



# **FINANCIAL AUDIT ISSAI IMPLEMENTATION HANDBOOK**



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# FINANCIAL AUDIT ISSAI IMPLEMENTATION HANDBOOK

**REVISED 2023**

*This is a new version of Financial Audit ISSAI Implementation Handbook  
following a light touch revision made as of 31 December 2023*

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# ACRONYMS & ABBREVIATIONS

<b>AWP</b>	Audit Working Paper
<b>COTABD</b>	Classes of Transactions, Account Balances or Disclosures
<b>FA</b>	Financial Audit
<b>FAAS</b>	Financial Audit and Accounting Subcommittee
<b>FRF</b>	Financial Reporting Framework
<b>FIPP</b>	Forum for INTOSAI Professional Pronouncements
<b>INTOSAI</b>	International Organisation of Supreme Audit Institutions
<b>INCOSAI</b>	International Congress of Supreme Audit Institutions
<b>IFPP</b>	INTOSAI Framework of Professional Pronouncements
<b>IDI</b>	INTOSAI Development Initiative
<b>ISSAI</b>	International Standards of Supreme Audit Institutions
<b>IAASB</b>	International Auditing and Assurance Standards Board
<b>IFRS</b>	International Financial Reporting Standards
<b>IPSAS</b>	International Public-Sector Accounting Standards
<b>KAM</b>	Key Audit Matters
<b>PN</b>	Practice Notes in ISSAI
<b>PSC</b>	INTOSAI Professional Standards Committee
<b>QA</b>	Quality Assurance
<b>ISA</b>	International Standards on Auditing
<b>ROMM</b>	Risk of Material Misstatement
<b>SAI</b>	Supreme Audit Institution
<b>SDG</b>	Sustainable Development Goal



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# QUALITY STATEMENT FOR FINANCIAL AUDIT ISSAI IMPLEMENTATION HANDBOOK (REVISED 2023)

INTOSAI Goal Chairs and IDI's joint paper on 'Quality assuring INTOSAI public goods that are developed and published outside due process' identifies three levels of quality assurance, as follows:

## QUALITY ASSURING INTOSAI PUBLIC GOODS THAT ARE DEVELOPED AND PUBLISHED OUTSIDE DUE PROCESS – Levels of Quality Assurance

- **Level 1:** Products that have been subjected to quality assurance processes equivalent to INTOSAI due process, including an extended period of transparent public exposure (90 days)
- **Level 2:** Products that have been subjected to more limited quality assurance processes involving stakeholders from outside the body or working group responsible for the products' initial development. Quality assurance processes might, for example, include piloting, testing and inviting comments from key stakeholders, although not go as far as full 90-day public exposure
- **LEVEL 3:** Products that have been subjected to rigorous quality control measures within the body or working group responsible for their development

Different levels of Quality Assurance may be appropriate for different GPGs. This GPG has been developed according to quality assurance level 1.

## Quality Assurance Protocol: Version 2.0

IDI's Protocol for Quality Assurance (QA) of IDI's Global Public Goods defines measures to ensure quality based on the three levels of quality assurance above. For quality assurance level 1, these measures include: approval by the IDI Board to create the GPG; formation of a competent product development team; peer review by experts external to the development team; modification based on review; proof-reading, editing and translation of the document by competent persons; public exposure for a period of 90 days/consultation with relevant stakeholders representing views from most regions, most models of auditing, developed and developing countries, and from the perspective of global bodies; modifications of the document based on comments received during public exposure; and due approvals for the GPG version 1.

## Updates to this GPG

To ensure that this GPG stays relevant, IDI will undertake major revision of this Financial Audit Handbook whenever there are changes in financial audit ISSAIs. Major revisions will follow IDI's Protocol for Quality Assurance. In addition, light touch reviews will be done annually based on FAAS updates. Such light touch reviews will not normally be subject to this Protocol. For this light touch review, a new QA review was not required.

This GPG is owned by IDI's Professional SAs work stream, which is responsible for maintenance of this GPG.

## Quality Assurance Review Process

Martin Aldcroft (Strategic Support Unit, IDI) has undertaken a QA review of the process followed for the development of this GPG, against QA Protocol Version 2.0. The QA reviewer is familiar with IDI's protocol for QA of GPGs and was not involved in development of the GPG. This QA review process is designed to provide all stakeholders with assurance that the IDI has carried out the quality control measures stated above, designed to meet quality assurance level 1.

## Results of the Quality Assurance Review

The QA review of the process followed in developing this GPG concluded that the Protocol has been followed as required for quality assurance level 1 in all respects.

## Conclusion

*Based on the QA review, IDI assures the users of this Global Public Good (GPG) that this document has been subjected to a quality assurance process equivalent to Due Process for INTOSAI Framework of Professional Pronouncements (IFPP), including an extended period of transparent public exposure.*



**Mr. Einar Gørissen**

Director General

INTOSAI Development Initiative

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No.	Name	Organisation
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4	Shelmadene Petzer	SAI of South Africa

Lastly, we would also like to express our gratitude to INTOSAI-PSC Financial Audit and Accounting Subcommittee (FAAS), especially the Chair and the Secretariat (SAI of United Arab Emirates) for ensuring the technical integrity of this Handbook through their review before and after the product has been exposed for public comments. This successful collaboration is a manifestation of the valued partnership between the IDI and the FAAS. The FAAS Chair has been very supportive and inspired us throughout the whole process of development of this handbook.

The light touch revision of this document in 2023 was done by Karma Tenzin FCCA, Senior Manager, and Mark Anthony Flores CPA, Manager, Department of Professional & Relevant SAIs, INTOSAI Development Initiative.



# ABOUT THE HANDBOOK

## BACKGROUND

Under Phase I of the **ISSAI**<sup>1</sup> Implementation Initiative (also known as **3i Programme**<sup>2</sup>) of **INTOSAI**<sup>3</sup> Development Initiative (IDI), a Financial Audit ISSAI Implementation Handbook was developed to address the institutional and strategic issues that Supreme Audit Institutions (SAIs) might have to deal with when performing financial audits in accordance with applicable ISSAI. The assumption made was that prior to ISSAI implementation, the SAIs should understand the internal and external environment supporting ISSAI-based audits (cf. ISSAI 100). Hence, the said handbook did not dwell much on financial auditing standards and their application (or corresponding application material, methodology, etc.). Moreover, the IDI also received feedback that SAIs needed a handbook that the financial auditor could use in conducting ISSAI compliant audit.

The IDI embarked upon facilitating implementation of ISSAIs in SAIs since 2012, wherein the support was extended at the global, regional and SAI level following a programme-based delivery approach, which generally had a short to medium-term time perspective of two to three years. In its strategic plan 2019-23, the IDI envisages to provide support to SAIs for implementation of ISSAIs through a workstream based approach, which will be a long-term, continuous and a regular support function. Within the workstream, support and training will be open to all SAIs on a continual basis, not just to participating SAIs at specific points within a programme.

## PURPOSE AND SCOPE OF THE HANDBOOK

The Handbook consists the audit methodology that contains explanations of the ISSAI-based financial audit process as well as audit working paper templates, that are designed to facilitate the application of ISSAIs in practice. SAIs may need to design and develop additional guidance and working paper templates where required to meet additional requirements that may be imposed by their law, regulation and practice.

This Handbook may be used and adapted by SAIs who adopted financial audit ISSAIs as authoritative auditing standards for auditing the financial statements. The methodology suggested in this handbook extensively covers the audit work to be performed and documented at the audit engagement level.

The handbook may also be used by those organisations supporting SAIs in developing audit methodology for financial audit.

<sup>1</sup> International Standards of Supreme Audit Institutions.

<sup>2</sup> The INTOSAI Strategic Plan and the ISSAI Rollout Model approved by INTOSAI Governing Board in October 2011 mandated the IDI to 'support ISSAI Implementation'. In keeping with this mandate, the IDI has launched a comprehensive capacity development programme called the ISSAI Implementation Initiative (3i Programme).

<sup>3</sup> International Organisation of Supreme Audit Institutions.

## PROCESS OF DEVELOPING THE HANDBOOK

The IDI followed the Protocol for Quality Assurance of its Global Public Goods for development of this handbook, which determines the due process for ensuring the quality of product as highlighted below:

- The first draft of this handbook was developed by a pool of global resource persons mobilised from different INTOSAI regions and the IDI staff. Upon completing the first draft, the product development team and IDI staff reviewed and finalised the draft.
- The draft was then independently reviewed by a group of financial audit experts. The draft was modified as draft version 0 based on comments received from this group of experts.
- The draft version 0 of this handbook was exposed for a period of 90 days to receive feedback and comments from stakeholders. The draft was placed on IDI and INTOSAI websites, upon which an email communication was sent out to all relevant stakeholders, both internal and external to IDI, informing the availability of draft version 0 for comments.
- Upon receiving comments from stakeholders on draft Version 0 of this handbook, which was exposed for a period of 90 days in four IDI languages (English, Arabic, Spanish and French), this version (Version 1) was finalised in collaboration with Financial Audit and Accounting Sub-committee of INTOSAI-PSC.

This handbook replaces draft Version 0, which stands withdrawn as on the date of availability of this Version 1. While the major revision of this handbook will take place when there are changes in financial audit ISSAIs (expected after 2019), light touch reviews will be done annually based on FAAS updates.

## CONTENT OF THE HANDBOOK

This Handbook includes ISSAI-based audit methodology intended to address, among the thirty-seven financial audit standards (ISSAI 2200-2810), those that are key and commonly applicable to audits of financial statements conducted by SAIs in a public-sector environment.

The numbering structure of the financial audit ISSAIs follows the numbering structure of the International Standards on Auditing (ISAs) that are developed by the International Auditing and Assurance Standards Board (IAASB) since the ISAs are incorporated into the INTOSAI Framework of Professional Pronouncement (IFPP) without modification. The financial audit ISSAIs may include additional leading numbers to conform to the ISSAI numbering structure and these leading numbers may change from time to time.

Besides depicting the difference between standards and this Handbook, **Illustration 1.1** also establishes that these two complements each other, i.e. the requirements of the standards become the basis for proposing an approach to audit methodology.

The handbook promotes global best practice. The SAIs need to adapt the methodology described in this handbook to suit local needs depending on the applicable financial reporting framework or other reporting responsibilities.

There are 10 chapters in this Handbook: Chapter 2 provides a background of the INTOSAI Framework of Professional Pronouncement (IFPP), along with an understanding of the relevant financial reporting framework in an audit of financial statements. As the Handbook also intends to establish an understanding of the financial audit process, Chapter 3 explains the financial audit process; subsequent chapters (chapters 4 to 10) follow the order of the audit process.

As audits are iterative processes, due care was taken to maintain the linkage between different stages of the audit when writing each chapter and developing working paper templates. Cross-referencing to working paper templates also ensures that the users understand the need to maintain such a linkage in an actual audit of financial statements.

Other IDI global products complement this Handbook and should be read in conjunction with those products, such as the Supreme Audit Institutions Performance Measurement Framework 2021, ISSAI implementation need assessment tool (through iCAT), and the Playbook on System of Audit Quality Management.

**ILLUSTRATION 1.1**  
**Comparison between standards and FA Handbook**

FA ISSAIs	FA ISSAI IMPLEMENTATION HANDBOOK
<p><b>Basic Purpose</b></p> <p>What needs to be done in an audit of financial statements to claim that the audit was conducted in accordance with ISSAI?</p> <p><b>Sets a minimum benchmark to ensure the quality of financial audit.</b></p> <p><b>What is it all about?</b></p> <ul style="list-style-type: none"> <li>• Requirements</li> <li>• Application and other explanatory notes to requirements</li> <li>• Practice notes</li> </ul>	<p><b>Basic Purpose</b></p> <p>How to conduct an audit of financial statements to meet the requirements of ISSAI?</p> <p><b>Provides a mechanism (method) to attain the minimum benchmark in financial audit.</b></p> <p><b>What is it all about?</b></p> <ul style="list-style-type: none"> <li>• Defined financial audit process (<i>reflecting among others the methodology for compliance to ethics, communication, role of leadership and quality</i>)</li> <li>• Tools and techniques</li> <li>• Illustrations</li> <li>• Audit working paper templates to document audit works</li> </ul>

ISSAI BASED FINANCIAL AUDIT

## CHAPTER 2

# INTRODUCTION TO IFPP AND PUBLIC SECTOR FINANCIAL AUDITING

Chapter 2 explains the history of the development of the financial audit ISSAIs and introduces the general principles of public sector auditing, demonstrating the links between general principles of public sector auditing and financial auditing ISSAI requirements.

## ISSAI FRAMEWORK AND THE REVISED INTOSAI FRAMEWORK OF PROFESSIONAL PRONOUNCEMENTS

This section describes the revised INTOSAI Framework of Professional Pronouncements (IFPP), including the ISSAI, as a set of professional standards developed by INTOSAI's Professional Standards Committee (IPSC).

Prior to the adoption of the ISSAI, INTOSAI had separate auditing standards approved at **INCOSAI**<sup>4</sup> in 1998 and updated in 2001. However, in its strategic plan 2005–2010, INTOSAI decided to “provide an up-to-date framework of professional standards,” and therefore the PSC decided to merge the existing and the new INTOSAI standards and guidelines into a single framework. The extant ISSAI framework classified official pronouncements into four levels, as presented in **Illustration 2.1**.



<sup>4</sup> INTOSAI Congress.

## ILLUSTRATION 2.1

### ISSAI Framework

#### LEVEL 1

##### Founding Principles (ISSAI 1-2)

Level 1 of the ISSAI framework contains the founding principles of INTOSAI. ISSAI 1, The Lima Declaration from 1977, calls for the establishment of effective Supreme Audit Institutions and provides guidelines on auditing precepts.

#### LEVEL 2

##### Prerequisites for the Functioning of Supreme Audit Institutions (ISSAI 10-99)

The Prerequisites for the Functioning of Supreme Audit Institutions contains INTOSAI's pronouncements on the necessary preconditions for the proper functioning and professional conduct of SAIs. These include principles and guidance on independence, transparency and accountability, ethics and quality control. The prerequisites may concern the institution's mandate and further legislation as well as the established procedures and daily practices of the organisation and its staff.

#### LEVEL 3

##### Fundamental Auditing Principles (ISSAI 100-999)

Level 3 ISSAI are the fundamental principles for public sector auditing, which provide a conceptual basis for public sector auditing and ensure consistency in the ISSAI framework. ISSAI 100 includes the fundamental principles of public sector auditing and establishes the basic concepts and principles shared by the three areas of auditing (financial, compliance and performance audit). The specific principles of the three audit types are in ISSAI 200, 300 and 400.

#### LEVEL 4

##### Auditing Guidelines (ISSAI 1000-4999)

The auditing standards at level 4 translate the fundamental auditing principles into more specific, detailed and operational standards that auditors can resort to daily in the conduct of auditing tasks. The purpose of the standards is to provide a basis for development of audit methodologies (and manuals) on public sector auditing that individual members of INTOSAI may apply. The general auditing guidelines (ISSAI 1000-4999) contain the recommended requirements of financial, performance and compliance auditing and provide further guidance to the auditor. They define the internationally recognized current best practices within their general scope of application.

A revised framework endorsed at INCOSAI 2019 reclassified INTOSAI Professional Pronouncements. This framework contains three categories of professional pronouncements as shown in **Illustration 2.2**.

### ILLUSTRATION 2.2 Revised Framework





## GENERAL PRINCIPLES OF PUBLIC SECTOR AUDITING

ISSAI 100 “Fundamental Principles of Public Sector Auditing” defines both the authority of the ISSAI and how an auditor can claim ISSAI compliance in the auditor’s report. This ISSAI operationalizes the INTOSAI principles into standards: it provides the fundamental principles that are applicable to public-sector compliance, financial, and performance audit engagements.

ISSAI 200 “Financial Audit Principles<sup>5</sup>” complements the fundamental principles of ISSAI 100 with the specific context of audits of financial statements. Together they constitute the basis for INTOSAI’s complete set of professional pronouncements in this area and should both be complied with.

### ILLUSTRATION 2.3

**General principles of public sector auditing as set out in ISSAI 100, and their link with specific financial audit requirements**

GENERAL AUDITING PRINCIPLES	PRINCIPLE EXPLANATION IN ISSAI 100	DETAILED REQUIREMENTS*
<b>1 Ethics and independence</b>	Auditors should comply with relevant ethical requirements and be independent.	<b>ISSAI 130, ISSAI 200</b>
<b>2 Professional judgement, due care and scepticism</b>	Auditors should maintain appropriate professional behaviour by applying professional scepticism, professional judgment and due care throughout the audit	<b>ISSAI 200, ISSAI 2200</b>
<b>3 Quality management</b>	Auditors should perform the audit in accordance with the procedures and requirements of the professional standards on quality management	<b>ISSAI 140, ISSAI 200, ISSAI 2200, ISSAI 2220</b>
<b>4 Audit team management and skills</b>	Auditors should possess or have access to the necessary skills	<b>ISSAI 200, ISSAI 2200, ISSAI 2220</b>
<b>5 Audit risk</b>	Auditors should manage the risks of providing an inappropriate report in the circumstances of the audit	<b>ISSAI 200, ISSAI 2315, ISSAI 2330</b>
<b>6 Materiality</b>	Auditors should prepare audit documentation in sufficient detail to provide a clear understanding of work performed, evidence obtained, and conclusions reached	<b>ISSAI 200, ISSAI 2230, all ISSAI</b>
<b>7 Documentation</b>	Auditors should prepare audit documentation in sufficient detail to provide a clear understanding of work performed, evidence obtained, and conclusions reached	<b>ISSAI 200, ISSAI 2230, all ISSAI</b>
<b>8 Communication</b>	Auditors should establish effective communication throughout the audit process	<b>ISSAI 200, ISSAI 2200, 2210, 2240, 2260, 2265, ISSAI 2700 series</b>

*\* Detailed requirements concerning principles in ISSAI 200 and ISSAI 2200-2810: It must be emphasised that all these eight general principles are critical in the context of financial auditing. Hence, requirements concerning these principles and references to these principles may exist in many other financial audit standards applicable at the engagement level, as referred to above.*

<sup>5</sup> ISSAI 200 Financial Audit Principles (Endorsement version as on 7 December 2020)

The above-mentioned principles apply throughout the audit process. In order to assure compliance with general principles of auditing, SAIs need to have policies and manuals in place that define the principles in the context of their own environment.

