT

### EUROPEAN IMPLEMENTING GUIDELINES FOR THE INTOSAI AUDITING STANDARDS

N° 41

#### PERFORMANCE AUDIT

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1      Reference to the INTOSAI Auditing Standards

1.1    Paragraphs 38 and 40 of the INTOSAI Auditing standards state that:



"The full scope of government auditing includes regularity and performance audit".

"Performance auditing is concerned with the audit of economy, efficiency and effectiveness and embraces:

(a) audit of the economy of administrative activities in accordance with sound administrative principles and practices, and management policies;

(b) audit of the efficiency of utilisation of human, financial and other resources, including examination of information systems, performance measures and monitoring arrangements, and procedures followed by audited entities for remedying identified deficiencies; and

(c) audit of the effectiveness of performance in relation to the achievement of the objectives of the audited entity, and audit of the actual impact of activities compared with the intended impact".

## 2. The mandate for performance auditing

2.1 In many countries, the constitution or legislation gives the SAI the right to undertake some form of performance audit. In some countries, the SAI has an obligation in certain circumstances to carry out some performance audit or to reach an opinion upon the reliability of performance indicators published by audited entities in their annual reports or similar. Even in countries where the constitution or legislation do not require the SAI to carry out audits of economy, efficiency and effectiveness, present practice shows a tendency to include this sort of work as part of financial and regularity audits ('comprehensive/integrated audit'). These audits often require the auditor to assess systems resulting in professional judgements relating to the efficiency and effectiveness of organisational structures and procedures, and to the economy with which actions were undertaken.

2.2 The global objectives of performance audit vary in different countries. They may be defined in the SAIs' basic legislation or be a matter for internal decision within the SAI. In general, most SAIs set to achieve one or more of the following global objectives:

- a. to provide the legislature or discharge authority with independent assurance as to the economic, efficient and/or effective implementation of policy;
- b. to provide the legislature or discharge authority with independent assurance as to the reliability of indicators of or statements about performance that are published by the audited entity;
- c. to identify areas where performance is poor and thus to help the audited entity, or government more generally, to improve their economy, efficiency and/or effectiveness;
- d. to identify examples of "best practice" and draw these to the attention of government and/or audited entities.

2.3 As part of the explanation of the standards, paragraph 42 of the INTOSAI Auditing Standards states that:

“In many countries the mandate for performance auditing will stop short of review of the policy bases of government programs”.

In these cases, performance audits do not question the merits of policy objectives but rather involve examination of actions taken to design, implement and evaluate the results of these policies, and may imply an examination of the adequacy of information leading to policy decisions (review of the planning phase of the policy cycle).

2.4 The INTOSAI standards applicable to performance audit are mentioned under the relevant headings in this guideline.

### 3. Basic concepts and definitions

#### 3.1 Performance audit

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As stated in paragraph 1 above, performance audit (or “value-for-money audit”, “audit of sound financial management”, “management audit”, ...) is concerned with the examination of economy, efficiency and/or effectiveness (“the three Es”). An individual performance audit may have as its objective to examine one or more of these three aspects.

A performance audit may thus include an examination of the systems put in place to secure aspects of the “three E’s” and/or a substantive examination of the audited entity’s performance in these respects. A performance audit may also involve an examination of the governance of the audited body, activity, programme or operation. In this latter sense, the audit will usually focus on questions relating to how the executive carries out its functions of strategic and other planning, implementation, control, evaluation and follow-up.

3.2 *Economy* can be understood as minimising the costs of resources or the use of public assets employed for an activity (the inputs), having regard to the appropriate quality<sup>(1)</sup>.

Economy refers to the standard of “good housekeeping” in spending public money. What should be called “good housekeeping” or “wasteful” is a matter of judgement that requires an external criterion (e.g. golden taps are excessive, for steel taps are as functional; however, there would be agreement on the functionality of a queen's crown being made of gold!)

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<sup>1</sup>In certain audits (of revenue, income or receipts), economy could imply maximising or optimising the revenue arising from the activity concerned (eg. maximising the proceeds arising from the privatisation of a state-owned company, ensuring that government publications are sold at the market price, etc.).

Consideration of economy often leads the auditor to examine such things as the drawing up of specifications for the supply of goods and services and other aspects of procurement, such as tendering and contracts.

*Efficiency* is the relationship between the outputs, in terms of goods, services and other results, and the resources (inputs) used to produce them. As such, efficiency is closely related to the concept of “productivity”.

Efficiency will, like economy, also need a reference point to be fully appreciated, e.g. the comparison with input and output ratios of similar organisations (“bench marking”, “best practice” standards, etc.).

The concept of *cost effectiveness* is concerned with the efficiency of an audited entity, activity, programme or operation in achieving given intervention outcomes in relation to its costs. Cost-effectiveness analyses are studies of the relationship between project costs and outcomes, expressed as costs per unit of outcome achieved. Cost effectiveness is just one element in the overall examination of efficiency, which might also include an analysis of such things as the time at which outputs were delivered against the optimal timing to maximise impact.

*Effectiveness* is concerned with measuring the extent to which the objectives have been achieved and the relationship between the intended impact and the actual impact of an activity.<sup>(2)</sup>

The auditor might seek to assess or measure effectiveness by comparing outcomes (or “impact”) with the goals set down in the policy objectives (this approach is often described as “goal achievement”). However, it is usually more appropriate when auditing effectiveness to also seek to determine the extent to which the instruments used have contributed towards the achievement of the policy objectives. This is the audit of effectiveness in its “true” meaning and requires evidence that the outcomes observed are actually the results of the action taken by the audited entity in respect of the policy goals being audited and not the results of some other external factors. For example, if the policy objective is to reduce unemployment, is an observed reduction in the number of unemployed people the result of the actions of the audited entity, or did it result from a generally improved economic climate over which the audited entity had no influence? Here, the design of the audit must include questions of attribution: it faces the problem of effectively excluding external, intermediary variables.

3.3 Economy and efficiency are generally concerned with processes and management decisions internal to the audited entity (although this may involve making comparisons with similar external entities or processes). However, effectiveness audit can be understood:

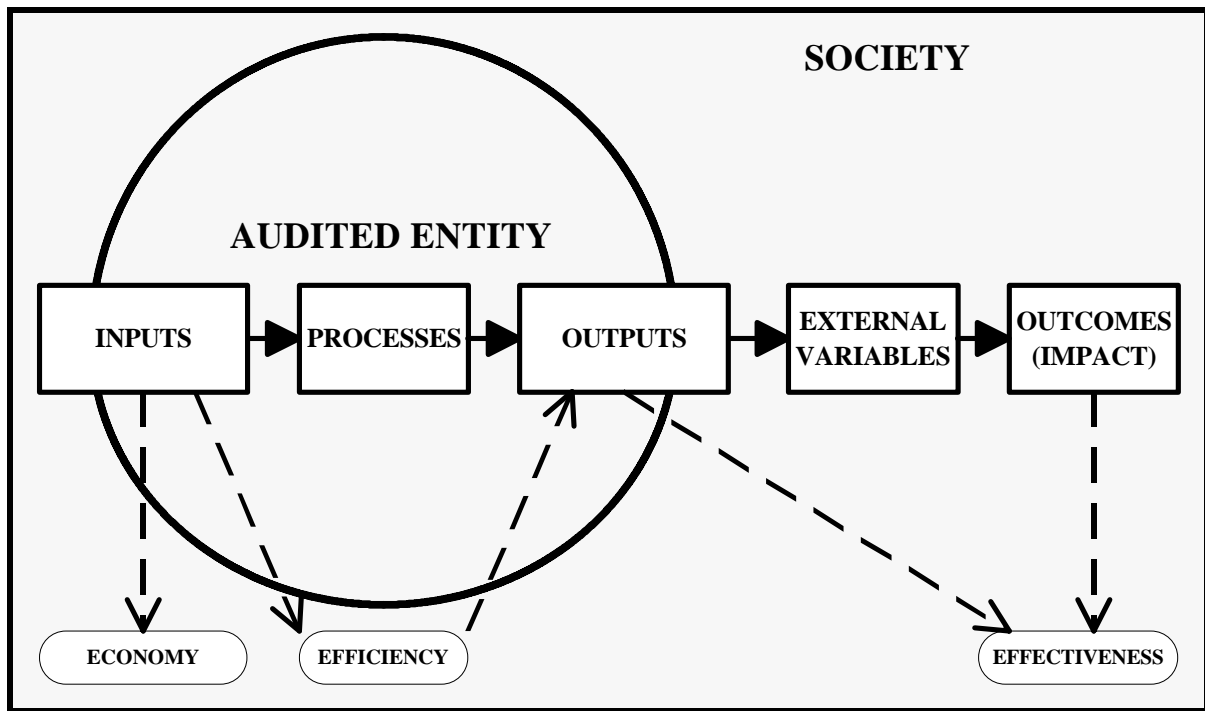
- in a restricted sense, whereby only the management and operations internal to the audited entity are examined. In these circumstances, an audit of effectiveness will

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<sup>2</sup>Source: INTOSAI Audit Standards, Glossary. See also guideline N° 13 “Audit Evidence and Approach”, Annex 2, point 6.1.

normally focus on the outputs of the entity and will thus examine the “internal impacts” (ie. those identifiable within the audited entity).

- in a broader sense, whereby the examination extends beyond the boundaries of the audited entity. In this case, an audit of effectiveness may seek to measure not only the outputs, but also the outcomes or impact achieved by the audited entity. To achieve this, the auditor must take account of the impact that external variables (ie. factors outside of the control of the entity’s management) have upon the outputs of the audited entity.



3.4 The diagram below illustrates these concepts.

3.5 Whilst a particular performance audit will not necessarily seek to reach conclusions about all three aspects (ie. economy, efficiency and effectiveness), there may be limited benefit in examining in isolation aspects of economy or efficiency of activities without also considering - at least briefly - their effectiveness. Conversely, in an audit of effectiveness, the auditor may also wish to consider aspects of economy and efficiency : the outcomes of an audited entity, activity, programme or operation may have had the desired impact, but were the resources employed to achieve this used economically and efficiently ?

For the examination of effectiveness, it is generally necessary to assess the outcome or impact of an activity. Thus, whilst a systems based approach may be useful (e.g. to assess how the audited entity measures and monitors its impact), the auditor will usually also need to obtain sufficient substantive evidence of the outcome and impact of the activity, programme or body.

3.6 A specific aspect of both efficiency and effectiveness audits is formed by the study of the *unintentional effects*, especially if these effects were negative. There is a problem of demarcation here, because these effects may spread into areas beyond the competence and powers of the SAI. A way of limiting the choice might be to look at those unintentional effects that are being combatted in other programmes, e.g. environmental side effects of an economic stimulation programme.

4. Financial audit and performance audit: similarities and differences

4.1 As part of the explanation of the standards, paragraph 183 of the INTOSAI Auditing Standards states that:

"In contrast to regularity [*ie. financial*] audit, which is subject to fairly specific requirements and expectations, performance audit is wide-ranging in nature and is more open to judgement and interpretation; coverage is also more selective and may be carried out over a cycle of several years, rather than in one financial period; and it does not normally relate to particular financial or other statements. As a consequence, performance audit reports are varied and contain more discussion and reasoned argument".

Auditing Standards  
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4.2 Notwithstanding the wider nature and possible scope of a performance audit, the auditor must still seek, to the fullest degree possible in the circumstances of the specific audit being undertaken, to carry out that audit in accordance with the INTOSAI Auditing Standards. In particular, the auditor:

- may need, in determining the extent and scope of the audit, to study and evaluate the reliability of internal control (INTOSAI Auditing Standards, paragraph 141 - see Guideline N° 13 “Audit evidence and approach”);
- should plan the audit in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way and in a timely manner (INTOSAI Auditing Standards, paragraph 132 - see Guideline N° 11 “Audit Planning”); and
- should ensure that competent, relevant and reasonable evidence is obtained to support the auditor’s judgement and conclusions regarding the organisation, programme, activity or function under audit (INTOSAI Auditing Standards, paragraph 152 - see Guideline N° 13 “Audit evidence and approach”). This evidence and the judgements made by the auditor on the basis of this evidence must be adequately documented and subject to quality assurance measures (Explanation of the INTOSAI Auditing Standards, paragraphs 156 - see Guidelines N° 26 “Documentation” and INTOSAI Auditing Standards, paragraph 118 - see Guideline N° 51 “Quality assurance”).

Moreover, given that performance audit may be more open to judgement and interpretation than financial audit, the auditor must exercise additional care to ensure the independence and objectivity of the report that is produced.