As explained in ISSAI 100.8, the principles can be used as a basis for developing authoritative standards in three ways:

- As a basis on which standards are developed by a SAI (but this option is not likely to be feasible in practice).
- As a basis on which consistent national standards are adopted.
- As a basis for adoption of the ISSAIs.

## IMPORTANCE OF AUDIT IN THE PUBLIC SECTOR

The main purpose of public sector auditing is to uphold and promote public accountability between public entities and democratically elected bodies. According to the principles listed in INTOSAI-P 12 “Value and Benefits of SAIs—Making a Difference to the Lives of Citizens”, SAIs should carry out audits to ensure that governments and public entities account for their stewardship over and use of public resources and for the transparency of government operations; and ultimately to contribute to maintaining a country’s financial discipline.

ISSAI 100.18 states, “In general, public-sector auditing can be described as a systematic process of objectively obtaining and evaluating evidence to determine whether information or actual conditions conform to established criteria. Public-sector auditing is essential in that it provides legislative and oversight bodies, those charged with governance and the general public with information and independent and objective assessments concerning the stewardship and performance of government policies, programmes or operations.”

Financial accountability is about sound (legal and regular) financial management; the fairness with which the entity has reported its financial position, results, and use of resources; and the compliance of that reporting with the applicable FRF.

Financial auditing in the public sector is commonly acknowledged as a control mechanism of the state to secure financial accountability: better financial accountability mechanisms within states support the functioning of systems by conveying information to parliaments or the equivalent about the functioning of the executive and administrative branches of the state.

Therefore, public sector auditors have an important role to play in looking at the money spent on public programmes. That role includes providing reasonable assurance that the information prepared by government properly presents the financial situation of public sector institutions, including government ministries/entities or the whole of government.

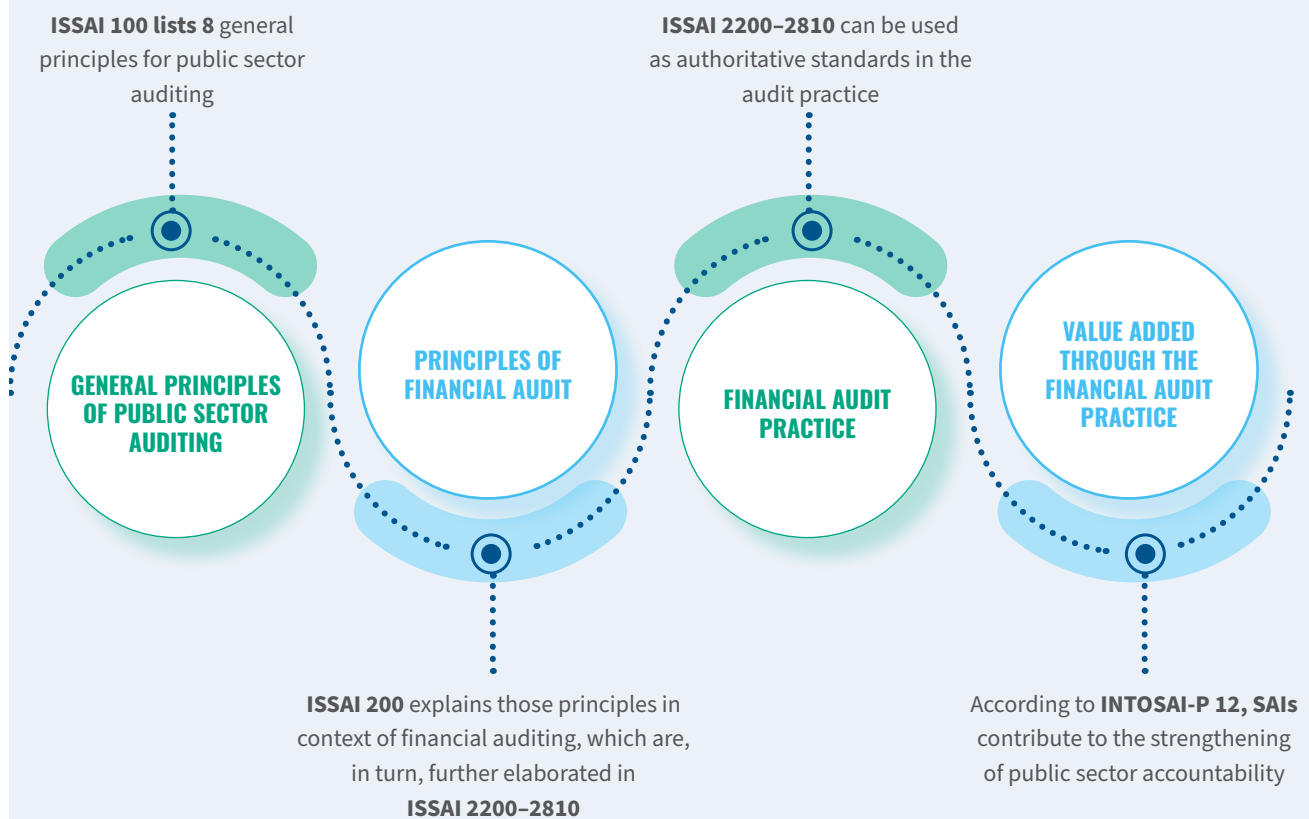
In the public sector, the cycle of accountability begins with the budget process and ends with the presentation of reports to Parliament. SAIs’ published audit reports may include an opinion on the financial statements and may, as well, include audit findings on the regularity of the underlying transactions, weaknesses internal control systems, fraud, mismanagement of funds, etc.

Figure 2(a) below explains how implementing the general principles of public sector auditing in the audit of financial statements enables SAIs to meet the expectations of stakeholders and to add value by strengthening the accountability of government:

- First, the SAI’s financial audit policies and auditing guidance need to explain how to meet those principles in the specific context of the SAI’s mandate, i.e., those principles should be translated into audit procedures (in approved audit manuals) and be implemented in practice.
- Second, each financial audit will directly contribute to the SAI’s role of strengthening accountability, integrity and transparency of government and public-sector entities as defined in INTOSAI-P 12.

**FIGURE 2(a)**

**General principles of public sector auditing in the audit of financial statements**

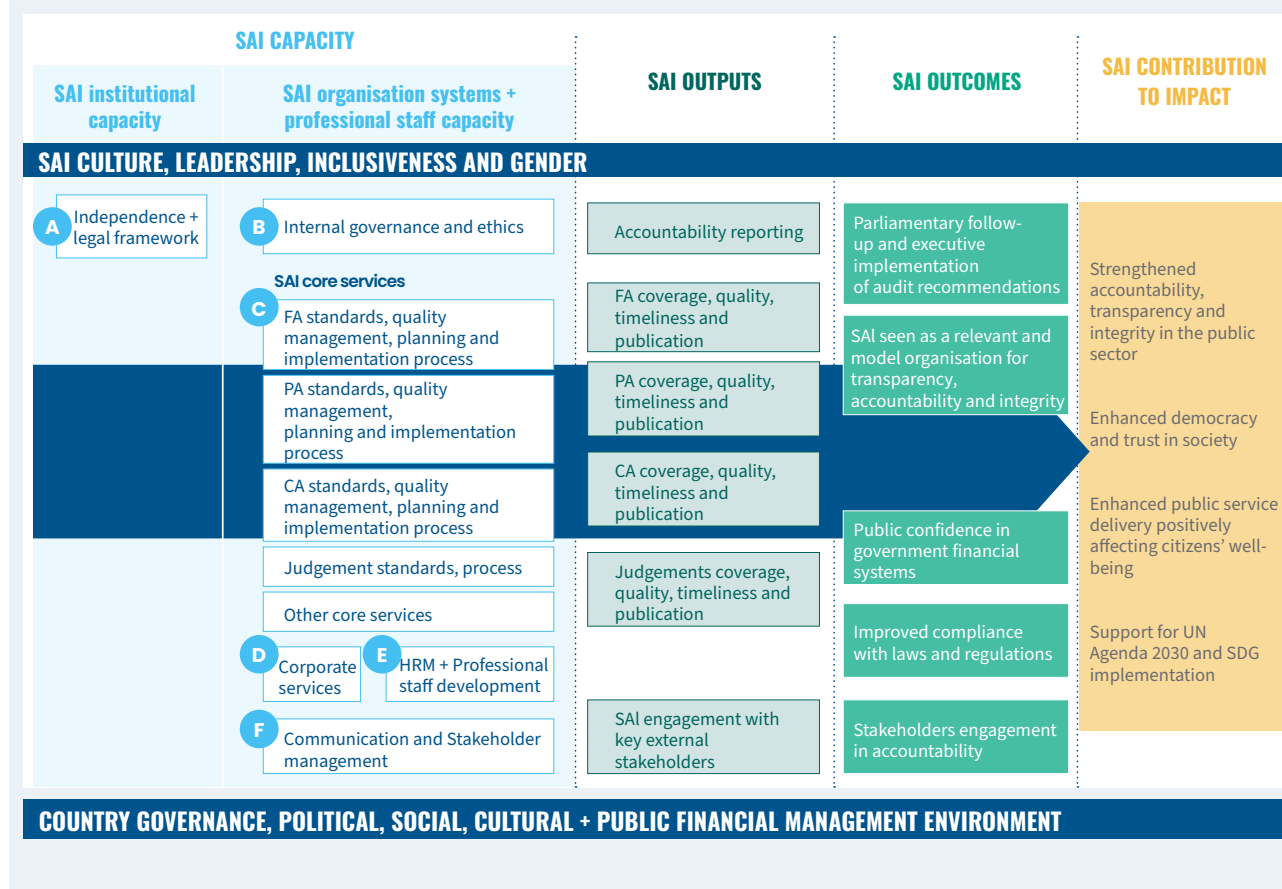


However, to achieve impact and add value through financial audits, SAIs also have to ensure that their work is adequately reported and available in the public domain and that it is presented in a way that is clear and accessible to the different audiences (Cf. INTOSAI Capacity Building Committee's good practice note on "How to increase the use and impact of audit reports", October 2013, prepared for INCOSAI XXI, Beijing). The IDI SAI Strategic Management Framework given in Figure 2(b) also demonstrates how the financial audit in the public sector contributes to the quality of public sector governance and service delivery for the value and benefit of citizens.

In the context of SDG, the financial audit contributes to achievement of Gol 16: Peace, Justice and Strong Institution as it provides an assurance on the presentation of financial statements of public sector entities and the overall government level, particularly in the target area of effective, accountable and transparent institutions at all levels.

Achieving the above objectives requires the application of ISSAI which includes the disciplines of compliance, financial, and performance audit. The objective of an ISSAI financial audit is explained in the next section.

**FIGURE 2(b)**  
**SAI Strategic Management Framework**



## OVERALL OBJECTIVES OF THE EXTERNAL PUBLIC-SECTOR AUDITOR WHEN CONDUCTING A FINANCIAL AUDIT IN ACCORDANCE WITH ISSAIs

ISSAI 2200 deals with the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with ISSAI. Specifically, it sets out the overall objectives of the independent auditor and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives.

The purpose of a financial audit is to enhance the confidence that intended users can have in the

financial statements. This is achieved by the expression of the auditor's opinion on whether the financial statements were prepared, in all material respects, in accordance with an applicable financial reporting framework.

The remaining standards (ISSAI 2210–2810), which expand on ISSAI 2200, deal with the independent auditor's specific requirements when conducting an audit of financial statements.

## HOW TO REFER TO THE FINANCIAL AUDITING STANDARDS IN A SAI'S AUDIT REPORT

ISSAI 100.9 states, "An SAI may declare that the standards it has developed or adopted are based on or are consistent with the principles of the ISSAIs only if the standards fully comply with all relevant principles in ISSAIs 100, 200, 300 and 400.

Audit reports may include a reference to the fact that the standards used were based on or consistent with the ISSAI or ISSAIs relevant to the audit work carried out. Such reference may be made by stating:

***"... We conducted our audit[s] in accordance with [standards], which are based on [or consistent with] ISSAI 100 Fundamental Principles of Public-Sector Auditing [and the principles of ISSAI 200 Financial Audit Principles] of the International Standards of Supreme Audit Institutions."***

ISSAI 100.10 states; "SAIs may choose to adopt the ISSAIs as their authoritative standards. In such cases the auditor must comply with all ISSAIs relevant to the audit. Reference to the ISSAIs applied may be made by stating:

***"We conducted our audit(s) in accordance with the International Standards of Supreme Audit Institutions."***

## CIRCUMSTANCES WHERE IT IS NOT POSSIBLE TO REFER TO FINANCIAL AUDIT ISSAIs (ISSAI 2200-2810) AS AN AUTHORITATIVE STANDARD

### 1. When the engagement does not provide reasonable level of assurance

SAIs may perform investigations, reviews, or agreed upon procedures engagements. Such engagements conducted by the SAI are currently not covered by the existing ISSAIs. According to ISSAI 200.25 audits of financial statements conducted in accordance with the ISSAIs are attestation engagements which aim to provide reasonable assurance. ISSAI 200.26 further states that in general, reasonable assurance audits are designed to result in a conclusion expressed in a positive form, such as "in our opinion the financial statements present fairly, in all material respects (or give a true and fair view of) the financial position of .... and its financial performance as cash flows." or in the case of compliance framework, "in our opinion the financial statements are prepared, in all material respects, in accordance with ...".

According to the standards ISSAI 100.24 and ISSAI 200.20–22, the elements of an assurance engagement are existence of a three-party relationship, involving an auditor, a responsible party and intended users; a subject matter; criteria for assessing the subject matter; and the resulting subject matter information (the financial statements).

**ILLUSTRATION 2.4****Example of an assurance engagement**

Management (the responsible party) of Institution Y fulfilled its responsibility by recording and processing financial transactions and other accounting data (subject matter information) in accordance with the International Public Sector Accounting Standards (IPSAS)—the criteria. The elements (assets, liabilities, etc.) are recognized, measured, presented and disclosed in the financial statements which comprise the Statement of Financial Position, Statement of Financial Performance, Statement of Changes in Net Assets/Equity, Cash Flow Statement and Notes (the subject matter information) as per the requirements of IPSAS. A practitioner (auditor) of the SAI expresses his or her opinion (assurance) in the form of a report on the fair presentation of financial statements.

The auditor concludes that the financial statements (subject matter information) prepared by management (the responsible party) are presented in accordance with the criteria (FRF-IPSAS), and reports that the subject matter information represents fairly in all material respects the entity's financial position, financial performance, net equity and cash flows (subject matter).

If one or more of the above-mentioned elements is not present, then it is not a reasonable assurance engagement. In other words, if the auditor has a task, which does not involve the elements of an assurance engagement then it cannot be defined as a financial audit. For example, the SAI is asked to conduct a review on ministries budget execution and report on findings about deviations from budget approved by the parliament without giving an overall opinion.



## **2. When auditor is giving a report on financial information that is not historical financial information**

According to ISSAI 200.8, the objective of financial audit is, through collection of sufficient appropriate evidence, to provide reasonable assurance to the users, in the form of an audit opinion and/or report, as to whether the financial statements or other forms of presentation of financial information are fairly and/or in all material respects presented in accordance with the applicable financial reporting and regulatory framework. The financial audits deal with historical financial information, which are expressed in financial terms in relation to an entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past. In case where a SAI must report on financial information that is not historical financial information, Financial Audit ISSAIs cannot be referred as authoritative standards. For example, in a case where a SAI is issuing a report about accuracy of budget forecasts the reference to financial audit ISSAIs as an authoritative standard cannot be made.

When the SAI's mandate includes giving an opinion/statement on compliance with laws and regulations other than the applicable financial reporting framework, the SAI should consider using ISSAI 400 and ISSAI 4000 as guidance for those specific opinions/statements.

## **FINANCIAL AUDIT ISSAIS-EVALUATING THE EFFECTS OF A LEGAL AND REGULATORY FRAMEWORK ON THE FINANCIAL STATEMENTS**

The objective of an ISSAI-based financial audit is to enhance the degree of confidence of intended users in the audited financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. When performing such an audit, the subject matter information being audited is the financial statements and the criteria that the auditor evaluates this subject matter information against is the applicable financial reporting framework.

The objective of an ISSAI-based compliance audit is to assess whether a given subject matter is in compliance with a relevant law or regulation (authority). When performing such an audit, the subject matter being audited is the activity that is performed by the responsible party that must be in compliance with the relevant authority and this authority is the criteria for such an audit.

ISSAI-based financial and compliance audits therefore have different stated objectives but these objectives often converge due to the legislative nature of public sector environments.

When performing an ISSAI-based financial audit, there is a requirement to consider the effects of the audited entity's legal and regulatory framework on the financial statements. In the public sector, the legal and regulatory framework can have significant effects on the financial statements. The legal and regulatory framework can even form the applicable financial reporting framework that is applied to prepare the financial statements. For this reason, relevant authorities can sometimes become the criteria against evaluating the preparation of financial statements when performing an ISSAI-based financial audit. When this occurs, the objectives of ISSAI-based financial and compliance audits converge.

ISSAI 2250 defines two types of effects that a legal and regulatory framework may have on financial statements and that must therefore be considered by an auditor; direct and indirect.

The legal and regulatory framework has a direct effect on the financial statements if it directly impacts the information that must be reported in the financial statements. When public sector financial statements are prepared based on authorities as described above, these authorities are considered to have a direct effect on the financial statements and must be evaluated as required by ISSAI 2250. When public sector financial statements are prepared by applying an accounting framework that is not based on authorities, any other relevant authorities that directly impact the financial statements continue to fall within the scope of ISSAI 2250. For example, an authority that requires a specific type of expense to be recorded at a specific value or that requires a specific information disclosure to be provided in the financial statements would be considered to have a direct effect on the financial statements.

The legal and regulatory framework has an indirect effect on the financial statements if it does not have a direct effect on the financial statements as described above but could have an effect if non-compliance occurs. For example, non-compliance with an authority that could give rise to a fine or other potential liability would be considered to have an indirect effect on the financial statements if non-compliance occurred.

Public sector auditors typically have a responsibility to evaluate compliance with authorities as part of their mandate. Part of this responsibility may be met from the application of ISSAI 2250 as described above but public sector auditors may be required to or may choose to evaluate compliance with other authorities that may not be in scope of ISSAI 2250. It is often most efficient to evaluate compliance with such other authorities as part of the annual financial statement audit process since the auditor is typically evaluating material economic activities that have occurred when testing financial statements and

since the same samples that are selected and tested to gain comfort over the financial statements may also be relevant to the testing of compliance with such other authorities. For example, when testing a sample of purchases to gain comfort over relevant financial statement assertions, an auditor may evaluate compliance with a procurement authority that controls an element of the purchasing process but that does not have a direct or indirect effect on the financial statements.

The financial audit ISSAIs allow for the reporting of the results of testing of compliance with authorities in the auditor's report when this reporting is necessary to meet a specific statutory reporting requirement. This information must be reported in a separate paragraph in the auditor's report that is entitled "Report on Other Legal and Regulatory Requirements". These authorities may or may not be within the scope of ISSAI 2250.

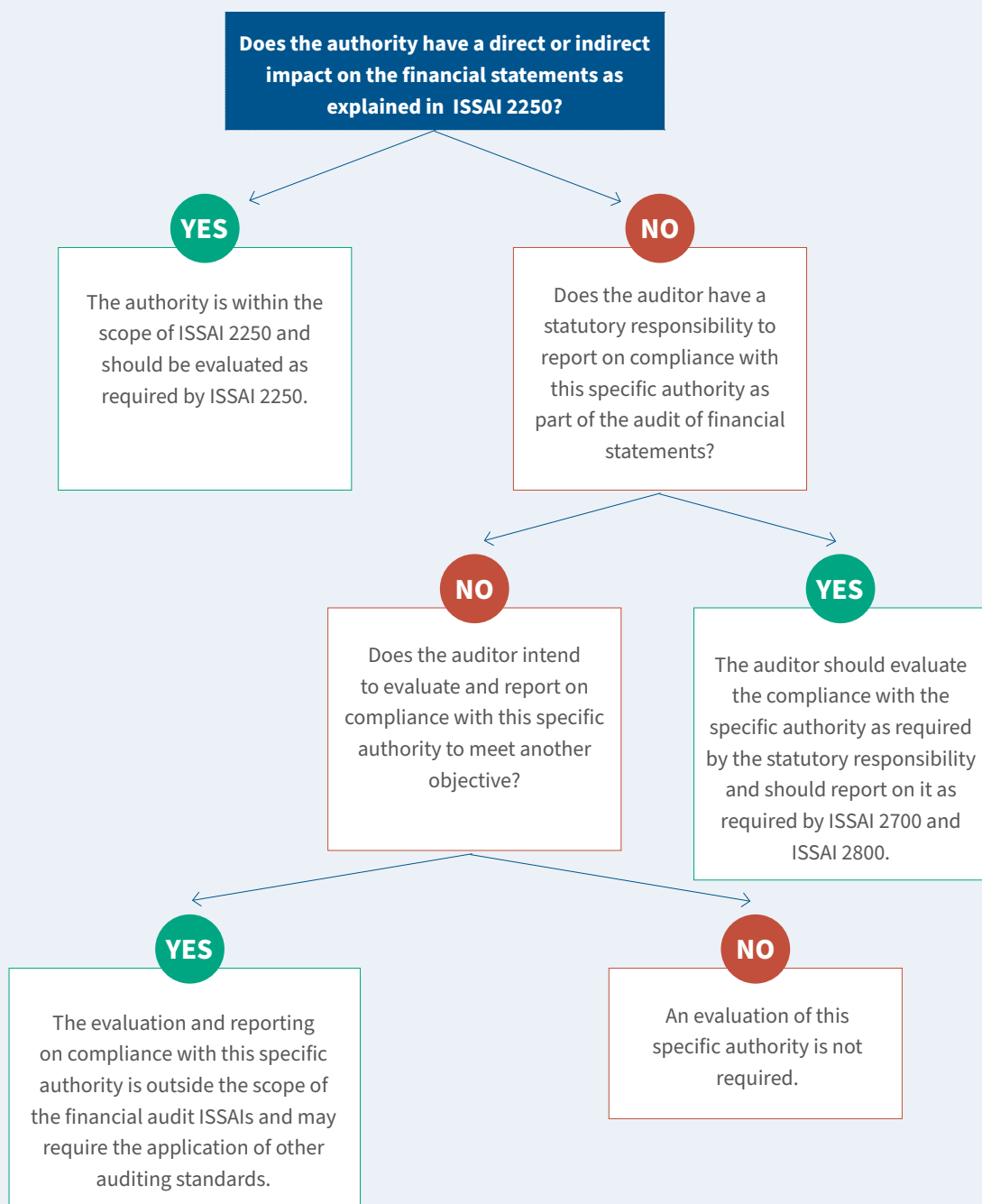
Non-compliances with authorities may need to be reported in the auditor's report for reasons other than a statutory reporting requirement for example as a "key audit matter" or as an "other matter" depending on the nature and significance of the non-compliance and its impact on the financial statements. These authorities may or may not be within the scope of ISSAI 2250 since auditors may scope authorities that are outside of the scope of ISSAI 2250 into their audit plan for the reasons explained above. The auditor must ensure that the non-compliance is appropriately reported in accordance with the requirements of the financial audit ISSAIs and professional judgement may need to be applied to determine the most appropriate reporting treatment especially when reporting on authorities that are outside the scope of ISSAI 2250 which do not impact the financial statements but which may nevertheless be of significant importance to the financial statement users.

Auditors in some environments may be required to factually report in their auditor's report all non-compliances with authorities that they have identified when performing their audit of financial statements, a reporting practice that is not required by the financial audit ISSAIs. When an auditor is required to report a non-compliance with an authority in a manner that

deviates from the requirements of the financial audit ISSAIs, the deviation should be evaluated to ensure that all relevant financial audit ISSAI requirements continue to be effectively met.

**Figure 2(c)** depicts the decision tree which clarifies the scope of ISSAI 2250.

**FIGURE 2(c)**  
**Decision tree clarifying the scope of ISSAI 2250**



## CHAPTER 3

## FINANCIAL AUDIT PROCESS

The purpose of an ISSAI financial audit is to enhance the degree of confidence of intended users in the audited financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

To be able to express an opinion, the auditor needs to gather sufficient appropriate audit evidence by designing and performing adequate audit procedures as required in the ISSAI. In doing so, the financial audit process needs to be followed as suggested in **Figure 3(a)**. The audit processes are well linked to each other and should be maintained throughout the audit process, being complete only upon issuance of the audit report.



## PRE-ENGAGEMENT ACTIVITIES

The financial audit process commences with pre-engagement activities. In the context of private sector audit, the auditor conducts an assessment as to whether the audit engagement can be accepted or whether there are any professional reasons why it cannot. There is also a practice, where applicable, of obtaining professional clearance from the previous auditor before accepting the engagement. In the public sector, however, the SAIs are bound by their legislation and other relevant laws and regulations to conduct the financial audit of entities mandated for audit. Therefore, not accepting the engagement will be a very rare situation in a public-sector audit, unless the SAI also has non-mandated audit engagements. A purpose of conducting the pre-engagement activities is, among others, to see whether the

pre-conditions for audit exist, such as an acceptable financial reporting framework, an understanding of its responsibilities by management, etc. The auditors also perform other specific activities: assessing the compliance with ethical requirements and the competency of the team, preparing and issuing the audit engagement letter, conducting the audit entry conference, etc. The completion of the pre-engagement activities needs to be reviewed and signed off by the reviewers. The reviewer would generally refer to an audit engagement supervisor in the context of a typical SAI audit engagement team composition.

*The detailed processes and methodologies for completing the pre-engagement activities are given in [Chapter 4 of this Handbook](#).*

## PLANNING AN AUDIT

Based on the completion of pre-engagement activities, the next step is the planning activities which involve establishment of overall audit strategy and development of audit plan for conducting the audit of the financial statements. ISSAIs are built upon a risk-based audit approach. At this stage of the process, the auditors mainly identify and assess the risks of material misstatements in the financial statements due to either fraud or error and, determine materiality. ISSAI 2315 requires an assessment of the risk of material misstatements through obtaining an understanding of the entity and its environment. Based on the risk assessment, the auditor is required to identify the controls in place that would mitigate or eliminate the risks. As a risk response (ISSAI 2330), the auditors are required to design audit procedures, e.g. test of controls and substantive tests. The audit plan needs to be reviewed and signed off by the reviewer and, as required by ISSAI, to be updated until the completion of the audit and the issuance of the audit report.

*The detailed processes and methodologies for preparation and finalisation of an audit plan are highlighted in [Chapter 5 of this Handbook](#).*

## CONDUCTING AN AUDIT

In the conducting phase, which mainly involves fieldwork, the auditors perform the audit procedures designed at the planning stage, document conclusions based on audit procedures performed, and gather audit evidence. The audit procedures performed by the auditors and the conclusions documented need to be reviewed and signed off by the reviewers.

*The detailed processes and methodologies for performing audit procedures, documenting the conclusions, and gathering audit evidence are highlighted in [Chapter 6 of this Handbook](#).*

## COMPLETION AND REVIEW

ISSAI 2500 requires auditors to gather sufficient appropriate audit evidence to provide an audit opinion on the financial statements. The audit evidence is gathered by performing specific audit procedures that respond to the risks identified at the assertion level or the financial statement level. In this phase of the audit process, the auditors evaluate the audit evidence gathered at the conducting phase. The audit evidence needs to be evaluated for sufficiency and appropriateness, and it forms the basis for providing an audit opinion on the financial statements and reporting on non-compliance with laws, rules and regulations, if any.

In this phase, the audit supervisor or reviewer considers the opinion and observations prepared by the auditor, ensuring that both are adequately supported by audit evidence and that professional judgement has been applied. Both auditors and reviewers should ensure that the audit plan was followed in conducting the audit, hence the work performed by auditors needs to be reviewed and signed off by the reviewers.

*The detailed processes and methodologies for evaluation and review are highlighted in [Chapter 7 of this Handbook](#).*

## REPORTING

Based on the evaluation and review of the work done by auditors, the next step is to prepare and issue the final audit report. Typically, the audit report contains the auditor's opinion on the financial statements. The opinion is based on the evidence as to whether the financial statements are fairly presented or presented in accordance with the financial reporting framework and any laws and regulations affecting their presentation. Further, there could be other reporting responsibilities as per the mandate of the SAI and these other reporting responsibilities may require the application of other auditing standards when they are beyond the scope of the financial audit ISSAIs. The reporting options within the scope of the financial audit ISSAIs are explained in the reporting section of this handbook.

*The detailed processes and methodologies for preparation of audit reports are highlighted in [Chapter 8 of this Handbook](#).*

## FOLLOW-UP PROCEDURES

ISSAI 100 states that SAIs have a role in monitoring action taken by the responsible party in response to those matters raised in an audit report: follow-up focuses on whether the audited entity has adequately addressed those matters, including any wider implications. Insufficient or unsatisfactory action taken by the audited entity may necessitate a further report by the SAI.

Also, follow-up procedures are considered a good practice under principle 3 of INTOSAI-P 20. Unless this follow-up process is put in place after issuance of the audit report, the SAI cannot gauge whether a desired *audit impact* has been created as a result of audit. Therefore, follow-up procedures are seen to be one of the important components of the audit process.

*Follow-up procedures are explained in [Chapter 9 of this Handbook](#).*

## QUALITY MANAGEMENT AT THE ENGAGEMENT LEVEL

Quality management is not an independent process, but is rather embedded within the audit process. The quality management responsibilities at the audit engagement level are often influenced by the operation of the system of audit quality management at the organisational level. ISSAI 140 (revised) sets the organisational requirements in setting up the system in the SAI, while ISSAI 2220 provides audit quality management responsibilities at the audit engagement level.

The approaches to manage quality in the audit engagement vary among different audit engagements of the SAI as these are affected by the designed SAI's quality risk responses that are relevant to audit engagements, and by the nature and circumstances of the specific audit engagement.

*In this Handbook, [Chapter 10](#) gives an overview of the quality management process at the engagement level, and how the responsibilities for the audit engagement is affected by the operation of the system of audit quality management at the organisational level.*



# PRE-ENGAGEMENT ACTIVITIES

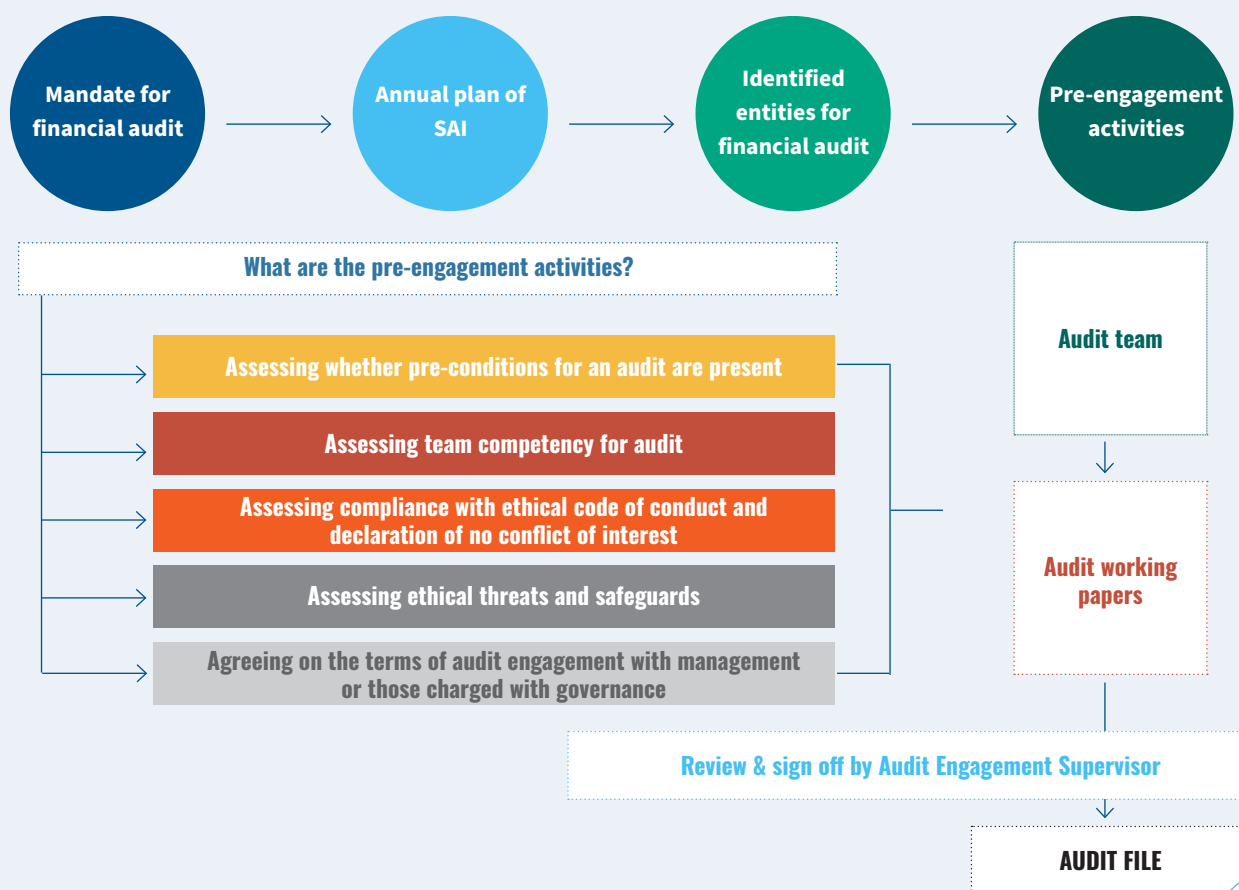
ISSAI 2210 prescribes the requirements related to agreeing on the terms of the audit engagement, an audit practice that is more in line with that observed in the private sector. Auditors are required to assess certain conditions before accepting the engagement and, based on that assessment, the auditor can either accept or decline the audit engagement.

Law and regulation usually mandate SAIs to conduct certain audits, and the public-sector auditor probably will not have an option to decline or withdraw from the audit. Yet, the requirements that are appropriate in the private sector audit practice could still be applied and are relevant to public sector auditing. The procedures applicable for the engagement are

influenced by how the SAI established the quality objectives, identified and assessed quality risks, and designed the responses under the ‘acceptance, initiation, and continuance’ component of the system of quality management for both mandated and non-mandated audits (if any).

The purpose of performing preliminary engagement activities is to help ensure that the auditor has considered any events or circumstances that may adversely affect the auditor’s capability to plan and perform the audit engagement to reduce audit risk to an acceptably low level. **Figure 4(a)** below provides a snapshot of pre-engagement activities identifiable within audits conducted by SAIs.