## The choice of audit subjects and the preliminary study

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- 4.3 In financial audits, the audit subject is often defined for the SAI by its own basic legislation or by the legislation establishing or governing the audited entity. The SAI is often required to provide an audit opinion upon the annual accounts of the audited entity or to comment in its annual report upon the legality and regularity of the audited entity's operations, etc. As noted in paragraph 4.1 above, the SAI usually has much greater freedom in the choice of performance audit subjects. Thus a performance audit may examine an audited entity, a programme, an activity or individual operations, etc. The SAI must therefore give careful consideration to the criteria to be applied in choosing subjects for performance audits (see paragraph 5.2 below).
- 4.4 In contrast to financial audits, the greater degree of freedom in the selection of subjects, coupled with the wider-ranging nature and greater opportunity for judgement and interpretation in performance audits, means that many SAIs consider it necessary to undertake detailed preliminary studies before performance audit plans can be drawn up (see paragraphs 5.3 to 5.6 below).

## Assessment criteria

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- 4.5 In financial audits, transactions that are examined tend to be judged by the auditor as being "correct" or "incorrect", "legal" or "illegal", etc. These assessment criteria that the auditor uses for reaching a final opinion at the end of the audit tend to be relatively closed and are usually predefined by, for example, the legislation establishing the audited entity. For performance audits, however, the choice of audit criteria is normally more open and made by the auditor himself. Thus, in performance auditing, the general concepts of 'economy', 'efficiency' and 'effectiveness' need to be interpreted in relation to the subject audited and the resulting criteria will vary from one audit to another<sup>(3)</sup>.

## The nature of audit evidence

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- 4.6 Paragraph 152 of the INTOSAI Auditing Standards states that:

“Competent, relevant and reasonable evidence should be obtained to support the auditor's judgement and conclusions regarding the organisation, program, activity or function under audit.”

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<sup>3</sup>Nevertheless, the auditor will usually have to refer to the legislative and regulatory environment establishing the activity being examined and determining its execution so as to identify the policy objectives and the instruments that are available to achieve these.

4.7 Whilst much evidence in financial audits tends towards being conclusive (“yes/no”, “right/wrong”), this is infrequently the case in performance audits. More typically, performance audit evidence is persuasive (“points towards the conclusion that ...). The auditor must carefully choose appropriate auditing methodologies so as to obtain audit evidence that is strongly persuasive (and to take advantage of any possibilities that exist to obtain conclusive evidence). Often the auditor may seek to obtain different types of data from different sources using different methodologies: if all this evidence points towards the same conclusion, the SAI’s report may be more persuasive.

4.8 When working in areas where the evidence to be obtained is persuasive rather than conclusive, it is frequently useful to discuss in advance with the audited entity the nature of the evidence to be obtained and the way in which it will be analysed and interpreted by the auditor. This approach reduces the risk of disagreement between the auditor and the audited entity at later stages and may speed up the reporting process. At least, it will normally permit the auditor to identify areas of potential later disagreement and allow the auditor to plan to obtain any additional evidence necessary to overcome these.

#### The audit approach

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4.9 As in financial audits, the audit approach for performance audits needs to be structured and the stages of the audit carried out in a logical order<sup>(4)</sup>. The audit might include both:

- in-depth examinations of systems of internal control procedures put in place by audited entities to ensure the economy, efficiency and effectiveness of their operations<sup>(5)</sup>. This allows the auditor to identify areas where remedial action is necessary to secure improvements;

and/or

- substantive examinations of the economy, efficiency and/or effectiveness of the organisations, activities, programmes or functions concerned.

4.10 In financial audits, the auditor may have the choice between adopting a systems-based or a direct substantive testing approach. Generally speaking, however, a performance audit report that identifies weaknesses in systems or procedures and provides examples obtained from substantive tests of the effect of these weaknesses (in terms of failures to achieve economy, efficiency and/or effectiveness) will have more impact than one that identifies weaknesses in systems without indicating the effect of these weaknesses or, conversely, identifies substantive cases of poor economy, efficiency and/or effectiveness without

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<sup>4</sup>Decide what to examine and identify the audit objectives, the key audit questions and the main audit criteria (points 4.3 to 4.5 above); plan the audit (point 5 below); carry out the audit (point 6 below); report and follow up the outcome of the report (point 7 below).

<sup>5</sup>It is to be noted that the INTOSAI Auditing Standards (paragraph 141) requires that the auditor carries out at least a limited examination of the reliability of internal control as part of the planning process.



identifying the reasons for these. Thus the auditor may often opt in a performance audit to obtain a mixture of systems-based and substantive evidence.

- 4.11 In circumstances where internal control procedures are highly developed, and particularly when legislation makes it mandatory upon ministerial departments and other agencies to have their policy programmes and their organisations (self-) evaluated ('self-assessment') on a regular basis, SAIs may choose to limit their performance audit to a form of meta-evaluation (evaluating the evaluations). It must be underlined, however, that such an approach is only feasible when the SAI auditor is fully satisfied that the internal evaluation processes provide objective, timely and comprehensive assessments of the programmes concerned.

## 5. Performance audit planning

- 5.1 Performance audits need to be planned. The main characteristics of the planning process are described in Guideline N° 11 “Audit planning”. This guideline concentrates on the planning aspects that are specific to performance audit design.

The choice of audit subjects  
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- 5.2 The choice of audit subjects will be based on the SAI's programming policies. The criteria for establishing priorities for audit tasks normally centre around the added value of the audit in terms of the central mission of the SAI. The added value is normally greater:

- when the special powers of the SAI are fully employed;
- when the policy field, organisation, activity, programme or function in question has not been subject to independent audit examination or evaluation in the recent past; or when it fits into the systematic coverage of the field/organisation in question in the long term work programme of the SAI.
- when there are significant risks involved of poor financial management, performance or value for money. The following are examples of factors that may point towards high risk:
  - the financial or budgetary amounts involved are substantial, or there have been significant changes in the amounts involved (eg. sudden growth or contraction of a programme);
  - areas traditionally prone to risk (procurement contracts, high technology projects, environmental projects, ...)
  - new or urgent activities;
  - complex management structures, confusion about responsibilities and lines of accountability, ...

- when the subject is of potential or current Parliamentary or public interest.
- when any conclusions arising from the audit can be influential in the framing of new or revised legislation or internal management procedures in the same policy area or can be applied in other related or similar areas of government activity.

#### Audit planning and the preliminary study

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- 5.3 After the choice of the audit subject has been made, the auditor can proceed to plan the performance audit. As was noted in paragraph 4.4 above, the fact that the auditor is faced by a more complex situation when conducting a performance audit than when undertaking a financial audit means that more attention must be given to its initial preparation and it may be necessary to undertake a “preliminary study” (or “pre-study”) before the definitive audit plan is drawn up.
- 5.4 The preliminary study and audit plan are largely concerned with the *design* of the performance audit and will often include the following elements:
- a. an analysis of the *context* of the activities in question including the objectives, performance to date and the regulatory environment.
  - b. obtaining an understanding of the audited entity or activity, including an understanding of the key management systems and information flows;
  - c. a statement of *audit objectives* (what is the planned outcome or effect of the audit?), and of the key audit *questions* to be answered to achieve the audit objectives.

The key audit objectives and questions are of pre-eminent importance in planning and carrying out performance audits.

The audit objectives will usually be closely related to the SAI's mission (which usually refers to the improvement of the efficiency and regularity of government operations); meanwhile, the key audit questions are dictated by the nature of the subject and by the objectives of the audit.

There are three types of inquiries and audit questions: descriptive (what is?), normative (what ought to be?) and cause-and-effect questions.

Together the audit objectives and the key audit questions are used to assist in identifying the audit evidence that will be necessary and thus the audit methodology as well as the audit assessment criteria.

- d. determination of the *audit evidence* that will answer the audit questions.  
The relevance, reliability and sufficiency of any data available within the audited entities (eg. performance indicators) should be evaluated. The possibility of collecting the required evidence (data availability) should also be tested.
- e. the choice of the *methods* to be used to gather and analyse audit evidence.

In performance audits, auditors frequently experience problems in obtaining and analysing the required audit evidence. It is thus usually advisable to test at the planning stage the practicality of proposed methods for gathering and analysing data.

f. the establishment of the *audit assessment criteria*.

The audit assessment criteria represent the normative standards against which the audit evidence is judged. For example, an auditor examining the economy of health services may seek to compare the costs of drugs dispensed at the hospital being audited against standard costs set by the responsible Ministry.

These assessment criteria will vary according to the specific audit subject and objectives, the legislation governing the organisation, activity, programme or function under audit, the stated objectives of the organisation (etc) and the specific normative criteria that the SAI deems relevant and important for the case.

In selecting assessment criteria, auditors must ensure that these are relevant, reasonable and attainable.

The assessment criteria need to be clearly stated and validated and where possible, drawn from authoritative sources, for example:

- legislation or official statements of policy or other published objectives and standards;
- accepted organisational and management theory and practice;
- industry standards or other relevant comparators.

Since organisations tend to “treasure what they measure”, the auditor must take particular care if the criteria adopted for the audit are those set and used by the audited entity itself. As well as quantitative criteria, the auditor should also consider using qualitative criteria.

In delineating the audit *subject*, the *key questions* as well as in the description of the audit *criteria*, central concepts should be correctly and carefully *defined*. This applies to both conceptual and operational definitions.

5.5 As well as the above questions relating to the design of the audit, the preliminary study and the audit plan that results will normally also include:

a. an evaluation of the *professional knowledge and skills* required by the audit team to carry out the audit.

In cases where the auditors concerned do not possess the required skills, consideration should be given to obtaining them from outside, either from other staff of the SAI or by using external consultants (see the guideline “Using the work of other auditors and experts”. Where the required skills and knowledge will not be available to the audit team, it is necessary to consider whether it will be possible to undertake the audit foreseen.

b. a budget for the *resources* needed to carry out the examination, and a timetable.

c. possible *conclusions and impact* of the examination.

The proposed outcome of the performance audit should also be judged in terms of 'usefulness' and 'feasibility'. Taken together with the resource budget for the audit, consideration of these factors should allow the auditor to reach a global assessment of the potential added value to be created by the audit.

- d. The auditor may wish also to consider the major *stakeholders* and their views and interests.

The auditor may wish to consult with and, to the extent possible without compromising the independence of the audit, take account of the views of stakeholders in defining the audit questions and preparing the audit plan.

- 5.6 Planning is often the key element in successful performance auditing. Careful planning generally gives rise to a cheaper, quicker audit that results in a more effective report. Many SAIs have found that it is beneficial to undertake a detailed preliminary study before reaching a final decision as to whether the audit should proceed.

## 6. Performance Audit Methodology

- 6.1 The specific nature of performance audits requires a careful choice of *methodologies* for examining the variables under scrutiny. The requirement to obtain competent, relevant and reliable audit evidence (INTOSAI Auditing Standards, paragraph 152) will normally influence the decisions taken by the auditor regarding appropriate methodologies. For performance audits in particular, the auditor will be concerned about the validity and the reliability of the methods used to collect and analyse data:

- \* Validity: methods/techniques should measure what they are intended to measure;
- \* Reliability: findings should remain consistent if measurements are made repeatedly from the same population of data.

Performance audits can draw upon a large variety of methods and techniques, for example surveys, interviews, (quasi-)field experiments, before-after studies, secondary data analysis, benchmarking etc. Within these general strategies, varying designs are possible and practised. **ANNEX A** provides an overview of some of the more commonly used methodologies in performance audits.

- 6.2 As stated in paragraph 4.2 above, auditors should seek to carry out performance audits in conformity with the other INTOSAI Auditing Standards and these will also influence the choice of methodologies.

### Fieldwork

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- 6.3 For general guidance on fieldwork, see Guideline N° 13 “Audit evidence and approach”. Consideration of this guideline may in particular lead the auditor to consider whether a systems based approach should be adopted for the specific audit that is being carried out.

Even in cases where it is decided not to follow a systems based approach, the auditor should, as part of the audit planning process, have carried out a preliminary assessment of the system of internal control procedures.

- 6.4 The following comments apply specifically in the context of performance audits.
- 6.5 *Data collection* may be on a one-time basis or through ongoing measurement (time series design, longitudinal analysis). Information may be gathered on the basis of physical evidence, documents (including written statements), oral testimonies (interviews) or by other means depending on the objectives of the audit. Often, it will be necessary to collect both qualitative and quantitative data. The types of data to be obtained should be explainable and justifiable in terms of their sufficiency, validity, reliability, relevance and reasonableness.
- 6.6 The results of fieldwork and analysis (the audit evidence), along with the audit planning documentation, need to be *documented*, filed and cross-referenced so as to permit audit managers to review the work done and validate the conclusions reached (see Guideline N° 26 “Documentation” and Guideline N° 51 “Quality assurance”).

## 7. Performance Audit Reporting

- 7.1 For general guidance on audit reporting, see Guideline N° 31 “Reporting”.
- 7.2 Published reports arising from performance audits normally include the following elements:
- a summary of the *context* in which the activities under scrutiny take place, including the organisational context;
  - the *objectives* for those activities, a description of the activities, and an analysis of the prospects for achieving economy, efficiency and effectiveness, leading to a statement of the objectives of the audit;
  - a description or summary of *audit methodologies* used for collecting and analysing data and an indication of the sources of the data;
  - an explanation of the *criteria* used to interpret the findings;
  - the audit *findings* or, at least, those audit findings that are considered material to the intended users of the report;
  - *conclusions* relating to the audit objectives.

Depending on the policy of the SAI, the report may also include *recommendations* arising from the conclusions.

- 7.3 The relationship between audit objectives, criteria, findings and conclusions needs to be verifiable and complete. To allow the user to verify the conclusions, the report needs to explain this relationship. The link between the audit findings and the conclusions needs to be complete and clearly expressed. In cases where the auditor has ascribed different relative

weights to the various audit criteria as applied in the conclusions, this also needs to be made clear in order to help the user to understand the report.

- 7.4 In cases where it is the policy of the SAI to make *recommendations*, there needs to be a clear link between conclusions and recommendations. *Recommendations* should normally only be made when the audit has identified plausible, cost effective remedies for any weaknesses identified. These should not normally amount to detailed implementation plans - which are a matter for management - but should indicate the main components of any changes required, with due regard to the likely cost of implementation. It should normally be made clear who was responsible for failings identified and who should be responsible for rectifying them.
- 7.5 Performance audit reports should aim to be *objective and fair* in their presentation. This requires that:
- there are separate presentations of findings and conclusions;
  - the facts are presented in neutral terms;
  - all relevant material findings are included;
  - reports are constructive and positive conclusions are also presented.

#### Consultation with the audited entity

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- 7.6 For most SAIs, the management of the audited body is normally given the opportunity to comment on the draft report. So as to ease this process and achieve a constructive and positive dialogue, the auditor may seek to have discussions and exchanges of views, on either a formal or informal basis, both at the preliminary study/planning stage and as the audit fieldwork progresses.

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## **Performance Audit Methodology**

Performance audits can draw upon a large variety of methods and techniques. A short description is offered below of the most commonly used methods and techniques for data gathering and for analysis of that data.

### **1 Data gathering techniques**

#### **1.1 File examination**

Documents provide a very efficient way of collecting data and file examination is likely to form the basis of many performance audits. Files contain a wide range of types of evidence such as the decisions of officials, the “case records” of programme beneficiaries and the records of government programmes. It is important to establish the nature, location and availability of files at the outset of a performance audit so that they can be examined cost effectively.

#### **1.2 Audit Sampling**

As paragraph 6.3 of the Audit Sampling Guideline states: Audit Sampling is often used to obtain evidence in performance audits. Whilst the specific objectives of the sampling exercise may be different, the underlying principles are the same.

#### **1.3 Secondary analysis/Literature Search**

Secondary analysis may relate to the review of general research reports, books and papers in the subject area of the programme or to more specific studies in the area, including past audits and evaluations. It may update/enlarge the auditor's working knowledge of a particular subject.

#### **1.4 Surveys**

A survey is a systematic collection of information from a defined population, usually by means of interviews or questionnaires administered to a sample of units in the population.

Surveys are used to gather detailed and specific information from a group of people or organisations. They are particularly useful when one needs to quantify information from a large number of individuals on a specific issue or topic

There are a wide range of survey techniques available. The most commonly used are mail, telephone and in-person interviews.

#### 1.5 Interviews

An interview is a question and answer session to elicit specific information. Interviews can be unstructured (that is with 'open-ended' questions) or structured (closed questions).

Interviews may be used in the planning phase and in the examination itself, to obtain documents, opinions and ideas that relate to the audit's objectives, to confirm facts and corroborate data from other sources, or to explore potential recommendations.

#### 1.6 Focus Groups

Focus groups are a selection of individuals brought together to discuss specific topics and issues. They are primarily used to collect qualitative data, that is to say, information that can provide insights into the values and opinions of those individuals in the process or activity being audited.

#### 1.7 Comparative Analysis (“Benchmarking”)

Benchmarking is a process for comparing an organisation's methods, processes, procedures, products, and services against those of organisations that consistently distinguish themselves in the same categories of performance.

Benchmarking may be used:

- to stimulate an objective review of critical processes, practices and systems;
- to develop criteria and identify potentially better ways of operating;
- to lend more credibility to audit recommendations.

#### 1.8 Before-After Studies

In a Before-After Study the situation before the programme was started is compared with that after programme implementation.

A simple Before-After study is one in which one set of measurements is taken on targets before programme participation and a second set is taken on the same set of participants after sufficiently long participation. Impact is estimated by comparing the two sets of measurements.



The main drawback to this design is that the differences between before and after measures cannot be confidently ascribed to the programme.

## 1.9 (Quasi-) Field Experiments/Experimental Method

The essential feature of true experiments is the random assignment of targets to treated and untreated groups constituting, respectively the experimental and control groups.

A control group is a group of untreated targets that is compared to experimental groups on outcome measurement in impact evaluations.

An experimental group is a group of targets to whom an intervention is delivered and whose outcome measures are compared with those of control groups.

A quasi experiment is an impact research design in which 'experimental' and 'control' groups are formed non-randomly.

The practical and political problems of using the experimental method have led to increases in 'quasi-experimental' methods, which attempts to separate out as much as possible of the extraneous effects which make assessment of impact difficult, though without providing the full protection which a properly conducted experiment would do.

The two common types of quasi-experimental designs involve constructing control or comparison groups in an attempt to approximate random assignment. This is done by either matching participating and nonparticipating targets or by statistical adjustment of participants and non-participants so they are as equivalent as possible on relevant characteristics.

## 2 **Techniques for information analysis**

### 2.1 Programme Logic Model (PLM)

A programme logic model (or a policy theory/intervention theory) depicts the structure or logic of the programme being audited. It shows the programme hierarchy in terms of objectives and responsibilities. Starting with the highest level programme objectives and desired effects, the PLM moves down through sub-programmes, sub-programme components and specific activities with each lower-level element being logically related to a higher level element.

A PLM can help the auditor to obtain an understanding of the performance audit issues as it focuses attention on the relationship between the programme's objectives and sub-objectives and the outputs and outcomes (impacts and effects) that result from the programme. It can help the auditor to identify and seek answers to questions such as:

- do the objectives provide a clear understanding of the rationale for the programme, of the products and services that are being provided and of the recipients of these goods and services?
- do the objectives allow the identification of clear and measurable desirable outcomes?
- are the causal linkages between the hierarchical levels plausible?

In the planning phase, PLMs help the auditor, inter alia, to understand the audited entity and to identify key programme results and the programme systems and operations that produce them.

## 2.2 Descriptive Statistics to understand Data Distributions

A data distribution generally is expressed by a graph (bar-chart or curve) that shows all the values of a variable. The statistics that describe data distributions can be powerful tools for audit analysis and reporting. There are three basic dimensions of a data distribution that may be important to an audit observation:

- the level of the data (mode, median, mean, quartile level, etc.);
- the spread of the data (minimum and maximum values, clumpiness, tails, etc.); and
- the shape of the data (normal distribution, flat distribution, bi-modal distribution, etc.).

Data distributions may be used:

- to identify the level, spread or shape of the data when this is more important than a single 'average' number;
- to decide whether a variable performance meets an audit criterion or not;
- to interpret probability distributions to assess risk; and
- to assess whether sample data are representative of the population.

## 2.3 Regression analysis

Regression analysis is a technique for assessing the degree to which variables are associated (correlated).

Regression analysis may be used:

- to test a relationship that is supposed to hold true;
- to identify relationships among variables that may be causally related that might explain outcomes;
- to identify unusual cases that stand out from expected values; and
- to make predictions about values in the future.

## 2.4 Cost-Benefit Analysis (CBA)

CBA's are studies of the relationship between project costs and benefits/disbenefits, with both costs and benefits/disbenefits expressed in monetary terms. A CBA might be used, for example, in the performance audit of a road building project.

The purpose of cost-benefit analysis is to determine whether the benefits of an entity, programme or project exceed its costs.

CBA may be used:

- to obtain assurance that an analysis done by the audit entity meets professional standards;
- to compare costs and benefits when both are known or can reasonably be estimated;
- to compare costs of alternatives when benefits can be assumed constant.

Done properly, a CBA should normally consider not only the tangible (and relatively easily measurable) costs and benefits, but also the intangible (and difficult to estimate) costs and benefits, such as social and environmental costs.

## 2.5 Cost-Effectiveness Analysis (CEA)

Cost-Effectiveness Analyses (CEA) are studies of the relationship between projects costs and outcomes, expressed as costs per unit of outcome achieved.

Whilst CBA allows evaluators to compare the economic efficiency of programme alternatives, CEA is concerned with finding the cheapest means of accomplishing a defined objective or the maximum value from a given expenditure.

In contrast to the economists' version of CBA, in CEA the benefits may be expressed in physical rather than monetary units: the effectiveness of a programme in reaching given substantive goals is related to the monetary value of the resources going into the programme or activity.

For example:

- it is found that 20% of unemployed persons obtain permanent employment following training programmes at an average cost of 1000 ECU per head and that 50% obtain permanent employment following programmes costing, on average, 2000 ECU per head;
- it is found that in Member State X, training programmes that result in 30% of the participants obtaining permanent employment cost, on average, 1400 ECU per head,

whilst in Member State Y, similar results are only achieved with an average expenditure of 1730 ECU per head.

## 2.6 Meta-evaluation

The purposes of meta-evaluation are to judge the quality of evaluation (research), to improve the quality of evaluations and to promote the actual use of evaluation research in the management process.

The role of the SAI would then be to examine the actual quality of evaluations undertaken and of the adequacy of organisational and procedural conditions for evaluation.

Criteria for meta-evaluation will concern the quality of the evaluation research undertaken and the way the evaluation function has been integrated into the management process:

a. The quality of the performance audit/evaluation:

Broadly, there are two criteria:

- the scientific/epistemological quality of evaluation research: theoretical, methodological and technical criteria which reflect the state of the art. The theoretical requirements concern, among other things, the formulation of the problem, the definition of the concepts, the hypotheses and the cohesion of the theory as a whole.

The methodological requirements imposed on evaluation research involve among others the validity and reliability of the research results.

The technical requirements concern, among others, the operationalization of the evaluation criteria, on the basis of which it can be determined whether the situation in the policy field satisfies the evaluation standards.

- criteria of usefulness of the research for policy/management practice: this means that an evaluation report should provide information which is important to an effective, efficient and legitimate approach to a certain policy problem. E.g.: the report should contain explicit and clear references to the need for information to be satisfied by the research, to a problem in policy practice, to the research objectives associated with policy practice etc. The report should be clearly (understandably) written also for non-scientists; reports should be complete, accurate and balanced, etc<sup>(1)</sup>.

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<sup>1</sup>Source: (various chapters in) J. Mayne, M.L. Bemelmans-Videc et al., *Advancing Public Policy Evaluation; Learning from International Experiences*, Elsevier/North Holland, 1992

b. Performance audit/evaluation as a management function:

Criteria deduced from regulations concerning the integration of the evaluation function in the organisation, e.g. regarding planning of evaluations, integration of the programme evaluation function within the central budgetary process, (ex ante and ex post evaluation results to accompany (proposals for) new policy programmes/legislation to ensure actual use in the consideration of these new programmes, creation of evaluation units, training of staff, etc.

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Sources:

*B.W. Hogwood and L.A. Gunn, Policy Analysis for the Real World, Oxford University Press 1984*

*P.H. Rossi and H.E. Freeman, Evaluation; A Systematic Approach, Newbury Park etc. 1993*

*Office of the Auditor General of Canada; Choosing and Applying the Right Evidence - Gathering Techniques in Value-for-Money Audits, Audit Guide 24 (Field Testing Draft), June 1994*

*Sage Evaluation Kit*

## GROUP 5 OTHER MATTERS

### EUROPEAN IMPLEMENTING GUIDELINES FOR THE INTOSAI AUDITING STANDARDS

N° 51

#### QUALITY ASSURANCE

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#### 1 Reference to the INTOSAI Auditing Standards

- 1.1 Assuring the quality of audits carried out by Supreme Audit Institutions (SAIs) and thus ensuring compliance with the INTOSAI Auditing Standards can be seen as a two-stage process. At the first level, it is necessary for SAIs to adopt policies and procedures designed to ensure that audit tasks are carried out to an acceptable level of quality. At the second level, it is recommended that SAIs carry out higher level quality assurance (Q.A.) reviews of audit tasks to establish that these policies and procedures are adhered to within the SAI, and that they are having the desired effect of ensuring that work is carried out to an acceptable level of quality.

- 1.2 At the first level the SAI must, as a matter of policy, define and decide upon the appropriate standards and level of quality for its outputs and then establish comprehensive procedures designed to ensure that this level of quality is attained. These policies and procedures should be established by reference to the global objectives of the SAI, which will normally reflect the legal requirements and socio-political expectations that the SAI faces.
- 1.3 So that these policies and procedures can be adhered to by the staff of the SAI, it is important that they are promulgated (e.g. via an Audit Manual) and that staff receive appropriate training.