**FIGURE 4(a)**  
Snapshot of pre-engagement activities



## ASSESSING WHETHER PRE-CONDITIONS FOR AN AUDIT ARE PRESENT

This section explains the process of assessing the FRF applied by the audited entity in preparing the financial statements. In the public-sector environment, the auditor might encounter a variety of FRF. Therefore, it is important to know:

- how to determine whether the financial reporting framework applied is acceptable or not (cf. ISSAI 2210.6 and Paragraphs A2-A10);
- the difference between fair presentation reporting frameworks and compliance frameworks; and
- the impact of type of financial reporting framework on the wording of the auditor's opinion on the financial statements.

### Definitions relevant to understanding the financial reporting framework (FRF)

Financial statements ordinarily refer to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework but can also refer to a single financial statement. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or other allowed by the applicable financial reporting framework on the face of the financial statements, or in the notes, or incorporated therein by cross reference<sup>6</sup>.

Historical financial information is information expressed in financial terms in relation to a particular entity derived primarily from that entity's accounting system, about economic events occurring in the past time periods or about economic conditions or circumstances at points in time in the past<sup>7</sup>.

The applicable FRF is the financial reporting framework adopted by the management and, where

appropriate, those charged with governance in preparation of the financial statements and that is acceptable in view of the nature of the entity and the objective of the financial statements or that is required by law or regulation<sup>8</sup>. There are two types of FRF, which are further explained in ISSAI 2200:

**Fair presentation framework** is used to refer to an FRF that requires compliance with the requirements of the framework and that:

- acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or that
- acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

**Compliance framework** is used to refer to a FRF that requires compliance with the requirements of the framework but does not contain the acknowledgements in (i) and (ii) above.

Both compliance and fair presentation accounting frameworks are found in public sector environments.

In addition to preparing general-purpose financial statements, public sector entities may also prepare financial statements for other parties (such as governing bodies, the legislature or other parties that perform an oversight function) that can demand financial statements tailored to meet their specific information needs. These would be special-purpose financial statements and may be prepared using a special-purpose reporting framework.

<sup>6</sup> ISSAI 2200, Paragraph 13(f).

<sup>7</sup> ISSAI 2200, Paragraph 13(g)

<sup>8</sup> ISSAI 2200, Paragraph 13(a)

## Assessing the acceptability of the FRF

The FRF is the audit criteria and the benchmark against which the subject matter (the financial statements) will be evaluated. Without an acceptable FRF the auditor will not be able to fulfil the audit objectives. But also, management needs to have acceptable criteria to use when preparing the financial statements. This is because the existence of an acceptable FRF is one of the preconditions of auditing the financial statements. Therefore, the SAI or the auditor may perform the steps implied in the following questions to see whether an applicable FRF exists and whether it is acceptable, and how the matter can be dealt with if it is not acceptable. Considering that similar entities exist across SAIs for the purpose of conducting financial audits, these steps can be performed at the SAI level rather than at the level of every audit engagement:

<b>Step1:</b>	Is there an applicable FRF for public sector entities?
<b>Step 2:</b>	Is the FRF acceptable?
<b>Step3:</b>	Is the FRF a special-purpose or a general-purpose framework?
<b>Step 4:</b>	Is the FRF a fair presentation framework or a compliance framework? How to report accordingly?
<b>Step 5:</b>	What are the SAI's options if the FRF is deemed unacceptable?

In the absence of basis in judging the acceptability of general purpose frameworks, financial reporting standards established by authorized or recognized organizations promulgating standards are presumed to be acceptable (ISSAI 2210.A8). The SAI may skip this step when the FRF is IFRS/IPSAS.

### STEP1: Is there an applicable FRF for public sector entities?

In many cases, laws and regulations prescribe the FRF for public sector entities. The financial statements of public sector entities may be prepared on an accrual basis, a cash basis or both:

- In the first case, they may include a statement of financial position, a statement of comprehensive income, a statement of cash flows, and notes comprising a summary of significant accounting policies and other explanatory information.
- If the entity has prepared its financial statements on a cash basis, it may present a Statement of Cash Receipts, a Statement of Payments, associated notes and a comparison of budget and actual amounts. In certain environments, according to the FRF, a complete set of financial statements may also include other reports such as reports on performance and appropriation reports. However, laws and regulations may also describe a different presentation of historical financial information.

To conclude on the first step of assessing the FRF, SAIs need to identify if there is an applicable FRF for public sector entities in the SAI's environment or jurisdiction.

### STEP 2: Is the FRF acceptable?

The acceptability of a FRF is evaluated against the nature of the entity and the objective of its financial statements. The characteristics of an acceptable FRF are discussed under ISSAI 200 and ISSAI 2210 (*refer to Appendix 2 of ISSAI 2210*). Acceptable FRFs normally exhibit the attributes referred to in **Illustration 4.1**.

**ILLUSTRATION 4.1****Acceptable FRF**

<b>Characteristics</b>	<b>Description</b>
<b>Relevance</b>	<p>The information provided in the financial statements is relevant to the nature of the audited entity and the purpose of the financial statements.</p> <p>Relevance is subject to the entity's nature as reflected in Illustration 4.2 below. Clearly the relevance is a critical decision for the SAI and it needs to be assessed in consultation with the stakeholders.</p>
<b>Completeness</b>	<p>No transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are omitted.</p> <p>The purpose of the financial statements may vary from funding/investment purposes as explained in the Illustration 4.2 below to certification and approval of the annual budget. This needs to be evaluated in the context of the stakeholders' needs and accountability cycle.</p>
<b>Reliability</b>	<p>The information provided in the financial statements reflects, where applicable, the economic substance of events and transactions and not merely their legal form; and</p> <p>results in reasonably consistent evaluation, measurement, presentation and disclosure when used in similar circumstances.</p> <p>Reliability reflects whether the information provided is in a format that links to the accounting policies and / or financial procedures.</p>
<b>Neutrality</b>	<p>Information in the financial statements is free from bias. In other words, information provided in the financial statements does not provide an interpretation that can lead to bias toward certain results or entities.</p>
<b>Understandability</b>	<p>The information in the financial statements is clear and comprehensive and not subject to significantly diverse interpretation. This underlines that the statements are "fit for purpose" and are used and understood in the manner for which they were intended.</p>

Acceptability of the FRF results in information provided in the financial statements that is useful to the intended users. To determine that usefulness, users themselves must be identified and their requirements understood.

In the public sector, there will typically be users of financial statements of several types of entities and for different reasons. **Illustration 4.2** presents situations within a public-sector environment. The

last column lists examples of commonly used FRFs; however, their inclusion does not mean that the corresponding FRFs are acceptable. That decision must be taken by SAIs in the context of their auditing practice.

To conclude on the third step for assessing FRF, SAIs need to identify whether the FRF in question is acceptable.

## ILLUSTRATION 4.2

### Typical situation of a FRF in a public-sector environment

Type of Entity	Typical User	Type of Requirement	Commonly Used FRF
<b>Ministry</b>	Public Accounts Committee, ministries	Accountability for government expenditure and the assessment of financial management	Cash basis Modified cash basis Accrual basis
<b>Non-revenue-generating agencies</b>	Public Accounts Committee and responsible ministries, donor community	Accountability for funding and assessment of the performance of the entities against their mandates	Cash basis Modified cash basis Accrual basis
<b>Revenue generating entities and corporations</b>	Public Accounts Committee, ministries, investment authorities, banks, etc.	Assessment of return on investment and sustainability; assessment of effects of policy and regulation of the entities	Accrual-basis financial statements often aligned to a recognized reporting framework (e.g. IFRS & IPSAS)

#### STEP 3: Is the FRF a general-purpose or a special-purpose framework?

The frameworks may be categorized as either general- or special-purpose. A special-purpose framework is one designed to meet the financial information needs of specific users. A general-purpose framework is one designed to meet the needs of a wide range of users.

In some environments, special-purpose financial statements are the only financial statements prepared by the public-sector entity. It is therefore important to carefully determine whether the FRF is designed to meet the financial information needs of a wide range of users (“general-purpose framework”) or the financial information needs of specific users (cf. ISSAI 2800).

Hence, based on ISSAI 200 and 2200, SAs need to examine whether the applicable FRF is a general- or a specific-purpose framework. For example, in many cases government consolidated accounts and financial statements of public sector agencies or ministries are designed to meet the common financial information needs of a wide range of users, and the

applicable reporting framework would consequently be classified as general-purpose.

When the auditor concludes that the accounting framework that is applied to prepare the financial statements to be audited is a special purpose framework, the auditor must apply ISSAI 2800 which deals with special considerations relevant to

- the acceptance of the engagement;
- the planning and performance of that engagement; and
- forming an opinion and reporting on the financial statements.

ISSAI 2800 does not override but complements the requirements of the other ISSAIs. Therefore, the auditor must continue to comply with all relevant requirements in other ISSAIs when applying ISSAI 2800.

To conclude on the second step for assessing FRF, SAs need to conclude if the FRF in question is a general-purpose framework or a special-purpose framework.

#### STEP 4: Is the FRF a fair presentation framework or a compliance framework? How to report accordingly?

The FRF can be either a fair presentation framework or a compliance framework. The type of framework used to prepare the financial statements affects the wording of the auditor's opinion. In case of a **fair presentation framework**, SAIs need to evaluate whether the financial statements achieve fair presentation, including (cf. ISSAI 2700.14) a consideration of:

- the overall presentation, structure and content of the financial statements; and
- whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

When expressing an opinion on the financial statements prepared in accordance with the fair presentation framework, the auditor's report includes expressions such as *"the financial statements present fairly..."* or *"the financial statements give a true and fair view of..."*.

When the financial statements are prepared in accordance with a **compliance** framework, the auditor does not express an opinion on the fairness of presentation. Instead, the auditor is required to evaluate whether the financial statements are prepared, in all material respects, in accordance with the prescribed presentation of the financial statements that may be included in a specific FRF or in applicable laws and regulations. The use of a compliance framework should not be confused with a compliance audit. The wording of the opinion will be as follows: *"Financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework."*

To conclude on the fourth step for assessing FRF:

- SAIs need to decide whether the FRF in question is a fair presentation framework or a compliance framework; and
- depending on the FRF used by an entity to prepare the financial statements, the SAI words the audit opinion accordingly.

#### STEP 5: What are the SAI's options if the FRF is deemed unacceptable?

As explained in ISSAI 2210.8, if the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation, the auditor shall not accept the proposed audit engagement.

Non-acceptance of the engagement is often not possible in the SAI's environment, since SAIs are required to carry out audits according to their legal mandate. In this regard, SAIs need to explore alternative ways to deal with unacceptable FRFs.

If the auditor has determined that the FRF prescribed by law or regulation is unacceptable, ISSAI 2210.19 requires that the auditor discuss the issue with management of the audited entity and ask it to provide **additional disclosures** to prevent the financial statements from misleading<sup>9</sup> users. Even if management prepares additional disclosures, the auditor's report on the financial statements needs to incorporate an **Emphasis of Matter** paragraph, drawing users' attention to the additional disclosures (see **Chapter 8**).

If management refuses to act upon the auditor's request to prepare additional disclosures, and the SAI cannot withdraw from the engagement as discussed in paragraph 28 above, the SAI should in accordance with ISSAI 2210.20; a) evaluate the effect of the misleading nature of the financial statements on the auditor's report; and b) include appropriate reference to this matter in the terms of the audit engagement.

ISSAI 2210.20 prescribes that if conditions outlined in ISSAI 2210.19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor should:

- evaluate the effect of the misleading nature of the financial statements on the auditor's report; and
- include appropriate reference to this matter in the terms of the audit engagement.

<sup>9</sup> The auditor has to determine if the financial statements are misleading using the criteria for acceptability.

In addition, GUID 2900 provides that the auditors may consider informing the legislature and influencing standard-setters.

To conclude on actions in the case of an unacceptable FRF:

- The SAI needs to ask management of the audited entity to prepare additional disclosures.
- If additional disclosures are presented, then the SAI should add an Emphasis of Matter paragraph to the opinion.
- If management refuses to present additional disclosures, the SAI may consider withdrawal from the audit engagement; if withdrawal is not possible, the SAI may consider a modified auditor's opinion (a disclaimer of opinion) explaining the misleading nature of the financial statements.
- The SAI should consider informing the legislature and standard setting bodies about the unacceptability of the FRF.

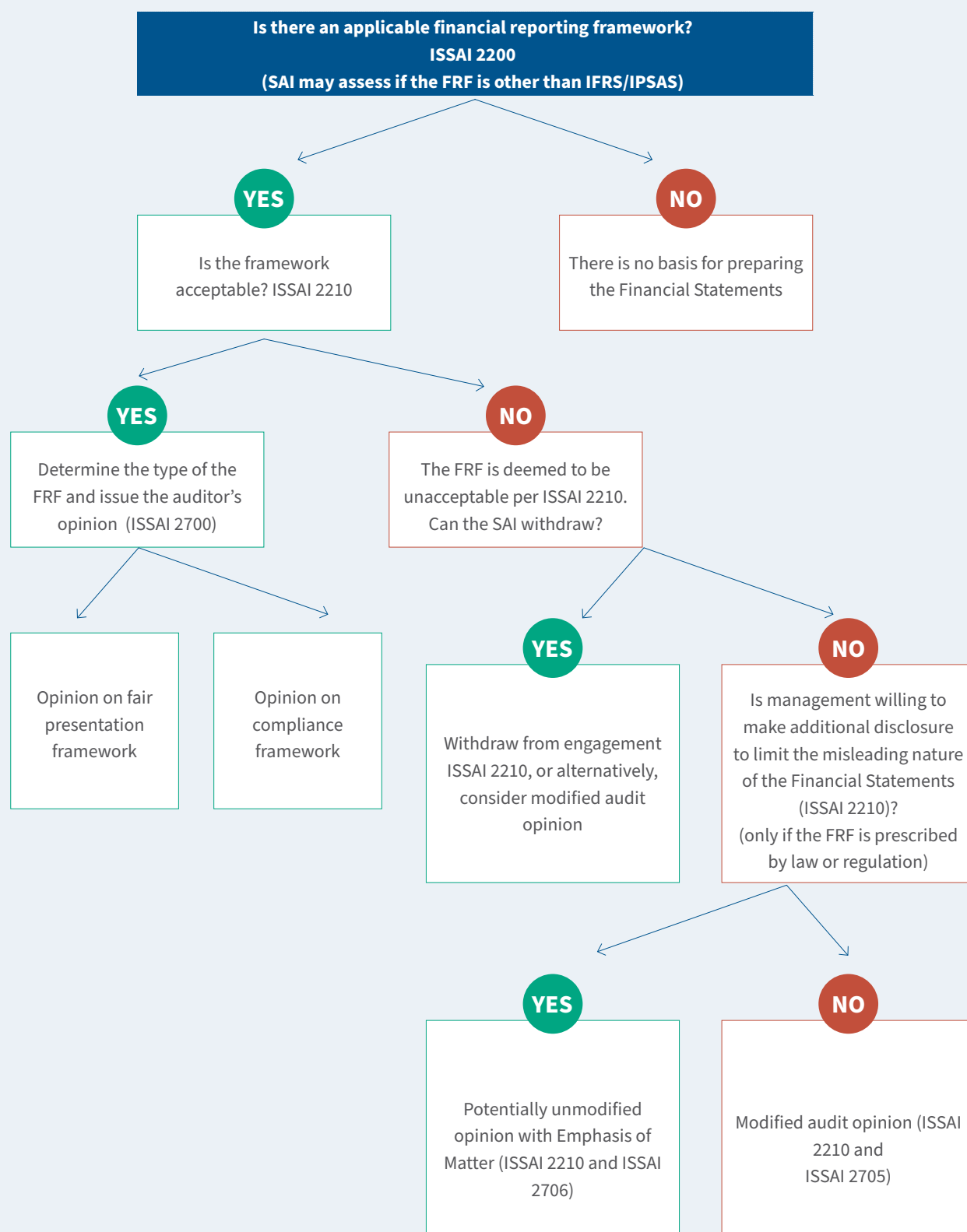
The process of assessing the FRF as explained above is summarised in the decision tree given below as **Figure 4(b)**. The auditor or the assessor can document the conclusion arrived at on assessment of acceptability of the financial reporting framework using audit working paper template **AWP 4.1**.

This working paper template also suggests recording the risks that may result in material misstatement in the financial statements which can be identified while assessing the acceptability of the financial reporting framework. These risks will be carried forward to **AWP 5.4** in the planning stage as discussed in the next chapter.

Examples of acceptable FRFs include IFRS and IPSAS. Accounting principles promulgated by the national accounting standards authorities are also deemed acceptable if a due process for pronouncement of the standards has been followed to consider views of wide range of stakeholders. Nevertheless, in the public sector it may also happen that those standards are supplemented by law or regulation, and then the auditor shall determine whether there are **any conflicts** between the financial reporting standards and the additional requirements (ISSAI 2210.18, A36). The additional requirements refer to those requirements that are prescribed by the law or regulation, in addition to the requirements of the financial reporting framework relating to preparation of financial statements. This may for example, be the case when law or regulation prescribes additional disclosures in addition to those required by the financial reporting standards (ISSAI 2210.A36).

In some countries, the financial statements of government entities are prepared solely according to a set of financial rules and regulations issued by parliament, the ministry of finance or the treasury department. As *per* ISSAI 2210.A9, in the absence of indications to the contrary, the FRF prescribed by law or regulation is presumed to be acceptable for general-purpose financial statements prepared by such entities. If it is not acceptable, then the steps indicated above apply.