## 2 Quality Assurance Reviews

- 2.1 Whilst the policies and procedures outlined above provide the basis for achieving the desired level of quality, and thus adherence with the INTOSAI Auditing Standards, it is not usually sufficient just to put these policies and procedures in place. It is usually also necessary to obtain assurance that they are being adhered to and that they are achieving their objective. Paragraph 118 of the INTOSAI Auditing Standards (para. 118) states that:

"The SAI should adopt policies and procedures to review the efficiency and effectiveness of the SAI's internal standards and procedures."

- 2.2 This Standard is further explained (paragraph 121) as follows:

"... it is desirable for SAIs to establish their own quality assurance arrangements. That is, planning, conduct and reporting in relation to a sample of audits may be reviewed in depth by suitably qualified SAI personnel not involved in those audits, with consultation with the relevant audit line management regarding the outcome of the internal quality assurance arrangements and periodic reporting to the SAI's top management."

- 2.3 The objective of independent quality assurance reviews is to provide an assessment of the overall quality of work within the SAI. This is different to the policies and procedures referred to in paragraph 1. above which provide control over the quality of individual audits.
- 2.4 In certain European Community SAIs, the collegiate decision-making process operates as a quality assurance mechanism over the outputs of the SAI.
- 2.5 Frequently SAIs will decide to establish a distinct quality assurance function to assist its College or Auditor General in this area. Commonly found elements of such a function are described at **ANNEX 1**.

## **ANNEX 1: COMMONLY FOUND ELEMENTS IN THE Q.A. FUNCTION**

The following are commonly found as elements of internal quality assurance:

- \* staff carrying out Q.A. reviews are suitably qualified and experienced (they may be either employed full-time in quality assurance, or on short-term secondments from other parts of the SAI);
- \* staff carrying out Q.A. reviews are independent of the audits being reviewed;
- \* staff carrying out Q.A. reviews have the power to select audit tasks for review;
- \* procedures are established for the selection of all audits to be reviewed, which will ensure an appropriate coverage of all the activities of the SAI over a set period of time; all tasks of the SAI must potentially be subject to review (re. the reviewer must have full knowledge of the activities of the SAI);
- \* procedures are established to determine the nature, extent, frequency and timing of the Q.A. reviews;
- \* procedures are established to resolve disagreements which may arise between Q.A. reviewers and audit staff;
- \* staff carrying out reviews have right of access to all relevant internal documents and to the staff who prepared them or managed the task;
- \* staff carrying out reviews normally have the duty to report and make recommendations in a timely manner to the SAI's senior management, and senior management normally has the duty to respond to these;
- \* audit staff can request that a Q.A. review is carried out at any stage of an audit task;
- \* publication of an Annual Report - (normally) made available to all audit staff.

In certain cases, and particularly when the SAI uses temporary secondments to carry out internal quality assurance reviews, the SAI may decide to develop and use standard checklists of objectives that the reviewer must achieve to ensure the consistency and completeness of the reviews carried out.



EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 52

**IRREGULARITY**

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Introduction

1. Scope

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- 1.1 The purpose of this Implementing Guideline is to provide the external auditor (“auditor”) of European Community activities with guidance on the audit of irregularity, including irregularity arising from fraud.
- 1.2 Because the constitutional mandates of the National Audit Institutions and the European Court of Auditors may impose different responsibilities for the audit of irregularity, the

guidance contained in this Implementing Guideline needs to be applied as appropriate for the particular circumstances concerned. Because of the high level of importance that parliaments and the European taxpayers place upon propriety in the management of government activities, NAI may wish to consider incorporating examinations of regularity into all audits they undertake, including performance audits.

## 2. Legislative framework governing the audit of irregularity

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2.1 This Implementing Guideline includes at **ANNEX 1** a summary of the European legislation on the protection of the Communities' financial interests against fraud and irregularity. The terms "irregularity" and "fraud", as applied in the European Communities and this Guideline, are defined in Council Regulation (EC Euratom) No 2988/95 of 18 December 1995, the relevant extract of which is at **ANNEX 2**.

2.2 For the purpose of this Implementing Guideline, reference to "fraud" includes both suspected fraud and proven fraud. The auditor needs to be aware of the difference between "suspected fraud" and "proven fraud". The auditor normally applies the term "suspected fraud" to any particular set of circumstances which suggest fraudulent activity and which come to the auditor's attention during an audit. This approach reinforces the principle that only a court of law or equivalent jurisdiction can determine whether a particular transaction is fraudulent, or is "proven fraud".

## 3. Reference to the INTOSAI Auditing Standards

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3.1 Paragraph 145 of the INTOSAI Auditing Standards states that:

"In conducting regularity (financial) audits, a test should be made of compliance with applicable laws and regulations. The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of regularity audits. The auditor also should be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of regularity audits."

## 4. Respective responsibilities of management and auditors

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4.1 The explanation of the INTOSAI Auditing Standards (paragraph 150) states that:

"Generally, management is responsible for establishing an effective system of internal controls to ensure compliance with laws and regulations. In designing steps and procedures

to test or assess compliance, auditors should evaluate the entity’s internal controls and assess the risk that the control structure might not prevent or detect non-compliance.”

Thus the auditor is not and cannot be held responsible for the prevention of fraud and irregularity. This responsibility rests with management through the implementation and continued operation of adequate accounting and internal control systems. Such systems reduce but do not eliminate the possibility of fraud and irregularity.

4.2 In the context of European Communities funded activities, the term “management” as referred to in paragraph 4.1 of the Implementing Guideline is used to mean:

- the European Commission: which is responsible for managing the European Communities’ financial interests, including funds issued to public authorities at national, regional or local level and to private sector undertakings under the Communities’ various activities;
- the National, regional and/or local authorities: which are responsible as agents of the Commission for the effective and proper management of the Communities’ funds;
- the recipient undertakings or entities: management of the undertakings in receipt of Community funds are also responsible to the Commission for the effective and proper use of those funds.

4.3 The auditor’s responsibilities do not generally require him/her to search specifically for fraud or irregularity unless required to do so by statute or by the specific terms of the audit engagement. However, in an audit of financial information where the auditor gives an opinion on the proper presentation and legality and regularity of that information, the auditor plans and implements the audit in accordance with auditing standards for the purpose of obtaining competent, reasonable, relevant evidence as to the extent to which the financial information concerned contains material error, including error arising from irregularity.

4.4 An audit planned and implemented in accordance with auditing standards can not give complete assurance that the financial information is free from material error. This is because errors which are intentional, arising as a consequence of fraud or irregularity, often involve attempted concealment which the auditor may not necessarily detect, even though his/her audit was planned and executed in accordance with auditing standards. It is thus underlined that, other in cases where the auditor is specifically required to by statute, it is unusual for an audit carried out by an NAI to have the detection of fraud as a specific objective.

5. Inherent limitations of an audit

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5.1 The test nature of an audit of financial information involves judgment as to the areas to be tested and the number of transactions to be examined. Furthermore, much audit evidence is persuasive rather than conclusive in nature. Therefore, the auditor’s examination is subject to the inherent risk that a significant mis-statement of the financial information arising from fraud or irregularity, if it exists, will not be detected.

## Planning an audit

### 6. General

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6.1 In planning the audit, the auditor obtains a general understanding of the legal framework applicable to the specific European Community activity under audit and should understand how management complies with that framework. Amongst the sources of information that the auditor may refer to in carrying out this work are:

- the Treaties Establishing the European Communities as amended by the Treaty on European Union;
- the Community regulations, directives and decisions relevant to the schemes under audit;
- any relevant subordinate legislation enacted by the Member State(s) or by the Commission; and
- the provisions of the budget and any decisions relevant to the budget execution at the level of the Commission or in Member States.

### 7. Materiality considerations

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7.1 In planning an audit of financial information, the auditor considers the extent to which the incidence of fraud or other irregularity is likely to be material, either by nature or by value.

7.2 The Implementing Guideline N° 12 on Materiality and Audit Risk contains more detailed guidance to assist the auditor in making these judgements.

### 8. Assessment of risk

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#### *General*

8.1 In planning his audit, the auditor needs to be aware that the risk of not detecting material mis-statement resulting from fraud is greater than the risk of not detecting a material mis-statement resulting from irregularity which arises through unintentional error, oversight, or ignorance of the law. This is because fraud usually involves acts designed to conceal it, including collusion, forgery, deliberate failure to record transactions, or intentional misrepresentation.

#### *Inherent risk*

8.2 As part of the planning process, the auditor determines the extent to which the audit field he intends to examine is vulnerable to both irregularity arising from fraud, and irregularity

which arises through error. This inherent risk assessment will include reviewing, amongst other, relevant information from the following sources:

- reports by the European Court of Auditors;
- reports by National and/or Regional Audit Authorities;
- reports produced by Member States, in particular those produced under the reporting Regulations as set out in Annex A to this Guideline;
- reports by Parliamentary and/or Regional Authorities (ie the European, National and Regional Parliaments);
- reports produced by the Advisory Committee for the Co-ordination of Fraud Prevention;
- reports by the Commission’s Unit for the Co-ordination of Fraud Prevention (UCLAF);
- reports by Commission internal auditors/control units in DG XX and in the operational DGs;
  
- reports by national/local administrations involved in European Union revenue and expenditure programmes, including relevant reports by internal auditors; and
  
- other relevant documents produced by the Commission (Eg rules for the operation of particular schemes).

8.3 Having reviewed this information, the auditor then considers performing a more detailed risk analysis, on the specific audit field he intends to examine. Particular factors that he might consider, amongst other, are as follows:

- the complexity of the Community schemes and activities under examination, as reflected in the operating rules;
- the competences and perceived integrity of the managers of the Community funds, at European and national, regional or local level; and
- the likely reliability and/or sufficiency of the audit evidence available.

#### *Control risk*

8.4 In assessing control risk, the auditor recognises that whilst an effective system of internal control reduces the probability of mis-statement of financial information from fraud and irregularity, there will always be a risk of internal controls failing to operate as designed. Any system of internal control may be ineffective against fraud involving collusion amongst employees or by management. This is because certain levels of management may be in a position to override controls that would prevent similar frauds by other employees; for example, by directing subordinates to record transactions incorrectly or to conceal them.

8.5 In considering control risk, the auditor may wish to give attention to the adequacy of management’s controls for preventing and detecting fraud. For example, the auditor may decide to review management’s strategic response to the risk of fraud, including the steps taken by management to:

- identify the policy fields, activities and functions of the audited entity which may be particularly vulnerable to fraud risk;
- implement appropriate defence mechanisms in the areas which management have identified as having a high vulnerability to the risk of fraud, such mechanisms being:
  - segregation of duties;
  - systematic rotation of staff in post; and
  - internal oversight and inspections;
- establish effective human resources policies, to monitor admission of new staff into the public service and to ensure that they properly understand the requirement for honesty and integrity;
- establish a code of conduct designed to promote ethical behaviour amongst staff and provide guidance on such matters as:
  - relations with third parties;
  - acceptance of employment/appointments outside the public service; and
  - declaring conflicts of interest (Eg where a staff member has interests outside public service which may conflict with their official duties);
- monitor implementation of the human resources policies, including regular review of the code of conduct; and
- establish appropriate procedures for reporting, investigating and acting upon possible irregularities and/or suspected fraud, including, where necessary, appropriate disciplinary measures.

8.6 In the European Community context, management structures are complex, which adds to the importance of effective internal controls. Within the Community, there are at least three tiers of management: the Commission; the National, regional and/or local authorities ; and the recipient undertakings or entities (as defined in paragraph 4.2).

8.7 When the auditor has reviewed the internal controls, it is generally accepted that he/she has a duty to draw to management’s attention any significant weaknesses in controls detected by the audit, including, in this case, any weaknesses which are likely to increase the risk of fraud or irregularity. ( See Guideline N° 21”Evaluation of Internal Control and Tests of Control”).

Audit procedures where fraud or other irregularity is suspected

9. General  
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9.1 The following guidance indicates how an auditor may carry out additional audit procedures where fraud or other irregularity is suspected. However, this guidance is not intended to be exhaustive, nor does it attempt to address the diverse statutory responsibilities which National Audit Institutions and the European Court of Auditors have for the audit and investigation of fraud and irregularity. Accordingly, this guidance should be applied as appropriate to the particular circumstances concerned.

9.2 If, during his risk assessment, or as results of tests of control or substantive testing, the auditor concludes that circumstances indicate the possible existence of a fraud, he/she needs to consider the potential impact of such an occurrence on the financial information. If the auditor believes that the suspected fraud could have a material effect on the financial information (Eg because he has previously determined that any fraud is material by nature), then he/she performs such modified or additional procedures as he considers appropriate.

9.3 The extent of the auditor's modifications to the audit plan, or additional audit procedures, will depend on his/her judgement about:

- the nature of the suspected fraud that could have occurred;
- the perceived risk that suspected fraud has actually occurred, based on the risk assessment or results of testing; and
- the likelihood that a particular type of suspected fraud could have a material effect on the financial information.

10. Performing additional audit procedures  
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10.1 The auditor should use his/her judgement to determine the audit procedures best able to indicate the existence of suspected fraud. These may include, amongst others:

- *tests of control* : used to provide evidence on the effectiveness or otherwise of the controls designed to prevent or detect fraud and irregularity;
- *substantive testing*: used to substantiate the scope and/or value of the suspected fraud;
- *analytical procedures*: used to corroborate, through comparison, trend analysis or predictive testing, the possibility that fraud or irregularity exists;
- *interview techniques (used primarily in fraud investigation)*: used to provide corroborative evidence that fraud has occurred, usually from those around the individual(s) suspected of committing the fraud; and
- *observation techniques*: used to corroborate the suspicion of fraud, by observing changes in behaviour patterns of those suspected of committing fraud.

10.2 When carrying out interviews as a means of gathering evidence to substantiate fraud, the auditor needs to observe the rules of evidence appropriate to the jurisdiction in which he is operating. This is to ensure that the evidence gathered from such work can be used in any judicial proceedings which the authorities decide to pursue.

10.3 Before proceeding with any additional audit procedures, the auditor should consider whether to seek guidance or assistance from experts in fraud investigation, such as the Finance Police who operate in some national authorities.

11. Reviewing the results of additional procedures  
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- 11.1 Performing modified or additional procedures may enable the auditor to confirm or dispel a suspicion of fraud. Where confirmed, he should satisfy himself that the effect of fraud is properly reflected in the financial information. This is necessary to ensure that the Commission and the relevant national authorities are subsequently given correct notification of the nature and extent of the irregularity.
- 11.2 In some cases, the auditor may be unable to obtain sufficient evidence either to confirm or dispel a suspicion of fraud. In this situation, the auditor considers the possible impact of this uncertainty both on the financial information and on the statement of assurance. The auditor will also need to consider the relevant laws and regulations of the jurisdiction in which the suspected fraud has occurred. As appropriate, the auditor may wish to obtain legal advice before reporting, as appropriate, to the national authorities and/or the Commission on the financial information<sup>(2)</sup>.
- 11.3 Unless circumstances clearly indicate otherwise, the auditor does not assume that an instance of fraud is an isolated occurrence. If the fraud should have been prevented or detected by the system of internal control, the auditor reconsiders his/her prior evaluation of that system and, if necessary, adjust the nature, timing and extent of substantive procedures.
- 11.4 When a fraud involves a member of management, the auditor needs to reconsider the reliability of any representations made by that person to the auditor.

Audit procedures where irregularities other than fraud are identified

12. General

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- 12.1 When the auditor becomes aware of information concerning a possible existence of irregularities other than fraud, for example, irregularities arising from unintentional error, oversight or ignorance of the law, the auditor obtains an understanding of the nature of the irregularities and the circumstances in which they have occurred, and sufficient other information to evaluate the effects on the financial information. For example, the auditor considers:
- the potential financial consequences;
  - whether, and how the financial consequences of the irregularity should be disclosed in the financial information; and

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2 For example, the auditor may need to obtain legal advice regarding :

- the powers/duties of the NAI to hand documents over to judicial authorities ;
- the duties of the NAI to inform judicials authorities of any suspicions ;
- the powers/duties of the NAI to cooperate with judicial authorities in any subsequent investigations ;
- the impact of the above upon the independence of the NAI



- whether the potential financial consequences are so serious as to impact on the audit opinion or statement of assurance on the legality and regularity of the underlying transactions.

12.2 In the first instance, where the auditor discovers what he/she believes may be an irregularity, he/she documents the findings and discuss them with management. If management does not provide satisfactory information that the transactions concerned are, in fact, regular, the auditor may consult with management’s legal adviser about the application of the relevant laws and regulations to the particular circumstances and the possible effects on the financial information.

12.3 If the auditor believes that the irregularity could have a material effect on the financial information, he/she considers the effect of the irregularity on the opinion and as appropriate, perform additional audit procedures as he/she considers necessary.

### 13. Other implications of irregularities

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13.1 Where the auditor finds that within the audited entity, there is a high incidence of irregularities, the impact of these failures could have additional effects:

- it may raise doubts about other audit evidence supplied by the audited entity, including compliance reports and management representations;
- where internal controls have failed to detect irregularities, this may indicate significant control weaknesses, in which case the auditor may reconsider the control risk assessment.

## Responsibilities for reporting on fraud or irregularity

### 14. General

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- 14.1 As a general principle, the auditor needs to be aware of the internal and external reporting procedures which his audit institution (European or national) will normally apply when fraud, suspected fraud, or irregularity is discovered. Knowledge of these procedures, and timely consultation with the appropriate authorities (internal and external) is important to ensure that investigation of suspected fraud is properly carried out, without risk of compromising any judicial or administrative proceedings that may follow.

### 15. Internal reporting

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- 15.1 The auditor normally observes the internal reporting procedures for the notification of fraud, suspected fraud or irregularity which his audit institution has prescribed. To help determine the most appropriate action to take, the auditor reports to his senior management where:

- the results of the initial risk assessment, tests of control or substantive testing indicate a possibility that fraud exist (paragraph 8.1);
- the results of the additional audit procedures point to suspected fraud (paragraph 10.1); and
- management of the audited entity fail to take the appropriate action to investigate or report the suspected fraud (paragraph 16.4 below).

### 16. Reporting to management

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- 16.1 Once the auditor has carried out additional audit procedures to confirm the existence or otherwise of suspected fraud or other irregularity, he/she then reports the findings to the management of the audited entity as soon as possible.
- 16.2 Guidance issued to auditors of the European Court of Auditors advises them that they need to report cases of suspected fraud directly to their line management rather than to the management of the audited entity concerned. This information is then normally communicated to the Commission's anti-fraud co-ordination unit (UCLAF) and to the National Audit Institution.
- 16.3 In the National Audit Institutions, the auditor needs to consider all aspects of the suspected fraud in determining who to report to in the management of the audited body. In particular, the auditor assesses the likelihood of senior management involvement in the fraud. In most cases, it is appropriate for the auditor to report the findings to a management level above that responsible for the persons believed to be implicated in the fraud. However, where the

auditor has doubts about the integrity of those persons ultimately responsible for the overall direction of the audited entity, the auditor normally seeks advice to assist him/her in determining who to report to on the suspected fraud. Such advice could be from both internal and external sources.

16.4 In the case of both suspected fraud or other irregularity, the auditor's interest does not end when he/she has reported to management. The auditors monitors management's response to the notification of the suspected fraud or irregularity and in particular, confirms that:

- the entity's management have taken the necessary action to investigate the suspected fraud or irregularity (Eg by asking Internal Audit to carry out further work, as appropriate);
- management have notified, and sought advice from, the appropriate Community and national authorities (Eg the Finance Police);
- management have reported the proven fraud, suspected fraud, or other irregularity in accordance with the statutory requirements set out in **ANNEX 1** to this Implementing Guideline.

## 17. External reporting

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17.1 The auditor of a national audit institution, will, in the first instance, observe the external reporting requirements determined by national authorities, as laid down in the institution's prescribed procedures for the external reporting of suspected fraud, proven fraud or other irregularity. Auditors of the European Court of Auditors will follow the reporting guidance laid down in the Court's own reporting instructions.

17.2 Reporting to the European Commission, under the legislation set out in **ANNEX 1** to this Guideline, of suspected fraud, proven fraud or other irregularity is the responsibility of the relevant national, regional or local authorities designated to manage particular Community activities. As part of follow up procedures, the auditor normally satisfies himself/herself that this reporting responsibility has been properly carried out.

## 18. Reporting on financial information

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18.1 Where the auditor is required to give an audit opinion both on the proper presentation and the legality and regularity of financial information, then the auditor needs to consider the implication of the incidence of fraud and irregularity for that opinion.

18.2 Fraudulent transactions cannot, by definition, be legal or regular since they are without proper authority. Where an auditor is required to give a separate opinion on the legality and regularity of financial information, proven fraud which is material will result in the

qualification of that opinion, regardless of the extent of management's disclosure of the suspected or proven fraud in the financial information.

- 18.3 Only a court of law can determine whether a particular transaction is fraudulent. However, the auditor may encounter situations where there is suspicion of fraud, identified by management, internal auditors, third parties or by the auditor himself. Although the auditor does not normally have the authority to determine whether a fraud has actually occurred, he/she does have a responsibility to determine whether, in his/her opinion, the transactions concerned are legal and regular. In most cases of suspected fraud which are discovered, the auditor is able to reach agreement with management on whether the relevant transactions are without proper authority. In these circumstances, the auditor can therefore conclude whether the transactions concerned are irregular, even if he/she is unable to conclude that they are fraudulent.

**PROTECTING THE EUROPEAN COMMUNITIES' FINANCIAL INTERESTS  
AGAINST FRAUD AND OTHER IRREGULARITY  
LEGISLATIVE FRAMEWORK**

**Treaty European Union**

**1. Treaty obligations on Member States**

- 1.1 Member States have a responsibility to protect the Community's financial interests against fraud and irregularity, a requirement which is stated in Article 209a of the Treaty:

“Member States shall take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interests.”

Without prejudice to other provisions of this Treaty, Member States shall co-ordinate their action aimed at protecting the financial interests of the Community against fraud. To this end they shall organise, with the help of the Commission, close and regular co-operation between the competent departments of their administrations”

- 1.2 Article 78i of the Treaty establishing the European Coal and Steel Communities (ECSC) and Article 183a of the Treaty establishing the European Atomic Energy Agency (Euratom) are identical to Article 209a above, and therefore place similar responsibilities on Member States for protecting the financial interests of ECSC and Euratom against fraud.

- 1.3 Member States' responsibilities for the prevention and detection of irregularity may also be covered in regulations governing specific Community activities. For example, Article 8 of Council Regulation (EEC) No 729/ 70 of 21 April 1970 (OJ L 94 of 28.04.1970, p. 13) on the European Agricultural Guidance and Guarantee Fund (EAGGF), as amended by Regulation (EEC) No 2048/88 of 24 June 1988 (OJ L 185 of 15.07.1988, p. 1), requires Member States to:

“take the measures necessary to satisfy themselves that transactions financed by the EAGGF are actually carried out and are executed correctly, to prevent and deal with irregularities and to recover sums lost as a result of irregularities or negligence.”

**2. Treaty obligations on the Commission**

- 2.1 The Commission is bound by Article 205 to ensure proper implementation of the Community budget:

“The Commission shall implement the budget, in accordance with the provisions of regulations made pursuant to Article 209, on its own responsibility and within the limits of the appropriations, having regard to the principles of sound financial management.”

- 2.2 The Treaty on European Union strengthened the possibility of tackling fraud by providing a legal basis for future Commission initiatives to penalize those who commit fraud. Under Title VI (Justice and Home Affairs), Article K.1 states:

“For the purposes of achieving the objectives of the Union, in particular the free movement of persons, and without prejudice to the powers of the European Community, Member States shall regard the following areas as matters of common interest:

... (5) combatting fraud on an international scale”.

### **Reporting of irregularities**

3. **Regulations governing the Community’s own resources**

- 3.1 Council Regulation (EEC, Euratom) No 1552/89 of 29 May 1989 (OJ L 155 of 07.06.1989, p. 1) which implements Decision 88/376/EEC, Euratom of 24 June 1988 (OJ L 185 of 15.07.1988, p. 24) on the system of the Communities’ own resources, imposes on Member States under Article 6(3) the following reporting responsibilities:

“From 1 January 1990, each Member State shall send to the Commission a half yearly statement giving a brief description of cases of fraud and other irregularities involving entitlements of over ECU 10,000, indicating, where appropriate, measures taken or under consideration in order to prevent the recurrence of fraud and irregularities already detected.”

4. **Regulations governing agricultural funds**

- 4.1 Under Articles 3 and 5 of Council Regulation (EEC) No 595/91 of 4 March 1991 (OJ L 67 of 14.03.1991) concerning irregularities and the recovery of sums wrongly paid in connection with the financing of the common agricultural policy, Member States have the following reporting responsibilities:

#### **Article 3**

“1. During the two months following the end of each quarter, Member States shall communicate to the Commission a list of irregularities which have been the subject of the primary administrative or judicial findings of fact.



To this end they shall as far as possible give detailed information concerning: ... (then follows a list of the information required)”

#### Article 5

“1. During the two months following the end of each quarter, Member States shall inform the Commission of the procedures instituted following the irregularities notified under Article 3 and of all important changes resulting therefrom, including:

- the amounts which have been, or are expected to be, recovered;
- the precautionary action taken by Member States to safeguard recovery of sums wrongly paid;
- the judicial and administrative procedures instituted with a view to recovering sums wrongly paid and applying sanctions;
- the reasons for any abandonment of recovery procedures, the Commission shall, as far as possible, be notified before a decision is taken; and
- any abandonment of criminal prosecutions”.