**FIGURE 4(b)**  
**Decision Tree for determining FRF's acceptability**





## OBTAIN AN AGREEMENT THAT MANAGEMENT UNDERSTANDS ITS RESPONSIBILITY

As required under ISSAI 2210.6(b), the auditor needs to obtain the written agreement of the entity's management that it acknowledges and understands its responsibilities to prepare the financial statements in accordance with the applicable financial reporting framework including, where relevant, their fair presentation; to establish internal controls that management feels are necessary in order to prepare financial statements that are free from material misstatements; and to provide the auditors with access to information and persons within the entity and any additional information required by the auditors. The auditors ensure that these requirements are specified in the audit engagement letter and explained to management at the audit entry conference. However, the terms of an audit engagement in the public sector are normally mandated and therefore not subject to requests from, and agreement with, management.

## OTHER REQUIREMENTS

The requirements related to other pre-engagement activities are also highlighted in ISSAI 2220 and ISSAI 2300, e.g. where there has been a change of auditors, communication with the previous auditor in compliance with relevant ethical requirements.

To ensure audit quality, it is important to have the right team, in terms of qualifications, competence and experience. Generally, it is advisable to have some auditors with prior experience in audits of a particular entity or area, since they would be aware of the systems and procedures in place and this will enhance audit planning and performance efficiency.

It is also important to have a well-structured team whose responsibilities are clearly delegated and to have a quality review process in place. In the context of SAIs, the audit team is usually composed of team members, a team leader (audit manager) and an audit

engagement manager/supervisor. However, these members may have different titles in different SAIs. The audit team can use the suggested audit working paper template **AWP 4.2**, Team Competency Matrix, to indicate and document that the audit engagement team collectively has required competencies to perform the given audit engagement.

To ensure that the audit is conducted objectively and independently, auditors should comply with an ethical code of conduct (e.g. ISSAI 130 "Code of Ethics"<sup>10</sup>). It is also essential to ensure that auditors have no conflict of interest with an entity identified for audit. Audit working paper template **AWP 4.3** suggests a format for declaring compliance with the code of ethics; **AWP 4.4** suggests a format that may be adapted for auditors to declare no conflict of interest; and **AWP 4.5** is a sample declaration of conflict of interest.

Ethical threats may arise during an audit, such as self-review threat, self-interest threat, familiarity threat, advocacy threat, intimidation threat, etc. The team leader/audit manager or line manager/supervisor will be required to put necessary safeguards in place to reduce any such threats to an acceptable level, in the professional judgment of the team leader/ manager/supervisor). The Assessment of Ethical Threats and Safeguards can be recorded in audit working paper template **AWP 4.6**.

While these working papers are prepared during the pre-engagement activities, they need to be updated throughout the audit when new information or conditions become available that affect declarations previously provided.

The next step in the pre-engagement is to agree on the terms of the audit engagement with the auditee, particularly with management or, where appropriate, with those charged with governance. ISSAI 2210.10 states, "... the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement." The terms of audit engagement should include, among others, the following:

<sup>10</sup> Cf. SAIS-4: Organizational Control Environment, dimension (i) "Internal Control Environment – Ethics, Integrity and Organizational Structure", of SAIS PMF.

- The objective and scope of the audit of financial statements;
- The responsibilities of the auditor;
- The responsibilities of management;
- Identification of the applicable FRF for the preparation of the financial statements;
- Reference to the expected form and content of any reports to be issued by the auditor;
- A statement that there may be circumstances in which a report may differ from its expected form and content; and
- Relevant law and regulation affecting the audit.

The engagement team may also include other terms and conditions in the audit engagement letter if deemed appropriate and necessary. Audit working paper template **AWP 4.7** provides an example of an Audit Engagement Letter that can be used by an SAI's engagement team. This can be adapted to the specific needs of different SAIs.

The audit engagement letter should be sent out to management or, where appropriate, to those charged with governance and they should be asked to acknowledge agreement with these terms by signing a copy of the engagement letter. The engagement team can also inform management that the terms of the engagement can be discussed in the audit entry conference before being signed, as some terms may require explanation by the engagement team itself. The audit entry conference is usually convened after sending out the audit engagement letter.

Any changes to the terms of engagement from those initially stated in the audit engagement letter should be documented, in the form of either notes or minutes of the meeting between management and the audit engagement team.

A lack of agreement with the terms of engagement by management and those charged with governance may not arise, since laws and regulations usually mandate SAIs to conduct audits, and the audit terms and conditions for audit defined in the engagement letter are to be consistent with certain laws and regulations.

For recurring audits, sending engagement letter for each audit period is not required especially when there are no changes that will affect the original terms or understanding of the parties in the audit engagements. The audit team may, however, decide to send new engagement letter when the following are noted:

- Any indication that the audited entity misunderstands the objective and scope of the audit;
- Any revised or special terms of the audit engagement;
- A recent change of senior management;
- A significant change in ownership;
- A significant change in nature or size of the entity's operations.
- A change in legal or regulatory requirements;
- A change in the financial reporting framework adopted in the preparation of the financial statements; and
- A change in other reporting requirements.

In the practice of the Australian National Audit Office, engagement letter is issued for each new audit engagement and will be formally reconfirmed at least every 5 years, or when there are circumstances that would require its reissuance.

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## COMMUNICATION WITH MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

Communication with management and those charged with governance of the entity **throughout the audit process** is very important and facilitates the proper conduct of the audit. For some public sector entities in some jurisdictions, management may include some or all of those charged with governance.

As per ISSAI 2260.9, the objectives of the auditor on communication with those charged with governance are:

- To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
- To obtain from those charged with governance information relevant to the audit;
- To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
- To promote effective two-way communication between the auditor and those charged with governance.

The engagement team needs to consider three aspects about communication:

- Determining appropriate persons within the entity's governance structure with whom to communicate (which could be performed at audit entry meeting-before audit commences).
- Determining the matters that need to be communicated (i.e. auditor's responsibility, planned scope and timing of the audit, significant findings from the audit, and auditor independence).
- Establishing the communication process (the process, form, timing and adequacy of communication).

The engagement team needs to organize an **audit entry meeting** with the entity's management and those charged with its governance as a communication process. As part of the specific agenda for this meeting, the engagement team may want to discuss the terms of audit engagement mentioned in the audit engagement letter.

## CHAPTER 5

# PLANNING AN AUDIT

After the pre-engagement activities have been completed, the audit team needs to establish overall audit strategy and develop audit plan, having regard to the requirements of ISSAI 2300. A planning phase of the audit mainly entails assessing the risks of material misstatements (ISSAI 2315), determining materiality in planning and performing the audit (ISSAI 2320), and the auditor's response to assessed risks (ISSAI 2330), which determine the nature, timing and extent of further audit procedures.

The auditors are encouraged to adopt a risk-based approach to the audit of financial statements. That means devoting considerable time to assessing the risk of material misstatements in the financial statements, in line with the ISSAI. Other focus areas may be added depending on the resources required and their availability.

There are other ISSAI requirements relevant to planning an audit of financial statements, such as ISSAI 2220 "Quality management for an audit of financial statements"; ISSAI 2240 "Auditor's responsibilities relating to fraud in an audit of financial statements"; ISSAI 2250 "Considerations of laws and regulations in an audit of financial statements"; and ISSAI 2230 "Audit documentation". Since all thirty-seven ISSAI are interlinked, some of the requirements from ISSAI other than those mentioned here may be relevant to planning an audit of financial statements, and therefore the auditor needs also to take these into consideration in planning a financial statements audit.

## Establishment of Overall Audit Strategy

The auditor needs to set the scope, timing and direction of the audit which will guide the detailed audit planning. Establishing overall audit strategy requires auditor to:

- a.** Identify the characteristics of the engagement that define its scope. For this purpose, AWP 5.1 series facilitate documentation of the understanding of the reporting framework used, industry-specific reporting requirements, organisational set-up/structure including relationships with other government entities, reporting currency, existence of internal audit, relevance of service organisation, among others.
- b.** Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, which are normally discussed during audit entry conference. Among others, the discussion may include the entity's timetable of reporting, type and timing of reports and communications with the entity, communication with component auditors if applicable, and any expected communication with third parties.

**c.** Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts; and the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement supervisor for the entity is relevant. For instance, preliminary information are useful in:

- Further understanding the key developments in the entity that will be documented in AWP 5.1
- Identifying risk areas during the actual risk assessment using AWP 5.7
- Establishing evidence about the entity's internal controls using AWP 5.2
- Making decision whether test of controls will be an efficient approach when accomplishing AWP 5.8 (i.e., based on the understanding of the volume of transactions)

**d.** Ascertain the nature, timing, and extent of resources necessary to perform the engagement. AWP 4.2 can assist in assessing the collective competencies of the audit team which will be helpful in engagement planning and assignment of tasks.

In determining the scope of audit, the auditor needs to consider the period to be audited. The financial audit is supposed to be conducted on an annual basis, but due to the limited resources, some SAIs may be conducting cyclical audits covering more than 1 period (i.e., every 2 or 3 years). This will affect the total man days required for the audit which needs to be considered at the planning stage.

While planning the audit, the engagement team should estimate the time required to complete the audit and should consider how efficiently it can use that time in the audit. The team can allocate appropriate time to those areas that were identified as posing a high risk of material misstatement in the financial statements. The engagement team can prepare a time budget for guidance, which can be revised as the audit progresses.

The audit time schedule also needs to fit within the financial reporting cycle of entities being audited. Typically, most SAIs would have prepared an annual plan to come into force at the beginning of the year, based on which the respective functional divisions carry out the audit.

The auditor needs to consider if management has prepared the financial statements in accordance with the applicable financial reporting framework. Quite often, it may be that the audit has been scheduled but management has not yet prepared the financial statements. This will affect not only the scheduled audit but also the overall annual plan of the SAI. However, prior year financial statements can be used to plan the audit engagement where current year results are not yet known since the financial audits are typically recurring in nature. The audit plan can be updated upon receiving the current year's draft financial statements.

The auditor also needs to consider the location of the audit entity, its branches and units, etc., so that any necessary visits out of its head office can be properly planned. The audit engagement supervisor, in consultation with the team leader/audit manager, can assign audit work to the respective team members.

## DETERMINING MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

When establishing overall audit strategy, auditor determines the materiality that will help in identifying significant components and material classes of transactions, account balances and disclosures. This will provide an overview about the potential focus areas in the audit.

According to the *International Accounting Standards Board's Framework for the Preparation and Presentation of Financial Statements*, information is material "if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements."

There is no standard rule as to how materiality should be calculated. ISSAI 2320 refers to "professional judgment" and the "amount" and "nature" of misstatements as considerations. Professional judgement may be based on an understanding of the entity, the nature and extent of misstatements in previous audits, etc. The basis for professional judgement in determining materiality shall be recorded in the working paper.

The management of the SAI should perhaps have a policy covering the benchmarks that may be relevant and the percentages to be used in determining materiality.

ISSAI 2320 sets a framework of reference for auditors to use in determining materiality, if there is no discussion of this concept in the applicable FRF:

- Information is material if its omission or misstatement could influence the economic decisions of users, taken based on the financial statements.

- Judgements about materiality are influenced by surrounding circumstances and the size or nature of a misstatement, or both.

Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as an identifiable group.

The materiality must be relevant to the user rather than to the preparer of financial statements. Materiality must be considered in the planning, performing and evaluation phases of the audit.

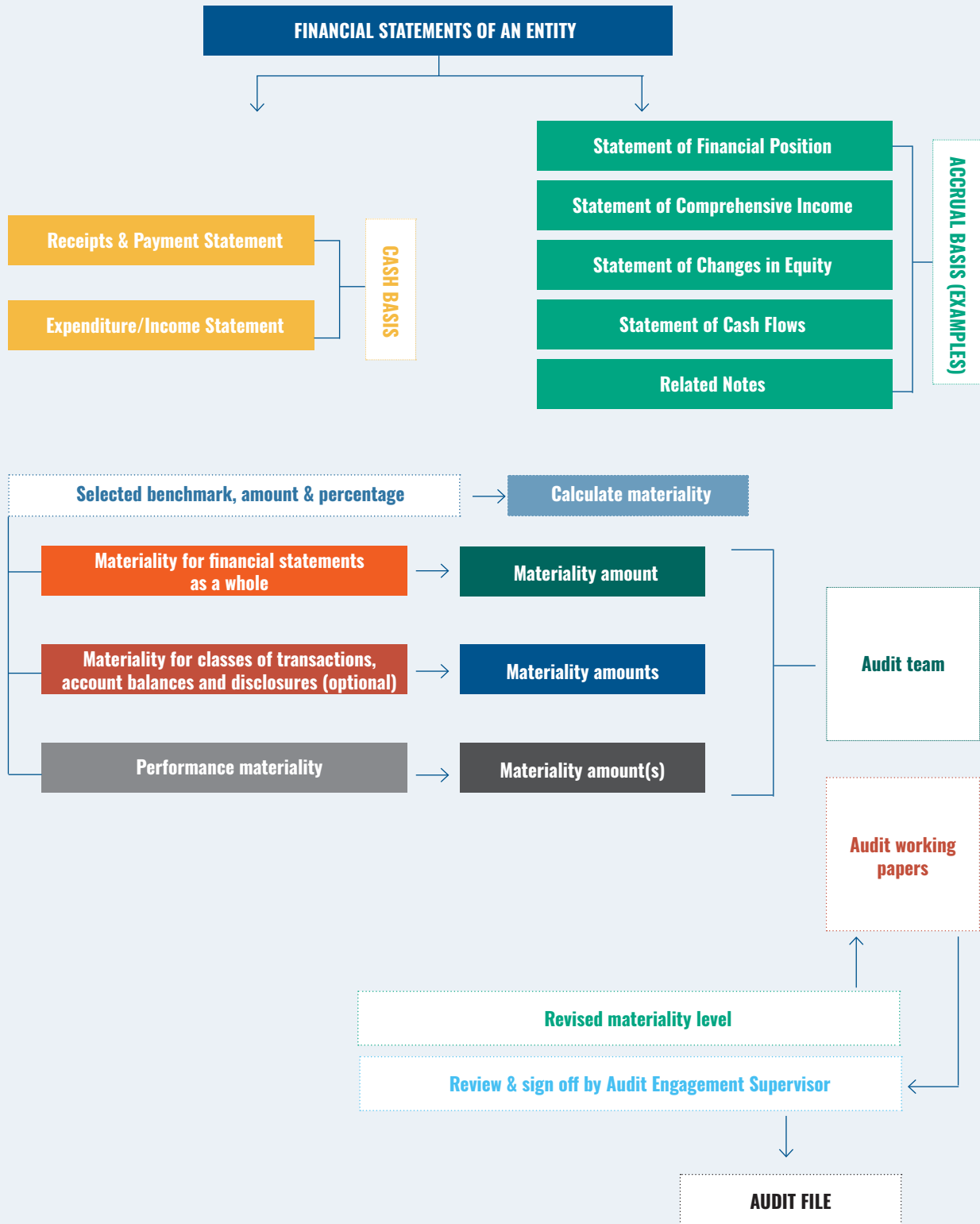
Materiality in planning is normally used in the following:

- Reference in identifying significant movements when performing analytical procedures as part of risk assessment;
- Basis in assessing the impact of the risk of material misstatements; and
- Threshold in identifying material accounts in the financial statements to determine the scope of testing when designing audit responses.

The process for determining materiality is given in **Figure 5(a)** below - in both planning and performing an audit.

**FIGURE 5(a)**

**Snapshot of determining materiality in planning and performing an audit**



## The concept of materiality applied in planning an audit

There may be items (classes of transactions, account balances or disclosures) where misstatements of less significant amounts could reasonably be expected to influence the economic and non-economic decisions of financial statements users. If the auditor concludes that such possibilities exist, then the auditor should calculate materiality for those particular classes of transactions, account balances, or disclosures.

The engagement team needs to discuss the matter of materiality from the users' perspective. When the materiality to be applied has been determined, it needs to be documented and communicated to the whole team involved, as materiality will affect the extent of the audit work that needs to be performed and the evaluation phase of the audit.

Where the engagement team can identify significant components and material classes of transactions, account balances and disclosures, materiality is determined based on the draft financial statements provided by management of the entity. This will provide an overview for at least the line manager/supervisor, allowing for the identification of areas where there may be high risk of material misstatement and on which the team needs to concentrate and focus attention.

Based on the identification of significant components and material classes of transactions, account balances, and disclosures, the engagement team may have identified areas where there may be high risk of material misstatement. Accordingly, the team leader/audit manager or the audit supervisor can allocate those high-risk areas to competent and experienced auditors on the team. These areas may even require

The identification of a benchmark for calculating the materiality would depend on many factors, such as the criticality/importance of the chosen benchmark to the users of the financial statements, nature of the entity, etc. In the above illustration, if an entity is a revenue-generating entity, total receipts become critical to users of the financial statements. Misstatements higher than CU 50,000 (as shown

the attention of the supervisor or team leader.

## Overall materiality for the financial statements as a whole

In determining materiality for financial statements as a whole, an appropriate benchmark may be used such as either total receipts, total expenditure, or net expenditure (expenditure less receipts) in cash-based accounting. In accrual-based accounting, the asset based benchmarks such as total equity or net asset value, and income statement based benchmarks such as profit before tax, total revenue, gross profit and total expenses can be used. Profit before tax is often used for profit oriented entities (cf ISSAI 2320. A5). The following example illustrates the calculation of materiality for financial statements, based on this possible approach:

### ILLUSTRATION 5.1

#### Calculating materiality for financial statement as a whole

Benchmark	Amount (CU)	Percentage used	Materiality amount (CU)
Total receipts	10,000,000	0.5%	50,000
Reason for applying 0.5% - why 0.5%?			

*Note: The percentage used here is just for example. It should not be used as a prescribed basis for calculating materiality while conducting the audit. The SAI or the auditor should use professional judgement to determine the percentage to be used in calculating materiality. The SAI may have its own policy for determining the level of materiality.*

in the illustration) will be considered a material misstatement in the financial statements. Table A of audit working paper template **AWP 5.1** suggests a template for calculating and documenting the planning materiality for financial statement as whole.