- 4.2 The auditor needs to note that these reporting requirements cover all types of irregularity, including fraud and irregularity arising through oversight, error or ignorance of the law.
- 4.3 The auditor needs to be aware that Member States are required to report to the Commission on their national audit and supervision of EAGGF, Guarantee Section expenditure. This responsibility is set out under Article 5(d) of Commission Regulation (EEC) No 1723/72, as amended by Commission Regulation (EEC) No 295/88 of 1 February 1988 (OJ L 30 of 02.02.1988). This requires, amongst other things, that Member States report on the audits undertaken on the agencies responsible for EAGGF payments, to confirm that the operations, payments, and accounting and administrative procedures of the agencies have been implemented in a proper manner.
- 4.4 Under paragraphs 4(v) and 4(vi) of Annex XI of Commission Regulation 295/88, the Member States’ reports on the paying agencies should include reference to any audits performed on agencies’ compliance with Community rules. Such audits should, therefore, include Members States’ compliance with the reporting of irregularities outlined in paragraph 8.1.
- 4.5 The auditor needs to be familiar with Council Regulation (EEC) No 4045/89 of 21 December 1989 (OJ L 388 of 30.12.1989, p. 18). This Regulation establishes scrutiny procedures for those undertakings receiving or making payments relating to the system of financing by the Guarantee Section of the EAGGF. The Articles dealing with irregularity are:

#### Article 2

“1. Member States shall carry out systematic scrutiny of the commercial documents of undertakings, taking account of the nature of the transactions to be scrutinized. Member



States shall ensure that the selection of undertakings for scrutiny gives the best possible assurance of the effectiveness of the measures for preventing and detecting irregularities under the system of financing by the Guarantee Section of the EAGGF. Inter alia, the section shall take account of the financial importance of the undertakings in that system and other risk factors.”

#### Article 9

“1. Before 1 January following the scrutiny period, Member States shall send to the Commission a detailed report on the application of the Regulation.”

### **5. Regulations governing structural funds**

5.1 Under Article 23(1) of Council Regulation (EEC) No 4253/88 of 19 December 1988 (OJ L 374 of 31.12.1988, p. 1) on the co-ordination of the activities of the different Structural Funds, as amended by Regulation (EEC) No 2082/93 of 20 July 1993 (OJ L 193 of 31.07.1993), Member States are required to report on irregularity as follows:

“1. In order to guarantee completion of operations carried out by public or private promoters, Member States shall take the necessary measures in implementing the operations:

- to verify on a regular basis that operations financed by the Community have been properly carried out;
- to prevent and to take action against irregularities;
- to recover any amounts lost as a result of an irregularity or negligence. Except where the Member State and/or the intermediary and/or the promoter provide proof that they were not responsible for the irregularity or negligence, the Member State shall be liable in the alternative for reimbursement of any sums unduly paid. For global loans, the intermediary may, with the agreement of the Member State and the Commission, take up a bank guarantee or other insurance covering this risk.

Member States shall inform the Commission of the measures taken for those purposes and, in particular, shall notify the Commission of the description of the management and control systems established to ensure the efficient implementation of operations. They shall regularly inform the Commission of the progress of administrative and judicial proceedings.

Member States shall keep and make available to the Commission any appropriate national control reports on the measures included in the programmes or other operations concerned.”

5.2 In addition, Commission Regulation (EC) No 1681/94 of 11 July 1994 (OJ L 178 of 12.07.1994) covers irregularity and the recovery of amounts wrongly paid in the area of the Structural Funds and also the organisation of an information system in this field.



**Other statutory matters**

**6. Advisory Committee for the Co-ordination of Fraud Prevention**

- 6.1 The auditor needs to be aware that under Commission Decision 94/140/EC of 23 February 1994 (OJ L 61 of 04.03.1994), the Commission established, with effect from 1 March 1994, an Advisory Committee for the Co-ordination of Fraud Prevention.
- 6.2 The Committee, which is chaired by the Commission, comprises two representatives for each Member State, who may be assisted by two officials of the services concerned.
- 6.3 The Committee serves to advise the Commission on any matter relating to the prevention and prosecution of fraud and irregularities, and on any matter relating to co-operation between Member States or between Member States and the Commission which exceeds the powers of any sectoral committee, to organize more effectively action to counter fraud.

**7. Protection of the European Communities' financial interests**

- 7.1 A legislative programme designed to provide the Commission and Member States with the necessary statutory powers to protect the Communities' financial interests was launched following the Essen Summit (December 1994). This consists, to date, of five elements that are briefly described in the following paragraphs.
- 7.2 The **Council Regulation (EC Euratom) No 2988/95** on the protection of the European Communities' financial interests was adopted on 18 December 1995 (OJ L 312 of 23 12 1995). The major feature of this Regulation is that it creates a basic legal framework for the formulation of uniform Community administrative penalties with the same force throughout the European Union. In addition, this regulation provides a definition of irregularity.
- 7.3 The **Council Act (95/C 316/03) of 26 July 1995** (OJ C 316 of 27 11 1995) drew up a **Convention** on the protection of the Communities' financial interests. In addition to defining, for the first time, fraud affecting the European Communities' financial interests (see Annex B), this Convention will play a role in harmonising criminal law in the Member States in respect to fraud. It is expected that this Convention will be particularly significant in the prosecution on international fraud.

7.4 The proposed **Council Act** drawing up a **Protocol**<sup>(3)</sup> on the protection of the Communities' financial interests seeks to supplement the above Convention by:

defining the criminal liability of legal persons;  
defining and making a specific offence the laundering of the proceeds of frauds committed against the Communities' financial interests; and  
putting in place procedures to enhance judicial co-operation.

7.5 Another **Council Act** has been proposed drawing up a further **Protocol**. This concerns the jurisdiction of Member States in cases of corruption committed by European Community officials within their territory. Under this Protocol, EC officials will be subject to the same criminal law as national officials.

7.6 Finally, a further **Council Regulation** has been proposed that will extend the rights of the Commission to carry out on the spot checks and inspections for the detection of frauds and irregularities in the Member States.

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<sup>3</sup> From the legal point of view, the two Protocols mentioned in paragraphs 7.4 and 7.5 will have the same status and binding force as the Convention (paragraph 7.3) in that they will be adopted by the same procedures, ie those provided for in Title VI of the Treaty on European Union and notably ratification by the national Parliaments.

**ANNEX 2**

**DEFINITION OF IRREGULARITY**

1. This Implementing Guideline is concerned with the audit of irregularity, where irregularity is defined in Council Regulation (EC, Euratom) No 2988/95 of 18 December 1995 (Article 1, paragraph 2) as follows:

“Irregularity’ shall mean any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure.”

2. In a Council Act of 26 July 1995 drawing up a Convention on the protection of the European Communities’ financial interests, the Member States of the European Union agreed that fraud affecting the Communities’ financial interests shall consist of:

“(a) in respect of expenditure, any intentional act or omission relating to:

the use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the misappropriation or wrongful retention of funds from the general budget of the European Communities or budgets managed by, or on behalf of the European Communities,

non-disclosure of information in violation of a specific obligation, with the same effect,

the misapplication of such funds for purposes other than those for which they were originally granted;

(b) in respect of revenue, any intentional act or omission relating to:

the use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the illegal diminution of the resources of the general budget of the European Communities or budgets managed by, or on behalf of the European Communities,

non-disclosure of information in violation of a specific obligation, with the same effect,

misapplication of a legally obtained benefit, with the same effect.

EUROPEAN IMPLEMENTING GUIDELINES FOR  
THE INTOSAI AUDITING STANDARDS

N° 53

**“PROMOTING GOOD ACCOUNTING PRACTICE”**

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1. Reference to the INTOSAI Auditing Standards

1.1 Paragraph 23 of the INTOSAI Auditing Standards states that:

“Development of adequate information, control, evaluation and reporting systems within the government will facilitate the accountability process. Management is responsible for the correctness and sufficiency of the form and content of financial reports and other information.”

1.2 Moreover, paragraph 25 of the INTOSAI Auditing Standards states that:

“Appropriate authorities should ensure the promulgation of acceptable accounting standards for financial reporting and disclosure relevant to the needs of government;....”

1.3 Finally, paragraph 28 of the INTOSAI Auditing Standards states that:

“Consistent application of acceptable accounting standards should result in the fair presentation of the financial position and the results of operations.”

## 2. Introduction

2.1 The purpose of this Implementing Guideline is to provide the Supreme Audit Institution (SAI), which will also be referred to as the “external auditor”, involved in the audit of European Community activities with information and guidance on the promotion of good accounting practice.

2.2 Because the constitutional mandates of the SAIs may impose different responsibilities with respect to the promotion of good accounting practice, the information and guidance contained in this Implementing Guideline needs to be applied as appropriate for the particular circumstances concerned.

2.3 From the point of view of the SAI, the promotion of good accounting practice may be considered to be the exercising of influence in four accounting, financial or organisational areas:

- a the basis of accounting;
- b. the accounting principles and methods;
- c. the financial statements;
- d. internal control and internal audit.

2.4 The object of this Implementing Guideline is to elaborate the concepts associated with each of these headings, to show the contribution they can make to the promotion of good accounting practice in the public sector and, finally, to determine the influence of the SAIs on the definition and evaluation of each of these four elements. Good accounting practice not only contributes to the preparation and presentation of high quality accounting and financial information, but also to the preparation of high quality management information, which, in turn, provides the basis for sound management decisions and, consequently, for good financial management.

2.5 For the purpose of this Implementing Guideline, financial statements can be defined as all the financial documents published in the name of the reporting entity and that are subject to the audit. These financial statements, as will be described in more detail in paragraph 6.7, normally include a summary of revenue and expenditure for the period, a balance sheet, a statement of cash flows and notes and other explanatory material that are an integral part of these financial statements. Financial statements do not, however, include such items as reports and analyses by management, and similar items that may be included in a financial or annual report, unless legislation requires the entity to publish and the SAI to audit them.

### 3. Role of the SAIs

3.1 In general, SAIs play no recognised legislative role in the setting of accounting standards and in the definition of the form and content of financial information, although their concern will be to influence the legislative or administrative authorities, as appropriate, in the direction that they consider is helping the promotion of good accounting practice. On the other hand, they exercise great influence on technical matters in the auditing, advisory and, sometimes, consultancy fields based on the work they carry out in these same areas. In addition, the SAIs are, without doubt, the external partners who take greatest interest in an organisation's accounting practice, in contrast to its other external partners, who tend to be users of its accounting and financial information (discharge authority, creditors etc.). The SAIs can intervene at every stage in the process of defining and evaluating accounting practices, and their intervention can take the following forms:

- a. contribution to the definition of good accounting practice: this includes making observations on the accounting basis and the reporting entity, on the accounting principles and methods, and also on the content and the form of the financial statements. Generally speaking, SAIs will, to varying degrees, guide the organisation in its consideration of these matters, whilst always respecting the framework defined by the legislature.
- b. analysis of the application of good accounting practice: here SAIs can fulfil their primary function, that of independent experts charged with the task of issuing opinions on the financial statements and on the quality of the accounting practice. This overlaps with points mentioned in a.) above and with the analysis of internal control, for example.
- c. analysis of the quality of the financial and accounting framework: this aspect of the SAIs' activity is a feed-back function and is partly based on the work carried out in b.) above. Its aim is to ensure that the legislative, financial and accounting framework within which the audited bodies operate is suited to their activities and is favourable to the application of good accounting practice. It is by means of this kind of analyses that SAIs can influence the process referred to in 3.1 above.

3.2 Finally, SAIs must ensure they retain a distinction between their role as auditor, in which capacity they issue an independent opinion on financial statements and/or on good financial management, and their supporting or advisory role, in which they propose and supervise the implementation of projects, or procedures, in the audited organisation. Likewise, SAIs should ensure that the various opinions and advice they give on one and the same subject are consistent and relevant to the task assigned to them.

### 4. Basis of accounting

4.1 The basis of accounting refers to the accounting principles which will determine the stage of the execution of the transaction or of the occurrence of the event at which the effects of the transaction or of the event will be recorded in the books of account. This basis, which is determined by the objectives of the financial statements (see paragraphs 6.1 and 6.2 below) and by the environment in which the organisation operates, can range from a "cash basis", which is technically the least highly developed, to a "modified cash basis", a "modified accruals basis", or to an "accruals basis", which is practised by the majority of



enterprises in the private sector and by certain organisations in the public and semi-public sectors.

- 4.2 **ANNEX 1** to this Implementing Guideline provides a more elaborate definition of these four methods, together with a summary description of the related financial information produced.
- 4.3 The four models proposed can all be adapted to the special features of the public sector and to answer the requirements of the users. The objective, however, is to promote the adoption of the framework which, in conjunction with the accounting principles applied and the financial statements presented, best achieves the objectives of financial information, that is to meet the needs of its users, and represent the activities of the organisation concerned in the context of the public sector and subject to compliance with the regulations laid down by the legislature.
- 4.4 It is to be noted, however, that there are moves in the public sector in some countries to promote the use of bases of accounting that are close to the accruals basis. This could be explained, amongst other things, by the need for comprehensive financial information about the financial position and the performance of the reporting entity, as expressed by investors in the context of the privatisation programmes that take place in many countries.