After deciding on the benchmark, it is also important to select the appropriate amounts to be used for the chosen benchmark. Normally, year-end balances are



not yet available during the time the overall materiality is calculated. In such cases, the audit team may use prior year balances, interim/annualised balances, normalised balances or budgeted amounts of the chosen benchmark. The use of these alternatives may require revision of materiality when the year-end balances become available.

Annualised balances can only be used when the chosen benchmark is a nominal account or comes from Statement of Financial Performance. The audit team estimates the year-end balance using the balances in the interim financial statements. For instance, the audit team chooses total expenses as the benchmark and that year-end balance is not yet available, the audit team may project the annual period, based on the monthly estimated total expenses. For example:

- Total expenses as of 30 September 20x1 – 90,000.00
- Annualised amount =  $(90,000.00 / 9 \text{ months}) \times 12 \text{ months}$
- Annualised amount = 120,000.00

When chosen benchmark is a real account or from Statement of Financial Position, there is no need for annualization as the balance at the interim period can already be used for calculation.

Normalised balance is used when the audit team decides to use certain benchmark where there are significant fluctuations that occurred during the year. For instance, the audit team chooses total expenditure since the users are interested on how the entity uses its funds, but upon reviewing the account, the balance is significantly higher as compared to previous years. Setting materiality using such benchmark will result to higher materiality which affect the extent of the testing. If the audit team still considers using such benchmark despite the volatility (see ISSAI 2320.A4), the balance may be normalised by removing transactions or items in the total expenses which are not part of the regular expense transactions of the entity.

The percentage to be applied on different benchmarks should be defined in the SAI policy.

## Materiality for particular classes of transactions, account balances and disclosures (optional)

The same principle applies to calculating materiality for particular classes of transactions, account balances or disclosures. Take note that this type of materiality, unlike the materiality for the financial statements as a whole, is not required for each audit but is based on the audit engagement needs. The following are the factors that may indicate the need for this type of materiality:

- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty).
- The key disclosures in relation to the environment in which the entity operates (for example, disclosures on liquidity risks or certain ratios that affect various accounts of the government banks; or the estimation and actuarial valuation for the insurance liabilities of the government pension fund).
- Whether attention is focused on a particular aspect of the entity's operations that is separately disclosed in the financial statements (for example, disclosures about segments or merger of government entities).

**Illustration 5.2** is an example of the calculation of materiality in this regard.

From this illustration, any travel expenditure misstatement above CU 1,000 will be considered material. However, in comparison with materiality for the financial statements as whole, the misstatement may not be material but could still influence the decisions of users of the financial statements; travel expenses could be a critical area of expenditure.

Table C of audit working paper template **AWP 5.1** suggests a template for determining materiality for particular classes of transactions, account balances or disclosures.

**ILLUSTRATION 5.2:****Calculating materiality for classes of transactions**

Benchmark	Amount (CU)	Percentage used	Materiality amount (CU)
<b>Classes of transaction:</b>			
Travel	1,000,000	0.1 %	1,000
Employee Cost	5,000,000	0.2%	10,000
<b>Reasons for applying given percentages</b>			

*Note: The percentage used here is just for example. It should not be used as a prescribed basis for calculating materiality while conducting the audit. The SAI or the auditor should use professional judgement to determine the percentage to be used in calculating the materiality. The SAI may have its own policy for determining the level of materiality.*

**Performance materiality applied in planning an audit**

In addition to the overall materiality level, ISSAI 2320 requires the auditor to determine the **performance materiality level** for the purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. This concept refers to the amount or amounts set by the auditor at less than materiality for the financial statements as a whole, to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. In other words, the performance materiality is set lower than the materiality for financial statements as a whole. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures;

and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period. The reduction of overall materiality to arrive at performance materiality is often referred to as a "haircut" and professional judgement must be applied to establish the appropriate haircut. The larger the haircut the larger the difference between overall and performance materiality. A larger difference is needed to allow for an increased risk that material misstatements may not be detected by the auditor.

The following example provides an illustration for calculation of performance materiality for financial statements as whole. Table B of audit working paper template **AWP 5.1** suggests a template for calculating and documenting the performance materiality:

**ILLUSTRATION 5.3****Calculating performance materiality for financial statement as a whole**

Benchmark	Overall materiality (from illustration 5.4) (CU)	Percentage used	Performance materiality amount (CU)
Total receipts	50,000	75%	37,500

*Note: As a general principle, Performance Materiality could be in the range of 60-80% of Overall Materiality. Normally auditors use 75% of Overall Materiality as Performance Materiality.*

In the Australian National Audit Office<sup>11</sup>, a haircut of 10%, 25% or 50% can generally be used depending on the proposed audit adjustments in the past, risk assessment and aggregation of risk, and control effectiveness. For instance, history of limited or no adjustments may result in 10% haircut, that is, 90% performance materiality percentage  $[(100\% - 10\% \text{ haircut}) \times \text{Overall Materiality}]$ .

The same principle applies when determining performance materiality for particular classes of transactions, account balances, or disclosures, as applicable.

**Illustration 5.4** shows an example of the calculation of performance materiality for particular classes of transactions, account balances or disclosure.

#### ILLUSTRATION 5.4

##### Calculating performance materiality for classes of transactions

Benchmark	Materiality (from illustration 5.5) (CU)	Percentage used	Performance materiality amount (CU)
<b>Classes of transaction:</b>			
Travel	1,000	75 %	750
Employee Cost	10,000	75%	7,500

Table C of audit working paper template **AWP 5.1** also includes determining materiality for particular classes of transactions, account balances or disclosures.

In some audit practices, various levels of thresholds are set for the purpose of identifying high value items for testing. These amounts may be set using the overall performance materiality as base amount, and the risk assessment rating as the determinant on whether to lower or increase the amount. For instance, these thresholds may be calculated using the table below:

When using audit sampling, testing thresholds may also be used as the equivalent of tolerable misstatement.

Testing thresholds	Testing threshold in terms of % of overall performance materiality			
	Minimal	Low	Moderate	High
Asset/ income accounts	75-100%	50-75%	25-50%	10-25%
Liability/ expense accounts	25-50%	15-25%	10-15%	5-10%

For instance, assume that accounts payable has an assessed risk of material misstatement of Moderate (combined assessment for inherent risk and control risk), then the auditor calculates testing threshold by choosing percentage within 10-15% and multiplying the percentage by the overall performance materiality. The resulting amount will be used as threshold in identifying high value items.

<sup>11</sup> <https://www.anao.gov.au/work/audit-manual/fsasg-specific>

## Clearly Trivial Threshold

In addition to the different thresholds above, the auditor may find it useful to calculate clearly trivial threshold which can be used in determining whether misstatement found (i.e., exceptions found in AWP 6.2) needs to be accumulated in AWP 7.1. “Clearly trivial” is not another expression for “not material.” Misstatements that are clearly trivial will be of a wholly different (smaller) order of magnitude, or of a wholly different nature than those that would be determined to be material, and will be misstatements that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the misstatement is considered not to be clearly trivial. Some of the audit practices follow the approach of setting this threshold to not exceeding 5% of the overall materiality. Take note that determining whether a misstatement is clearly trivial is not solely dependent on this threshold, but this also requires exercise of professional judgement.

In the Australian National Audit Office, this threshold can be set at 0%, 3% or 5% of the overall materiality, depending on the historical frequency and materiality of the misstatements, and the engagement risk involved. Engagements with no significant risks, with misstatements that are seldomly identified in the past and are not material may result in clearly trivial threshold at 5% of the overall materiality.

## Performance Materiality and Audit Risk

Audit risk is a function of the risk of material misstatement (i.e., inherent risk and control risk) and detection risk. Normally, the audit risk model is expressed as follows:

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

- **AR** – audit risk (risk of incorrect opinion)
- **IR** – inherent risk (susceptibility of an assertion to a misstatement before consideration of any related controls)
- **CR** – control risk (risks that controls will not detect, prevent and correct misstatements on a timely basis)
- **DR** – detection risk (risks that audit procedures will not detect material misstatements)

The auditor has no control over inherent risk and control risk, as such, the auditor can only identify and assess these risks through risk assessment procedures discussed in this chapter. For a given level of audit risk, and the assessed level of inherent and control risks, the auditor can only determine the level of detection risk that the auditor can accept. For instance, there is a higher assessed risk of material misstatements (IR and CR), the auditor can only accept a lower level of detection risk (i.e., inverse relationship).

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There is a “direct” relationship between performance materiality and detection risk. The lower the level of detection risk the auditor **can accept or tolerate** (i.e., lower acceptable risk that the audit procedures are not effective), a lower materiality is set which will mean extensive audit will be performed. The higher the level of detection risk the auditor **can accept or tolerate**, higher materiality can be used.

On the other hand, there is an “inverse” relationship between performance materiality and audit risk.

In the process of determining materiality, **sensitivity** of the items of underlying accounts should also be taken into consideration by the auditor. If the audited entity or financial statement account is more sensitive, the auditor should lower the materiality level respectively. Sensitivity is considered in terms of the users of the financial statements: in the public sector, main users of information who may be considered when determining materiality can be parliament, the media, state authorities and the public. Based on the users’ expectations, different thresholds may be applied.

## **Revision of materiality level as the audit progresses**

During an audit, there may be new situations or changes in circumstances that were not foreseen while determining materiality at the planning stage of the audit. In such circumstances, ISSAI 2320.12 requires the auditor to revise materiality for financial statements as a whole and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures. The revision of materiality levels and the reasons underlying the revision should be documented in the audit file.

As a result, the auditor needs to determine whether there is also a need to revise the performance materiality based on the revised overall materiality for the financial statements as a whole, and/or for particular classes of transactions, account balances or disclosures. The revised performance materiality should be documented in a similar manner.

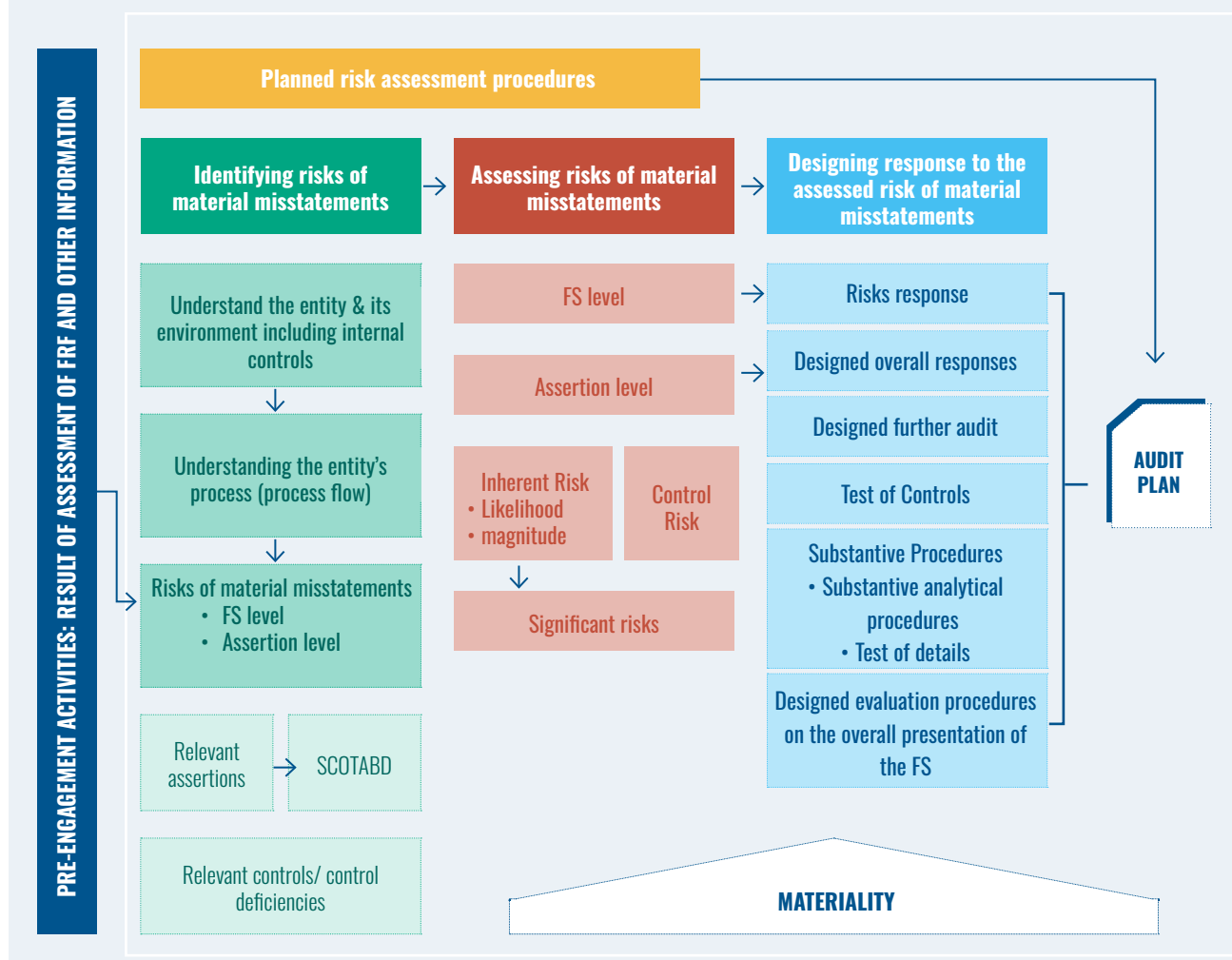
The revised materiality can be recorded in the audit working paper template on materiality (suggested as **AWP 5.1**).

## Detailed Audit Planning

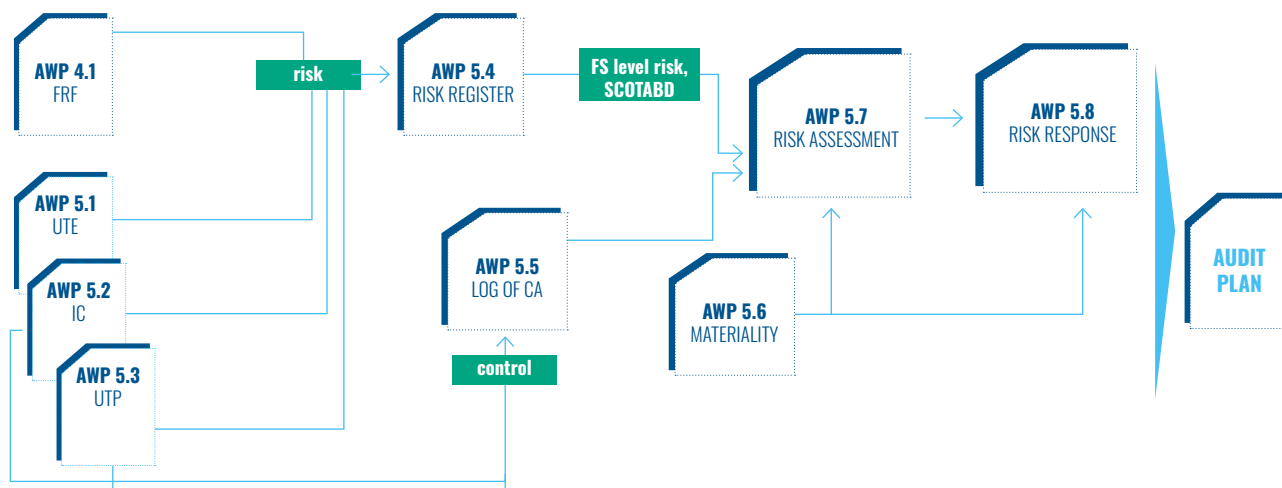
The general overview of planning phase of the audit is shown in Figure 5(b).