## 5. Accounting principles and methods

- 5.1 The purpose of the accounting principles and methods is to indicate how the effects of transactions and events are to be recorded in the financial statements. The two principles presented below (“going concern” and “consistency”) are held to be fundamental principles and their use is assumed. It is not necessary to mention them in the notes to the financial statements. However, if these principles are not adhered to, the fact must be mentioned together with the reasons.
- a. *going concern* : the organisation is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the organisation has neither the intention nor the necessity of liquidation or of reducing materially the scale of its operations. Even if the going concern principle does not apply, in theory, to the public sector, it merits mention, if only to establish the link with the financial statements and the information they should contain (for example, when plans for restructuring on a large scale are implemented, or when an operation is wound up or privatised).
  - b. *consistency* : it is assumed that the accounting principles and methods will remain consistent from one accounting period to another, with the exception of justified changes, the material effects of which should be quantified in the notes to the financial statements.
- 5.2 The following three principles should govern the organisation’s choice of accounting policies:

- a. *prudence*: the organisation's transactions may be surrounded by uncertainties. Prudence is thus a sensible evaluation of the facts in order to avoid the risk of carrying over into the future present uncertainties which are liable to be detrimental to the organisation's assets and results.
- b. *substance over form*: transactions and other events in the life of the organisation should be accounted for and presented in accordance with their substance and with financial reality and not merely with their legal form.
- c. *materiality* : the financial statements should disclose all operations which are material enough to affect evaluations and decisions and disclose all the information which serves to render these same financial statements clear and comprehensible. It should

be noted that, in the public sector, the concept of materiality is not only a function of value but equally the nature of the matter under consideration and the context in which it appears must be considered.

5.3 The other accounting principles and methods concern the treatment of transactions or specific events, such as revenue and expenditure accounts, foreign exchange transactions, etc. Certain organisations in the public sector carry on commercial activities, the analysis of and accounting for which require the adoption of specific accounting policies. In this case it may prove useful to consult different standards on the methods of establishing and recording revenue.

5.4 The external auditor must ensure that the accounting principles chosen are part of a coherent, accepted set of standards, adapted to the activities of the organisation and its constraints. In addition, he must ensure that they cover all the important aspects of the organisation's activities <sup>(4)</sup>.

## 6. **Financial statements**

### Objectives

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6.1 As a general rule, the objective of an organisation's financial statements, or those of a group of organisations, is to provide the users of these financial statements with information on the financial situation, the performance, and the development of the financial situation, of this organisation or group of organisations. In the context of the public sector, the objectives include, in addition to those mentioned above, supplying information on the compliance of the operations with legal requirements in order to ensure that the

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Article 31(1) of the Council's Fourth Directive (EEC) n°78/660 of 25 July 1978 (Official Journal L 222 of 14 August 1978, p.11) provides a list of general principles to be used for the valuation of items shown in the annual accounts of some types of companies. This Directive is applicable in all European Community Member states. Although the principles mentioned are mainly aimed at private sector companies, some SAIs may carry out work in public sector entities whose accounting principles are based on the provisions of the Fourth Directive. Annex 2 to this Implementing Guideline presents the relevant text of the Directive and analyses to which extent the general accounting principles included therein are in accordance with those presented in paragraphs 5.1 and 5.2 above.

organisation is properly accountable.

6.2 To be more precise, the following objectives can be defined in the context of the public sector:

- a. to provide users with the information they need: the definition of the users' needs is the starting point for the development of financial statements;
- b. to tell the users whether the budget and the operations carried out during the financial year were implemented in compliance with legal requirements. It should be noted that the financial statements themselves do not supply this information, but it is provided in the report which the external auditor produces, based on these same financial statements, and which may be attached to them;
- c. to help users to arrive at a better understanding of the nature, size and scope of the activities of the public sector and of its financial condition, or, if need be, of the financial condition of the activities of which it is composed;
- d. to help users understand and forecast how the public sector finances its activities;
- e. to help users understand and forecast the effects of the public sector's activities;
- f. to help users determine whether the public sector has achieved its objectives and to determine the cost of its activities. This aspect plays an important part in the evaluation of the activities of the public sector;
- g. to supply users with information on the quantitative aspects of the implementation of the budget: the qualitative aspects have been dealt with in the preceding paragraphs.

(NB: paragraphs a., c., d., e. and f. are taken from Statement 2, "Objectives of government financial reports", issued by the INTOSAI Accounting Standards Committee, which includes the SAIs of some of the Member States of the European Union).

Users

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6.3 Users of financial statements can be divided into the following categories:

- a. politicians, acting either as legislators or discharge authority. Politicians are the principal users of financial statements to whom paragraph 6.2.a. above refers. This can be explained by the fact that, generally, it falls to them to legislate on the nature of the financial information which public sector organisations will have to produce. The task of the organisation concerned is to produce, if necessary with the assistance of external consultants, the information required. The role of SAIs is to issue an opinion on the financial statements, i.e. to ensure that they have fulfilled their objectives in compliance with the regulations laid down for their preparation and presentation;
- b. the general public;
- c. the staff of the organisations preparing the financial statements;
- d. external business partners such as lenders, suppliers and customers;
- e. economists, policy analysts and special interest groups;
- f. the media.

(NB: points a. and d. to f. are taken from Statement 1, “Users of government financial reports”, issued by the INTOSAI Accounting Standards Committee)

- 6.4 In the context of the European Community, the Commission produces financial statements on the implementation of the Community budget by the Member States and the Commission’s own departments. The European Court of Auditors audits these financial statements, which are subsequently used by the discharge authority. The peculiarity of this situation is attributable to the fact that a significant amount of expenditure is managed by the Member States. Member State SAIs thus have an important role to play as they can, by being active at the national level with regard to accounting practice, contribute to improving the Communities’ financial statements.
- 6.5 The preceding paragraphs show that the requirements of these various categories differ considerably, whether in quantity of information, amount of detail or in technical complexity. The financial statements should provide each category with the information it needs: this can range from the ordinary citizen simply becoming aware of a public organisation’s activities, to the assessment of the achievement of very precisely defined objectives by politicians or by economists, and to the responsible authority’s exercise of its powers of discharge. The external auditor, in his/her advisory role, helps to ensure that the financial statements are adapted to the expectations of their users.

#### Content and form

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- 6.6 Before considering the content and form of the financial statements themselves, the question of the “reporting entity”, i.e. the totality of activities which the financial statements should account for, should be examined. The reporting entity may be broadly based and include all the activities or organisations controlled by, or in the ownership of, the government, or, on the contrary, cover only one particular activity or one specific organisation. The auditor must ensure that the reporting entity is effectively defined in an appropriate and relevant manner, for this determines not only the type of information which will be presented in the financial statements but also the method of consolidation or of combination of the various accounts singled out for the preparation of these financial statements depends on.
- 6.7 The financial statements form a whole made up of the following parts:
- a. the “revenue and expenditure ” account or the “receipts and payments” account (in French, the “*compte de gestion*”). This includes, where applicable, an analysis of revenue by sources, of expenditure by programme or activities, and an analysis of the use of different types of appropriations and of the fluctuations of the reserves;
  - b. the balance sheet, including assets, liabilities and the statement of reserves;
  - c. the statement of cash flows, documenting the sources and application of funds;
  - d. the notes to the financial statements, including a description of the accounting principles and methods used, and also all the information which enables the user to understand the financial statements and to form an opinion. Certain special items, such as exceptional events or transactions or those concerning previous financial years, post balance sheet events and contingent gains or losses, should be explained in notes if they

- are held to be of such significance that their non-publication would impair the users' capacity to understand the financial statements, to evaluate them correctly and to make sound decisions on the basis of the information they contain;
- e. other explanatory material, as appropriate, which can include performance indicators.

6.8 The financial statements must clearly state the currency and units (thousands or millions) in which they have been drawn up, the closing date of the accounts, and the accounting period. It is also useful if the financial statements present information for two successive periods with two successive closure dates to facilitate the comparison of information and to measure the development of the financial condition and of the performance of the reporting entity.

## Qualitative characteristics of financial statements

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6.9 Qualitative characteristics are the attributes which render the information presented in financial statements useful to readers. The principal characteristics are intelligibility, relevance, reliability and comparability. These notions are defined in detail in ANNEX 3 to this Implementing Guideline.

### 7. Internal control

7.1 An accounting basis, accounting principles and well-defined financial statements adapted to the activities and constraints of the organisation are not sufficient to ensure the reliability of the financial statements produced by an organisation and/or the quality of the financial management. It is also important that the organisation implements and maintains a high-quality internal control.

7.2 Internal control is established by, and the responsibility of, the management of an audited entity. Internal control is defined as all the policies and procedures conceived and put in place by an entity's management to ensure:

- the economical, efficient and effective achievement of the entity's objectives;
- the adherence to external rules (laws, regulations, ...) and to management policies;
- the safeguarding of assets and information;
- the prevention and detection of fraud and error; and
- the quality of accounting records and the timely production of reliable financial and management information.

7.3 The concept of internal control extends beyond strictly accounting and financial considerations and includes two elements, the control environment and internal control procedures. These are explained in more detail in paragraphs 2.1-2.5 of guideline N° 21, "Evaluation of internal control and tests of control".

7.4 The following points show how SAIs can assist the appropriate authorities to make a significant contribution to assuring the quality of internal control:

- a. *analysis of the organisation's control environment* : SAIs can evaluate the quality of an organisation's control environment by examining the achievement of criteria which correspond to the best practice in terms of organisation and management;
- b. *detailed analysis of internal control procedures*: this analysis concerns the procedures leading to the preparation and presentation of financial statements featuring the qualities described in paragraph 6.9;

- c. *quality of communication*: SAIs must ensure that they can communicate effectively with the audited organisations in order to bring to their attention the problems and weaknesses encountered during the evaluation of the internal controls and the analysis of the financial statements;
- d. *identification of good internal control practice*: SAIs may identify examples of good practice and disseminate them inside and outside the audited organisations by means of reports, seminars, publications etc.

## 8. Internal audit

8.1 Finally, internal audit also exercises a direct influence on the quality of the internal controls and the accounting practices of the organisation. An internal audit is an audit exercise conducted by an organisation within the responsibility of its highest hierarchical level. Its functions include, amongst other things, the examination, evaluation and monitoring of the adequacy and efficacy of the systems of accounting and internal controls. In some countries of the European Union, part of the internal audit function can be exercised by bodies such as the Financial Control or the Inspectorate General of Finances. The influence of internal audit mainly affects the following fields:

- a. review of accounting systems and internal controls;
- b. examination of financial and management information;
- c. review of the internal control procedures relating to the economy, efficiency and effectiveness of operations and of the quality of non-financial controls;
- d. review of the compliance of operations with laws of a general nature, and with accounting and financial laws.

8.2 In the context of the above, cooperation between SAIs and internal audit services may prove beneficial since the tasks carried out by both parties are often complementary. However SAIs must take into account the fact that the objectives of the two parties are partly overlapping and they should assure themselves of the quality of internal audit work. For this last point, information can be found in Guideline N° 24 “Using the work of other auditors and experts”. This cooperation between SAIs and internal audit can take other forms: participation with the authorities responsible (the ministries concerned, Inspectorate General of Finances, etc.) in promoting working standards (quality, audit standards, etc.), or assistance and advice on the subject of professional training, working methods, etc.

## ANNEX 1

### Bases of accounting and related financial reporting

The four bases of accounting and the related financial reporting commonly used can be defined along the following lines <sup>(1)</sup>:

- a. cash basis: accounting method by which revenue is not recorded into the accounts until the money has actually been received and expenditure is not recorded until the money has actually been paid out. Financial statements prepared on this basis would show cash received and paid out over a certain period of time (the financial year) and the balance of cash at the beginning and at the end of the period;
- b. modified cash basis: method by which the cash basis method is extended by the inclusion, in the financial reporting period, of receipts of cash and payments of cash that pertain to the financial period concerned, but take place in a specific period of time after the end of the financial period concerned. For a financial reporting period that covers the twelve months from 1 January to 31 December of year n, the modified cash basis will recognise all receipts of cash and payments of cash that relate to transactions or events pertaining to this year n, but that take place in, say, a specific 15-days period of time after the end of the year n, i.e. up to 15 January n+1. Financial statements prepared as at 31 December of year n on this basis would show, in addition to cash on hand at the beginning and at the end of the period, cash received and cash paid out during this 15-day period as assets and liabilities respectively. The specified period for recognising receipts may differ from that used for payments, and sometimes only payments are recognised.
- c. modified accruals basis: method by which transactions or events are recognised when they take place or occur, regardless of when cash is received or paid out. The focus of this method, which is often called *expenditure* accounting, is to measure and report the cost of goods and services *acquired* during the financial reporting period. Revenue reflects amounts that have become due during the period. Reported assets include cash, claims to cash such as accounts receivable and loans, and also investments. Liabilities include trade payables and accruals together with borrowings on financial markets and employee pension liabilities.
- d. accruals basis: method, which is often called *expense* accounting or full accruals basis, very similar to the above-described modified accruals basis and whose focus is to measure and report the cost of goods and services *consumed* during the financial reporting period. Reported assets also include physical assets such as land, buildings and equipment, which consumption is measured by the depreciation charged to the revenue and expenditure account, and also deferred costs. In addition, long-term capital

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1 This Annex is based on Statement 4 “Meeting the objectives of government financial reports” issued by the INTOSAI Accounting Standards Committee.



leases as well as deferred revenue are shown as liabilities. Revenue continues to reflect amounts that have become due during the period.

## ANNEX 2

### The accounting principles presented in the Fourth Council Directive (EEC)

Article 31(1) of the Fourth Council Directive <sup>(1)</sup> provides a list of general principles to be used for the valuation of items shown in the annual accounts of some types of companies. The text of this Article is as follows:

“1. The Member states shall ensure that the items shown in the annual accounts are valued in accordance with the following general principles:

- (a) the company must be presumed to be carrying on its business as a going concern;
- (b) the methods of valuation must be applied consistently from one financial year to another;
- (c) valuation must be made on a prudent basis, and in particular:
  - (aa) only profits made at the balance sheet date may be included,
  - (bb) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up,
  - (cc) account must be taken of all depreciation, whether the result of the financial year is a loss or a profit;
- (d) account must be taken of income and charges relating to the financial year, irrespective of the date of receipt or payment of such income and charges;
- (e) the components of asset and liability items must be valued separately;
- (f) the opening balance sheet for each financial year must correspond to the closing balance sheet for the preceding financial year.

2. Departures from these general principles shall be permitted in exceptional cases. Any such departures must be disclosed in the notes to the accounts and the reasons for them given together with an assessment of their effect on the assets, liabilities, financial position and profit or loss.”

The above-mentioned principles are similar to those expressed in paragraphs 5.1 to 5.4 of the main text of this Implementing Guideline. As far as paragraph 1.d above is concerned, the accruals basis of accounting which is referred to is presented in **ANNEX 1**, paragraph d. of this Implementing Guideline. However, paragraphs 5.1 to 5.4 of the main text include two principles which are not part of the above list: substance over form and materiality, which have grown in importance in Europe since this Directive was issued in 1978.

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1 Directive (EEC) n°78/660 of 25 July 1978 (Official Journal L 222 of 14 August 1978, p.11)

### **ANNEX 3**

#### **Qualitative characteristics of financial statements**

The financial statements should possess certain qualities which render the information they present useful to their readers. These qualitative characteristics are the following, as per Statement 3 “Qualitative characteristics of government financial reports”, issued by the INTOSAI Accounting Standards Committee <sup>(1)</sup>.

- a. **understandable**: information must be understood before it can be used. Government financial reports should present information clearly and simply. Excessive detail and overly complex reporting formats should be avoided, charts and graphs should be used whenever possible. Explanatory narrative should not only be precise but must be stated clearly and, as far as possible, presented in plain non-technical language. This is particularly so for disclosure of complicated information and interpretations. Care must also be taken to avoid misleading forms of presentation caused by excessive simplification or omission of detail.
- b. **relevant**: information is relevant if it helps those who use it to carry out their activities. Preparers of government financial reports should take into account the activities and information needs of users when deciding what is relevant to report. Relevance includes many of the other qualitative characteristics set out in this Statement. For example, if information is not timely, it may not be relevant. Reports should cover the full nature and extent of the financial activities presented.
- c. **reliable**: reliable information faithfully represents what it purports to represent. It is accurate within acceptable tolerances, free from bias, complete and verifiable. Reliability does not imply precision or absolute certainty. For example, government financial reports may include estimates of amounts owing to outside parties that are not known with certainty but for which a strong probability of liability exists. Such reports should disclose, to the extent possible, all significant assumptions and uncertainties.
- d. **material**: information is material if it could reasonably be expected to influence the activities of those who use it. An item may be material because of its size or because of its nature. Materiality is a matter of judgement. Factors that preparers and auditors of government financial reports may wish to consider when determining materiality would include: the purpose of the report, the activities of users and the nature and type of information they need for decision-making and accountability, and the nature of the entity itself.

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1As indicated by the title of this Statement, the INTOSAI Accounting Standards Committee considers that these characteristics apply to government financial reports as a whole, and not only to financial statements of a public sector entity, which generally form part of government or public sector entities financial reports.

- e. timely: Government financial reports should be published soon enough after reported events to help users carry out their activities. Timeliness alone does not make information useful. However, the passage of time after reported events generally decreases usefulness. A timely but realistic estimate may be more useful than precise information if the latter takes many months to produce.
  
- f. consistent: to be understandable, information in a government's financial report or set of reports should be presented on the same accounting basis to the extent possible. Consistency allows those who use financial reports or sets of reports about a government to move from aggregate to disaggregate displays of information, and from one report to another, with ease and confidence. If the basis of accounting and presentation has changed from one accounting period to the next because, for example, a more appropriate accounting policy or standard has been adopted, this fact and the effects on the financial report resulting therefrom should be highlighted and explained clearly.
  
- g. comparable: information is comparable when those who use it are able to identify similarities and differences, either between two or more government entities at a point in time or within the same entity over time. As with consistency, the basis of accounting and presentation, and the effects of any changes from one period to the next, should be highlighted and explained clearly.

The Statement 3 "Qualitative characteristics of government financial reports" also indicates that, in applying these characteristics, preparers and auditors of government financial reports will have to exercise professional judgement, assess benefits and costs, make trade-offs about the importance that should be allocated to each individual characteristic, consider substance over form and exercise prudence.

## ANNEX 4

### Glossary <sup>(1)</sup>

<u>accruals basis:</u>	the method of recording transactions by which revenues are recorded when earned and expenditures are recorded when incurred, whether or not the transactions have been finally settled by the receipt or disbursement of cash.
<u>assets:</u>	things of value that the government (or the public sector entity) legally owns.
<u>balance sheet:</u>	a financial statement that shows what the government (or the public sector entity) owns (its assets) and what the government (or the public sector entity) owes (its liabilities) at a point in time.
<u>cash basis:</u>	the method of recording transactions by which revenues are recorded only when cash is received and expenditures are recorded only when cash is disbursed.
<u>liabilities:</u>	amounts that will legally have to be paid in the future, as a result of events and transactions in the past (eg. trade accounts payable and bookkeeping accruals, liabilities for employee pensions, government borrowing, etc.).
<u>reporting entity:</u>	the boundaries of government (or of the public sector entity, at a lower level) for financial reporting purposes, within which all of the government's (or the public sector entity's) various organisational units are fully consolidated.
<u>surplus or deficit:</u>	the difference between revenues and expenditures (a surplus arises when revenues exceed expenditures; a deficit results when expenditures exceed revenues).

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This list is taken from the Glossary attached to the Study “The users of government financial reports and financial information that governments provide”, issued by the INTOSAI Accounting Standards Committee.

## **ANNEX 5**

### **List of reference documents and further reading**

#### **INTOSAI**

- Auditing standards (Committee on Auditing Standards)
- Accounting standards framework (Accounting Standards Committee)
  - Statement 1 “Users of government financial reports”
  - Statement 2 “Objectives of government financial reports”
  - Statement 3 “Qualitative characteristics of government financial reports”
  - Statement 4 “Meeting the objectives of government financial reports”
  - Study “Users of government financial reports and financial information that governments provide”

#### **EUROPEAN COMMUNITY DIRECTIVE**

- Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (n° 78/660/EEC) (Official Journal L 222 of 14 August 1978, p.11)

#### **IFAC**

- Guidelines (Public Sector Committee of the International Federation of Accountants)
  - Guideline 1 “Financial reporting by government business enterprises”
- Studies (Public Sector Committee of the International Federation of Accountants)
  - Study 1 “Financial reporting by national governments”
  - Study 2 “Elements of the financial statements of national governments”
  - Study 5 “Definition and recognition of assets”
  - Study 6 “Accounting for and reporting liabilities”
  - Study 7 “Performance reporting by government business enterprises”
  - Study 8 “The government financial reporting entity”
  - Study 9 “Definition and recognition of revenues”
  - Study 10 “Definition and recognition of expenses/expenditure”

#### **IASC**

- ”Framework for the preparation and presentation of financial statements” (International Accounting Standards Committee)

- International Accounting Standard n°1 “Disclosure of accounting policies” (International Accounting Standards Committee)
  
- International Accounting Standard n°18 “Revenue recognition” (International Accounting Standards Committee)

## GLOSSARY OF TERMS FROM INTOSAI AUDITING STANDARDS

(this glossary is reproduced from the INTOSAI Auditing Standards)

Accounting Control System	A series of actions which is considered to be part of the total internal control system concerned with realising the accounting goals of the entity. This includes compliance with accounting and financial policies and procedures, safeguarding the entity's resources and preparing reliable financial reports.
Administrative Control System	A series of actions, being an integral part of the internal control system, concerned with administrative procedures needed to make managerial decisions, realise the highest possible economic and administrative efficiency and ensure the implementation of administrative policies, whether related to financial affairs or otherwise.
Audited Entity	The organisation, programme, activity or function subject to audit by the SAI.
Audit Evidence	<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>
Audit Mandate	The auditing responsibilities, powers, discretions and duties conferred on a SAI under the constitution or other lawful authority of a country.
Audit Objective	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.



Audit Procedures	Tests, instructions and details included in the audit programme to be carried out systematically and reasonably.
Audit Scope	The framework or limits and subjects of the audit.
Auditing Standards	Auditing standards provide minimum guidance for the auditor that helps determine the extent of audit steps and procedures that should be applied to fulfil the audit objective. They are the criteria or yardsticks against which the quality of the audit results are evaluated.
Constitutional	A matter which is permitted or authorised by, the fundamental law of a country.
Due Care	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.
Economy	Minimising the cost of resources used for an activity, having regard to the appropriate quality.
Effectiveness	The extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.
Efficiency	The relationship between the output, in terms of goods, services or other results, and the resources used to produce them.
Executive Branch of Government (Executive)	The branch of government which administers the law.
Field Standards	The framework for the auditor to systematically fulfil the audit objective, including planning and supervision of the audit, gathering of competent, relevant and reasonable evidence, and an appropriate study and evaluation of internal controls.
Financial Systems	The procedures for preparing, recording and reporting reliable information concerning financial transactions.
Findings, Conclusions and Recommendations	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.

Fundamental	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.
General Standards	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 fields and reporting standards in a competent, efficient and effective manner.
Independence	The freedom of the SAI in auditing matters to act in accordance with its audit mandate without external direction or interference of any kind.
Internal Audit	The functional means by which the managers of an entity 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.
Internal Control	The whole system of financial and other controls, including the organisational structure, methods, procedures and internal audit, established by management within its corporate goals, to assist in conducting the business of the audited entity 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.
International Organisation of Supreme Audit Institutions (INTOSAI)	An international and independent body which aims at promoting the exchange of ideas and experience between Supreme Audit Institutions in the sphere of public financial control.
Legislature	The law making authority of a country, for example a Parliament.

Materiality and Significance (Material)	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. For example, considering an item in relation to the overall view given by the accounts, the total of which it forms a part ; associated terms ; the corresponding amount in previous years. Audit evidence plays an important part in the auditor's decision concerning the selection of issues and areas for audit and the nature, timing and extent of audit tests and procedures.
Opinion	The auditor's written conclusions on a set of financial statements as the result of a financial or regularity audit.
Performance Audit	An audit of the economy, efficiency and effectiveness with which the audited entity uses its resources in carrying out its responsibilities.
Planning	Defining the objectives, setting policies and determining the nature, scope, extent and timing of the procedures and tests needed to achieve the objectives.
Postulates	Basic assumptions, consistent premises, logical principles and requirements which represent the general framework for developing auditing standards.
Public Accountability	The obligations of persons or entities, including public enterprises and corporations, entrusted with public resources to be answerable for the fiscal, managerial and programme responsibilities that have been conferred on them, and to report to those that have conferred these responsibilities on them.

Regularity Audit	Attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions on financial statements ; attestation of financial accountability of the government administration as a whole ; audit of financial systems and transactions, including an evaluation of compliance with applicable statutes and regulations ; audit of internal control and internal audit functions ; audit of the probity and propriety of administrative decisions taken within the audited entity ; and reporting of any other matters arising from or relating to the audit that the SAI considers should be disclosed.
Report	The auditor's written opinion and other remarks on a set of financial statements as the result of a financial or regularity audit or the auditor's findings on completion of a performance audit.
Reporting Standards	The framework for the auditor to report the results of the audit, including guidance on the form and content of the auditor's report.
Supervision	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.
Supreme Audit Institution (SAI)	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.