**FIGURE 5(b)**

**General overview of audit planning process**



The linkage of the audit planning working papers is shown below:



This handbook does not provide specific template for audit plan as SAIs may have different requirements in the preparation of the audit plan based on their local context. The required documentation for the audit plan, however, can be supported through the collective audit working papers introduced in this handbook. Depending on SAI's practices, the audit plan may include, among others:

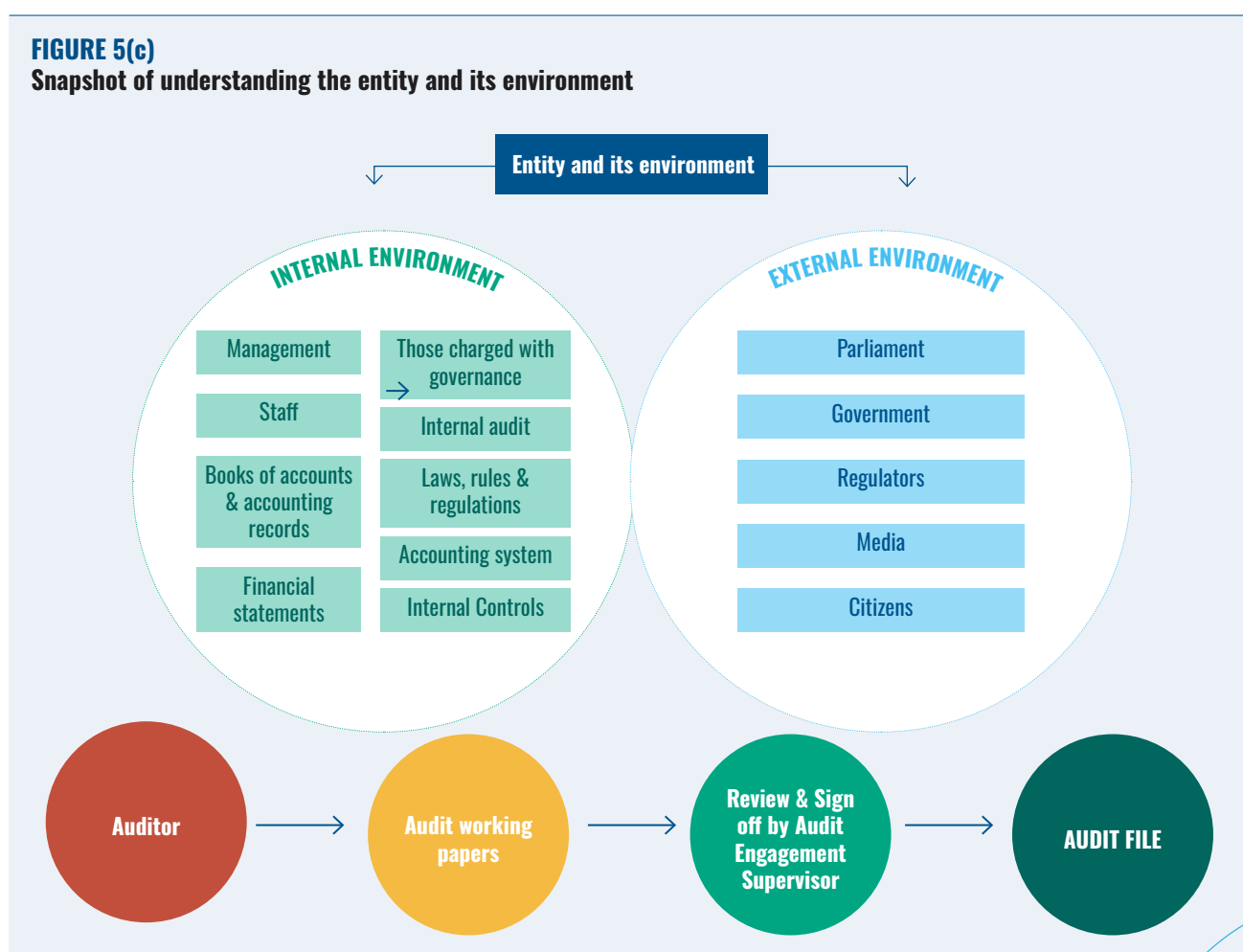
- a. Planned risk assessment procedures
- b. Further audit procedures (response to risk at the assertion level)
- c. Target timeline
- d. Distribution of assignment of the procedures to the audit team
- e. Planned supervisor's review
- f. Summary of the result of risk assessment (e.g., assessed risks, audit areas, other overall risk responses such as if expert is needed)
- g. Planned communication with the audited entity, with external parties or with component auditors as applicable
- h. Audit team resourcing requirements

## IDENTIFYING RISKS OF MATERIAL MISSTATEMENTS

### Understanding the entity and its environment including the system of internal control

At the financial statements and assertion levels, ISSAI 2315 broadly requires auditors to identify and assess the risks of material misstatement due to fraud or error by developing an understanding of the entity and its environment, including the entity's internal control. This understanding provides a basis for designing and implementing responses to the assessed risks of material misstatement. A snapshot of understanding the entity and its environment is shown in **Figure 5(c)** below.

**FIGURE 5(c)**  
**Snapshot of understanding the entity and its environment**



Knowledge of an entity is important to conduct the audit efficiently and effectively. While auditors would be expected to have prior knowledge of entities audited over many years, an audit of a new entity would require more time to gain the detailed understanding required. Where entities were audited in the past by the same auditors, any changes would need to be identified and documented accordingly.

Understanding the entity as a whole helps the auditor identify business risks or entity risks that may have an impact on the financial statements.

An example of how the auditor can establish the understanding of an entity and its environment is given in audit working paper template **AWP 5.2**.

Take note that based on the understanding of the entity and the applicable financial reporting framework, there is a need to determine how the inherent risk factors can affect susceptibility of assertions to misstatement. These considerations include:

- Complexity
- Subjectivity
- Change
- Uncertainty
- Management bias or other fraud risk factors
- Quantitative or qualitative significance of the class of transactions, account balance or disclosure
- Volume or a lack of uniformity in the composition of the items to be processed

Additional guidance on inherent risk factors is provided in Appendix 2 of ISSAI 2315.

## The understanding of the entity's legal framework

It is the responsibility of management and those charged with governance to ensure that the entity's operations are conducted in accordance with the provisions of applicable laws and regulations, including compliance with those provisions that determine the reported amounts and disclosures in an entity's financial statements. It is the responsibility of the auditor to identify any risk related to laws and regulations breached that could lead to financial effects on financial statements (refer to ISSAI 2250).

In an audit of financial statements, the auditor needs to have an understanding of the legal and regulatory framework within which the entity operates. This includes identifying the applicable laws, rules and regulations affecting the entity's operations. In the context of public sector entities, those applicable laws and regulations may be in the form of environmental regulation, public finance acts, financial regulation, procurement regulation, employment acts, parliamentary resolutions, etc.

In addition, the government is composed of different sectors such as agriculture, forestry, finance, treasury, education, health, transport, communication, culture, foreign affairs, etc., and consequently the auditor needs to gather sector-specific knowledge regarding the laws, rules and regulations applicable and relevant to different sectors. The entity's vision and mission statements, if any, also indicate the nature of and basis for its existence.

In public sector operations, especially in the government, the amounts reflected in the financial statements are often impacted by laws enacted by the parliament, such as budget law, regulations and other standing orders and circulars issued by the government. In addition, the applicable financial reporting framework that provides the basis for the preparation of financial statements of a government may be based on laws and regulations. Public sector auditors must carefully consider the scope of ISSAI 2250 to identify laws and regulations that have direct and indirect effects on the financial statements.

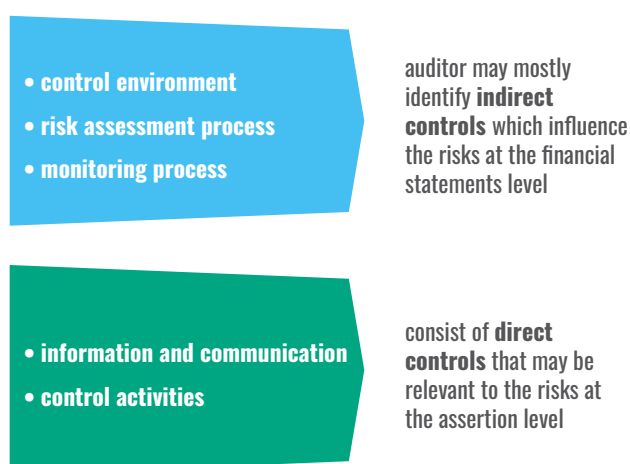


## The understanding of the entity's system of internal control

It is the responsibility of an entity to establish internal controls to prevent and detect material misstatements in the financial statements. The auditor's responsibility is to ascertain whether those controls were effectively designed. However, not all internal controls designed and implemented by management may be relevant to an audit. ISSAI 2315.21 to 27 require an auditor to obtain an understanding of the entity's system of internal control. In adopting the risk-based approach to auditing, auditors are expected to identify those controls relevant to risks identified by the auditor. This is explained in detail under the section of this chapter, **"Identifying and assessing the risks of material misstatements."**

ISSAI 2315 requires that when identifying internal controls, the auditor considers and establishes an understanding of all five components of internal controls. These consist of the control environment; the entity's risk assessment process; the entity's process to monitor the system of internal control, the information system and communication; and control activities.. The auditor may use **AWP 5.3** in documenting the understanding of the entity's system of internal control.

### The entity's system of internal control



## Control environment

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's system of internal control, and its importance in the entity..

The control environment sets the tone of an organisation, influencing the control consciousness of its staff and management. As such, it determines the effectiveness of other components of internal controls: internal control activities may not function unless a culture of honesty, integrity and ethical behaviour exists in an organisation. Deficiencies in the control environment undermine the effectiveness of controls that are put in place, particularly in relation to fraud. Therefore, in assessing the risks of material misstatement due to error or fraud, evaluating the control environment is very important.

### The entity's risk assessment process

The entity's risk assessment process is a component of internal control that is aimed at managing the risks faced by the entity in its operations .

The extent of audit procedures to be performed in this regard depends on the entity's environment and whether a risk assessment process exists. If there is such a process, the auditor should gain an understanding of it. The auditor's responsibility is not to understand just the entity's risk assessment process but also how management has responded to the assessed risks (management's action).

If a risk assessment process does not exist, the auditor shall also evaluate the impact on the preparation and presentation of the financial statements. Depending on the circumstances and the size of the entity, the absence of a risk assessment process may represent a significant deficiency in internal controls.

## The entity's process to monitor the system of internal control

Internal control systems need to be monitored — a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities and other actions personnel take in performing their duties.

The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

The **internal audit function** plays an important role in monitoring the implementation of internal controls within an entity. It is a management tool, and its effectiveness depends on how independently it is situated within the entity's structure, to whom it reports, and what action on the internal auditor's report is taken by management and those charged with governance.

An effective internal audit function may reduce the level of work to be done by the external auditors. However, not all work by internal audit will be relevant to an audit of financial statements.

Where an entity has an internal audit function, the auditor is required to obtain an understanding of that function, its responsibilities, its organisational status and the activities it performs. The procedure for obtaining this understanding is suggested in audit working paper template **AWP 5.2a**.

The work done by internal audit may also impact the nature and extent of audit procedures if an entity has an internal audit function whose work can be used, after a positive evaluation of the IA function as required by ISSAI 2610. The auditor can, in this regard, confirm whether the entity has an internal audit function and in which areas and to what extent the internal auditors' work can be used.

Since internal auditors are expected to monitor the implementation of internal controls and will have wider knowledge of the entity, they can provide direct assistance to external auditors in planning and performing the audit. Direct assistance as per ISSAI 2610.14 refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor. The auditor needs to agree with the entity, if planned to seek direct assistance of internal auditor as suggested in audit working paper template **AWP 5.2b and AWP 5.2c**.

## The information system and communication

ISSAI 2315.25 requires the auditors to obtain an understanding of entity's information system and communication relevant to the preparation of the financial statements. This involves:

- a. Understanding of the entity's information processing activities, including its data and information, the resources to be used in such activities and the policies that define, for significant classes of transactions, account balances and disclosures:
  - how information flows through the information system
  - the accounting records, specific accounts in the financial statements and other supporting records
  - the financial reporting process
  - the entity's resources relating to above
- b. Understanding how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities.
- c. Evaluating whether the entity's information system and communication appropriately support the preparation of the entity's financial statements in accordance with the applicable financial reporting framework.

Understanding the entity's information system may be obtained in various ways, which may include:

- Inquiries of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process
- Inspection of policy or process manuals or other documentation of the entity's information system
- Observation of the performance of the policies and procedures by the entity's personnel
- Selecting transactions and tracing them through the applicable process in the information system (i.e., performing a walk-through)

Performing understanding of the information processing activities, including the control activities below, are covered in the *Understanding the Process*.

### Control activities relevant to audit

Control activities are the policies and procedures that help to ensure that the organisation's activities are carried out as required and the financial statements are free from material misstatements.

It is the responsibility of management to institute control activities that will prevent and detect errors, omissions and fraud in preparing and presenting the financial statements. The auditor's responsibility is to see whether the controls are designed and implemented and operate effectively in preparing and presenting financial statements that are free from material misstatements.

In public sector entities, the relevant control activities in the preparation of financial statements are by and large defined in rules, regulations and standard operating procedures. Effective enforcement of and adherence to these rules and regulations will prevent material misstatements in the financial statements depending on the attitude (ethics and integrity) of management and those charged with governance. The auditor needs to obtain an understanding of those rules and regulations and other controls that are relevant to audit and risk identification.

Take note that understanding the control activities is embedded in the understanding process using the

#### **AWP 5.4.**

Auditors need to understand controls that address risks of material misstatement at the assertion level which include:

- Controls that address significant risk;
- Controls over journal entries used to record non-recurring, unusual transactions or adjustments;
- Controls for which the auditor plans to test operating effectiveness in determining the nature, timing and extent of substantive testing; and
- Other controls the auditor considers appropriate

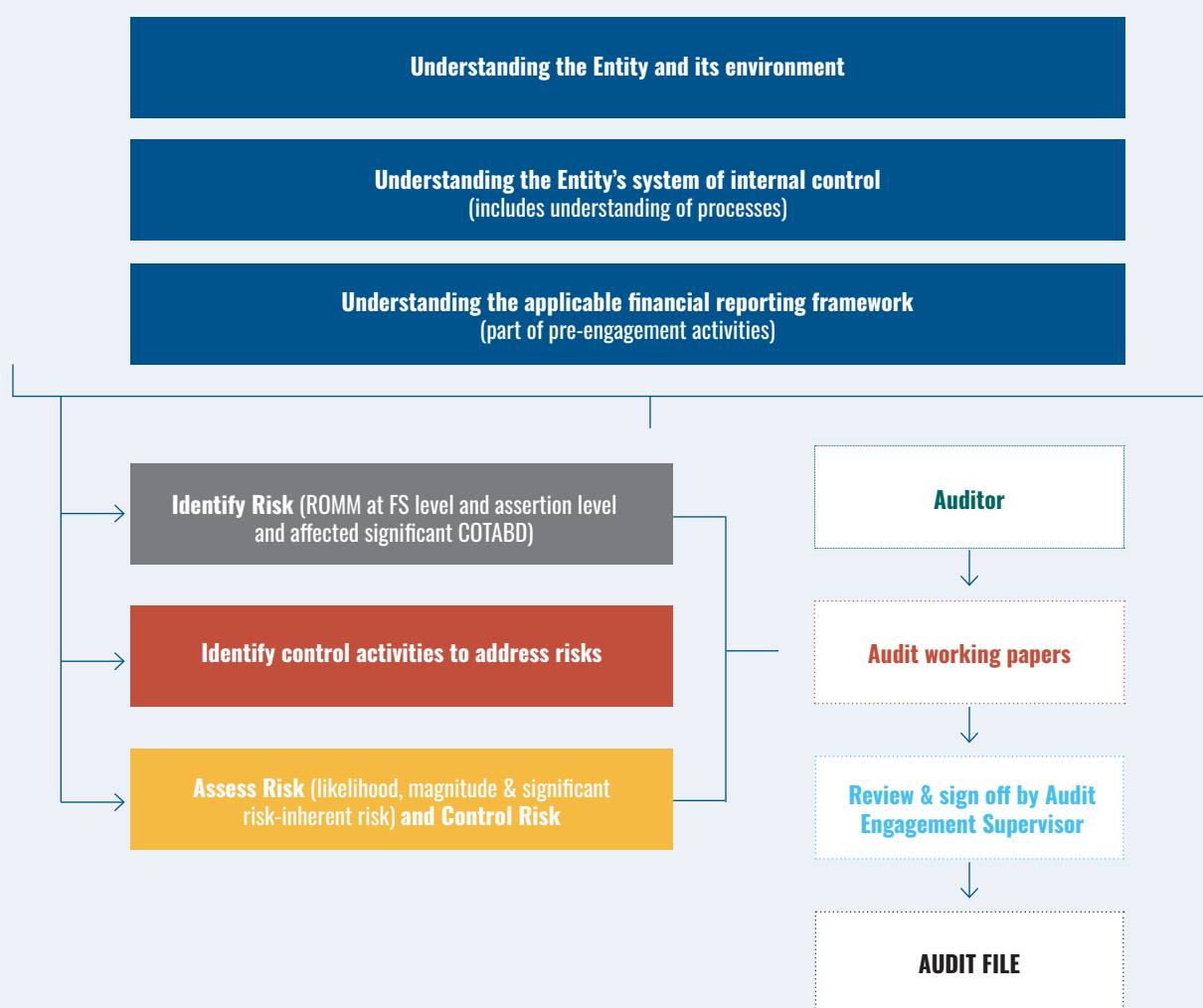
In addition, the understanding needs to cover the audited entity's general IT controls that address risks arising from the use of IT.

## Understanding the process

After obtaining a complete understanding of the entity and its environment, the next step is to identify the processes involved in the entity, which will include routine and non-routine processes undergone by classes of transactions, account balances and disclosures presented in the financial statements to identify risk of material misstatement. Take note

that this is part of the entity's information processing activities. **Figure 5(d)** below provides a snapshot of risk assessment process, which includes risk identification. The guidance on assessing the identified risk as to its likelihood, magnitude and significance is provided after the section on materiality in this chapter.

**FIGURE 5(d)**  
**Snapshot of risk assessment process**



## Identify risks of material misstatements

While documenting the understanding of this process, the auditor needs to **identify** risks at every stage of the process. In other words, the auditor should be able to identify “*what could go wrong*” at every stage of the process or at the assertion level given the risks—for instance, while processing a payment to the supplier as provided in **Illustration 5.5**.

A process flow can be documented in the form of narrative write up, flow chart, etc. by following the guidance provided in audit working paper template **AWP 5.4**. After documenting the processes, the auditor should perform walkthrough procedures to determine whether these processes are actually followed by the audited entity. There are instances wherein the processes written in the audited entity’s operations manual or other guidelines differ from the actual practice. As such, the auditor should use the actual practices for the purpose of risk assessment. In performing walkthrough procedures, the auditor may follow the critical path (initiation, processing, recording, reporting) using one sample transaction. As the auditor is expected to assess the design and implementation of controls during planning, walkthrough will also assist in determining whether the controls are actually implemented.

The auditor is expected to apply professional judgement while identifying the risks of material misstatement in the financial statements. The risks identified by the auditor are listed in the summary of **AWP 5.4** and carried forward to the risk register (using audit working paper template **AWP 5.5**).

Upon identifying risks of material misstatement at the assertion level, the auditor needs to identify significant classes of transactions, account balances and

disclosures and their relevant assertions, which are affected by those risks using **AWP 5.5**. (A significant class of transactions, account balance and disclosure are those where there is one or more relevant assertions).

ISSAI 2240 prescribes what is expected of the auditor in an audit of financial statements about fraud. This standard prescribes the requirements related to risk assessment procedures and related activities, responses to assessed risks of material misstatement due to fraud, audit evidence, etc. This section of the chapter covers the risk assessment procedures and related activities. The other requirements are covered in relevant chapters of this Handbook.

Unlike error, fraud is an intentional act of deception by one or more individuals to obtain an unjust or illegal advantage. Its effect might be fraudulent financial reporting or misappropriation of assets.

Primary responsibility for prevention and detection of fraud lies with management and those charged with governance of the entity, through implementing and operating an adequate accounting and internal control system.

Unless the audit reveals evidence to the contrary, the auditor is entitled to accept representations as truthful, and records and documents them as genuine. However, the auditor should plan and perform the audit with an attitude of professional scepticism, recognizing that conditions or events may be found that indicate that fraud may exist. But the auditor should neither assume that the entity management or employees are dishonest nor assume unquestioned integrity. Instead, the auditor should objectively evaluate the conditions and circumstances observed.

### ILLUSTRATION 5.5

#### Risk and what could go wrong in the financial statement

Payment process	Risk	What could go wrong
Processing final payment for purchase of computer equipment	Inflated rate in the final invoice (over and above quoted rate)	Overstatement of expenditure

Notwithstanding the auditor's experience, the risk of material misstatements due to fraud may arise because there have been changes in circumstances, of which the auditor needs to be aware (ISA 2240.12).

Risk of material misstatement may occur because of an error or fraud. The risks identified and documented in the Risk Register (see audit working paper template **AWP 5.5**) will contain the risks due to fraud or error. ISSAI 2240.27 requires the auditor to treat those assessed risk of material misstatement due to fraud as significant risks and accordingly, to the extent not already not done so, the auditor should obtain an understanding of the entity's related controls, including control activities, relevant to such risks.

Provided the audit procedures are adequately designed, the auditors may be able to detect an indication of fraud in an audit of financial statements. While some SAs may have a mandate to investigate fraud, others may not; in the latter case it would be necessary to report any possible indication of fraud to the investigating authority (ISSAI 2240.43).

It is common in developing countries that a major share of national budgets is allocated for procurement, construction and the development of infrastructure. As part of identifying and assessing the risks of material misstatements due to fraud in government departments, the auditor may review the components of capital expenditure and identify the amounts spent on building public infrastructure.

With different laws in different jurisdictions, public sector entities are required to have systems and procedures in place to identify and respond to risks of fraud. If such a system exists, the auditor should assess whether it operates effectively and should document the conclusions. Depending on the system's effectiveness, the level of risk assessment procedures the auditor needs to perform could be largely reduced.

## Identifying internal control activities to prevent occurrence of risks

To mitigate the risks of material misstatements in the preparation and presentation of financial statements, management and, where relevant, those charged with governance are expected to put internal controls in place. Based on obtaining an understanding of the entity process through process flow or narrative write-up (as provided in audit working paper template **AWP 5.4**) and linking the risks to every stage of the process, the auditor needs to identify those controls that are intended to mitigate the risks identified at an assertion level. These control activities may be recorded in an internal control log as suggested in audit working paper template **AWP 5.6**.

In public sector entities, the control activities relevant to the financial reporting process may be in the form of financial rules and regulations, government circulars, government policies, procurement rules and regulations, etc. In following the risk-based approach to auditing, the auditor is expected to take account of the rules, regulations and policies that are related to identified risks of material misstatements. See **Illustration 5.6** for an example.

Based on audit working paper template **AWP 5.6** the auditor is expected, where the control activities are recorded, to transfer these control activities to **AWP 5.8** and register them against each risk already recorded. This ensures that each of the control activities is linked to risks of material misstatements identified and assessed at the assertion level. Further, by following this process, the auditor is constantly reminded to consider the link between risks and internal control activities.

### ILLUSTRATION 5.6

#### Identifying control activities that address the risk

Risk	Control activity
Travel claim of an employee being paid at incorrect rates.	An independent check should be performed of standing data (eg: government approved travel claim rates) to travel claim processed by an employee.

*Note: This risk will occur at the assertion level in the financial statement. Financial Statements assertions are explained later in this section.*

It is important for the auditor to understand the link between risk assessment and audit assertions. The auditor identifies the risks that could cause material misstatement in the financial statements. Management of an entity makes various assertions while preparing the financial statements, which are referred as financial statements assertions. Therefore, the auditor should ensure that the identified risk is relevant to the assertion(s). After identifying the risk, the auditor must assess “*what could go*

*wrong*” at the assertion level as a result of that risk. This will be further explained in the next section on designing further audit procedures, where the linking of audit assertion, risk and further audit procedures will be illustrated.

As per ISSAI 2315.A190, assertions used by the auditor to consider different types of potential misstatements that may occur fall into the two categories in the table below and may take the following forms as described.

<b>A. Assertions about classes of transactions and events, and related disclosures for the period</b>		
<b>No.</b>	<b>Assertion</b>	<b>Description</b>
<b>1</b>	<b>Occurrence</b>	Transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
<b>2</b>	<b>Completeness</b>	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
<b>3</b>	<b>Accuracy</b>	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
<b>4</b>	<b>Cut-off</b>	Transactions and events have been recorded in the correct accounting period.
<b>5</b>	<b>Classification</b>	Transactions and events have been recorded in the proper accounts.
<b>6</b>	<b>Presentation</b>	Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of requirements of the applicable financial reporting framework.
<b>7</b>	<b>Compliance</b>	The transactions and events have been carried out in accordance with law, regulation or other authority.
<b>B. Assertions about account balances, and related disclosures, at the period end</b>		
<b>No.</b>	<b>Assertion</b>	<b>Description</b>
<b>1</b>	<b>Existence</b>	Assets, liabilities, and equity interest exist.
<b>2</b>	<b>Rights and obligations</b>	The entity holds or controls the right of assets and liabilities are obligation of the entity.
<b>3</b>	<b>Completeness</b>	All assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
<b>4</b>	<b>Accuracy, valuation and allocation</b>	Assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded, and related disclosures have been appropriately measured and described.
<b>5</b>	<b>Classification</b>	Assets, liabilities, and equity interests have been recorded accounts.
<b>6</b>	<b>Presentation</b>	Assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of requirements of the applicable financial reporting framework.



As recognized by ISSAI 2315.A192, the additional assertions in the audit of public sector financial statements need to be considered while planning the audit. This is very much related to risks of material misstatements due to non-compliance with law, regulations and authorities, which determine the design of appropriate audit procedures (additional assertion may be included pertaining to ‘compliance’). The “compliance” assertion below is an example of an assertion not prescribed by the financial audit ISSAI that may be added if deemed necessary to effectively evaluate the risks of material

misstatement of the financial statements. It would not be appropriate to add such an assertion to evaluate the compliance with all laws and regulations that may be evaluated by a public sector auditor including those that may not be relevant to the audit of the financial statements. The scope of ISSAI 2250 must be understood and respected when setting the scope of the ISSAI financial audit. A separate section considering these aspects and how they should be dealt with by the auditor is included in this Chapter (ISSAI 2250 “Consideration of laws and regulations in an audit of financial statements”).

### ILLUSTRATION 5.7

#### Financial Statement Assertions and examples

##### Transactions and Events

*For a transaction such as the purchase of office equipment, the management is asserting in the financial statements that:*

<b>Occurrence</b>	The purchase really did take place.
<b>Completeness</b>	All purchase transactions are included in the financial statements.
<b>Accuracy</b>	The quantities and prices are correctly stated.
<b>Cut-off</b>	The transaction was dealt with in the correct accounting period.
<b>Classification</b>	It really is a purchase of equipment, not a payroll cost or a motor vehicle and it has been accounted for accordingly.
<b>Compliance</b>	The payment of travel allowance was made in accordance with travel regulations.

##### Account balances at the year end

*For account balances at the year end, the assertions are slightly different, because the things about which the assertions are made are different:*

<b>Existence</b>	→	Are all these motor vehicles, office equipment, land and buildings, inventories real? Do they exist?
	→	Are these trade receivables real? Have we sold them something for which they owe us money?
	→	Was something effectively bought from these trade payables and therefore do we really owe them some money?
<b>Rights and obligations</b>	→	Do we own the factory? The car? The computer?
	→	The trade receivables may exist, but have we factored them or otherwise transferred our rights to them?
<b>Accuracy, Valuation and allocation</b>	→	Has depreciation/amortisation been calculated correctly on the depreciable assets/intangible assets?
	→	Is there an adequate provision for allowance or write-off for receivables which are doubtful of collections, or are considered unrecoverable?
	→	Is the inventory damaged, slow moving or obsolete?



## ASSESSING RISKS OF MATERIAL MISSTATEMENT

As explained in ISSAI 2320.A1, materiality and audit risk are considered when identifying and assessing the risk of material misstatement in classes of transactions, account balances and disclosures. To maintain the link and to follow the process of risk assessment, the methodology on determining the materiality is included before a section on risk assessment. However, this methodology needs to be followed and read in an iterative process, and the materiality can be determined simultaneously while identifying and assessing the risks of material misstatement.

After completing the risk identification process, the auditor needs to **assess** the risks of material misstatement at the financial statement level and the assertion level.

At the financial statement level, the auditor assesses the risks to evaluate the pervasive effect on the financial statements, and determines whether such risks affect the assessment of risks at the assertion level.

At the assertion level, the auditor needs to assess the risks of material misstatements in terms of likelihood and magnitude (inherent risks) and their significance and impact on the presentation of the financial statements—that may result in material misstatements in the financial statements. At the same time, the auditor needs to assess the control risk which will have an impact on auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the assessment of the risk of material misstatement will be the same as the assessment of inherent risk.

In assessing the inherent risk, the auditor may use the table below. Take note that those in the higher-end of the spectrum indicates the existence of significant risks which require special audit consideration.

Magnitude	High	Moderate	High
	Low	Low	Moderate
		Low	High
		Likelihood	

In combining the assessment of inherent risk and control risk (risk of material misstatement), the table below may be used. Take note that this rating of risk of material misstatement affect the calculation of detection risk and thus, the extent of testing.

Inherent Risk	High	Moderate	High
	Moderate	Low	High
	Low	Minimal	Moderate
		Low	High
		Likelihood	

ISSAI 2315.14 prescribes the risk **assessment procedures**, which include inquiries of management and appropriate individuals within the entity, analytical procedures, observation and inspection.

Whether an identified risk requires special audit consideration, i.e. if it is a **significant risk** or not, is also to be evaluated by the auditor using professional judgement and taking account of likelihood and magnitude of misstatements as a result of inherent risks assessed. Significant risks are risks for which the assessment of inherent risk is close to the upper end of the spectrum of the inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur. In addition, significant risks may arise from the following:

- risks arising from fraud
- risks associated with related party relationships and transactions
- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.
- Accounting estimates that have high estimation uncertainty or complex models.
- Complexity in data collection and processing to support account balances.
- Account balances or quantitative disclosures that involve complex calculations.
- Accounting principles that may be subject to differing interpretation.
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.

In this assessment, the auditor should also account for a degree of subjectivity in the measurement of financial information of the entity as a whole or the complexity of transactions or events the financial statements may represent.

The need to identify significant classes of transactions, account balances and disclosures based on the identified risks of material misstatement is highlighted under the section identifying risk of material misstatements at the assertion level. There may be classes of transactions, account balances or disclosures that are quantitatively and qualitatively material but were not determined as significant. These need to be identified since the auditor is required to perform minimum substantive auditor procedures

as required by ISSAI 2330.18. For the purpose of this ISSAI 2330 requirement, ISSAI 2315.A235 also considers *significant classes of transactions, account balances or disclosures as material classes of transactions, account balances or disclosures*.

Take note that paragraph 36 of ISSAI 2315 (Revised) has now “stand-back” requirement relating to the audit team’s determination whether the classification of NOT significant BUT material classes of transactions, account balances or disclosures remains appropriate. Otherwise, the risk assessment process needs to be updated and consider the implication that these could be both “significant” and “material”.

The auditor can use audit working paper template **AWP 5.7** for assessing and documenting the risk of material misstatement at both the financial statement level and the assertion level. Those classes of transactions, account balances or disclosures identified as material but significant can be derived from **AWP 5.1** and document in **AWP 5.7** to address appropriately at conducting phase of the audit.

The risks identified and assessed either due to fraud or error may change during an audit as the auditor obtains additional audit evidence. ISSAI 2315.37 requires the auditor to revise the risk assessment and modify planned audit procedures (see also ISSAI 2330 “Auditor’s response to assessed risks”). If, for example, the auditor initially intended to rely on controls on the expectations developed based on the design and implementation of controls, and that after testing the operating effectiveness during the conducting stage, the controls are not operating effectively as expected, the auditor needs to update the risk assessment in **AWP 5.7**. The revisions made to the assessment and the reasons for them need to be documented and signed off by the reviewer.

The risk assessment may be separately done per ‘assertion’ on each account. For instance, cutoff and existence assertions may have been identified for the receivable account. These two assertions may have different assessments which will affect the extent of testing. Assuming that existence assertion is assessed as high while cutoff is assessed as low, then the auditor is expected to have a more extensive procedure to ascertain existence assertion as compared

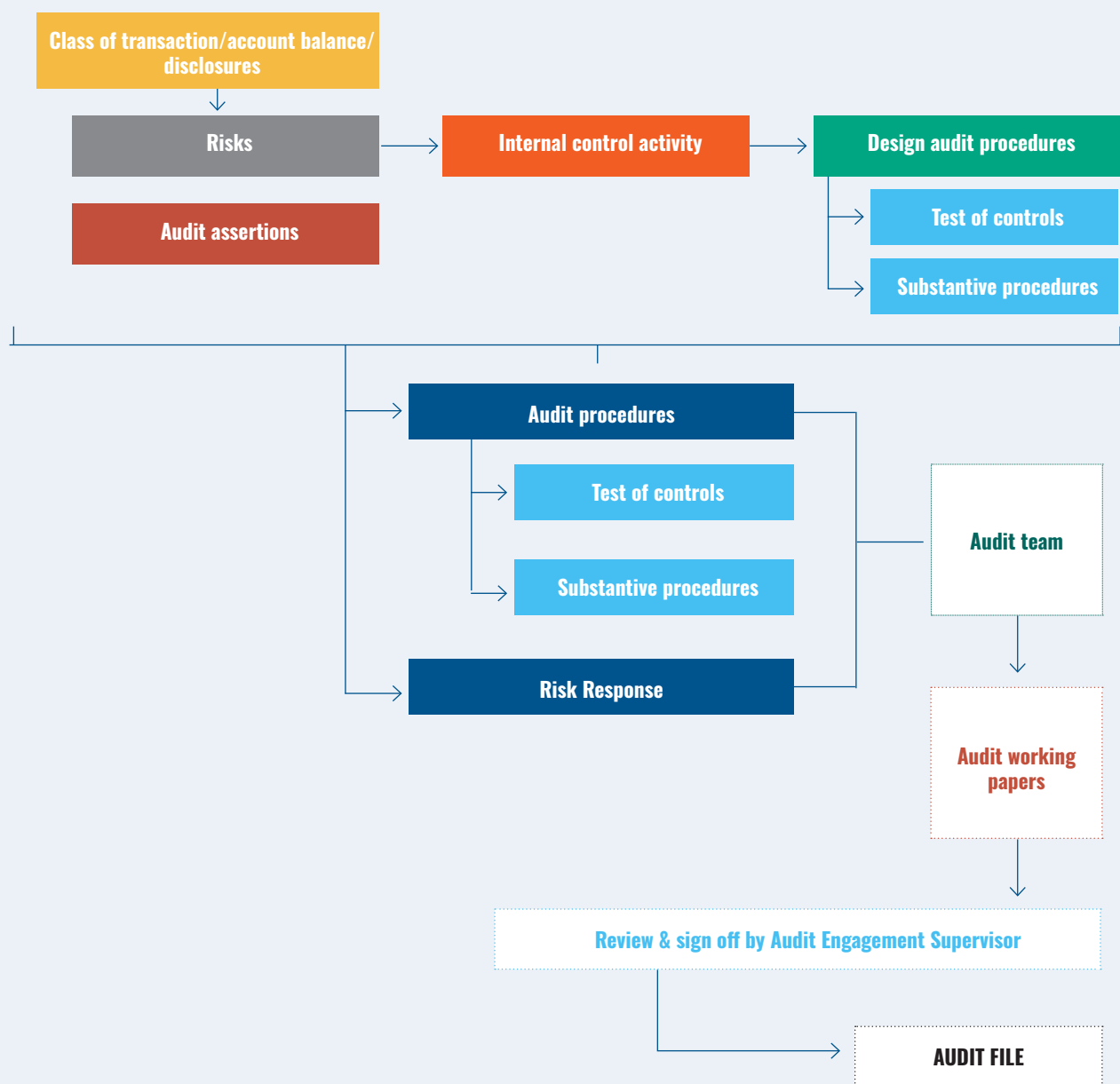
with the cutoff. In other practices, only single assessment is made per account irrespective of whether there are two or more assertions identified. In doing this, the conservative assessment is chosen if there are different levels of assessment on different assertions. (E.g., Cutoff is High, classification is Low, then the overall assessment will be HIGH).

## RESPONDING TO THE ASSESSED RISKS OF MATERIAL MISSTATEMENTS

The purpose of designing audit procedures is to gather sufficient appropriate audit evidence. Risk assessment procedures are considered audit procedures under ISSAI 2315. Upon identifying and assessing the risks of material misstatement, an auditor is expected to respond appropriately to those risks by designing appropriate “further audit procedures” as defined in ISSAI 2330. **Figure 5(e)** provides a snapshot of designing further audit procedures.

**FIGURE 5(e)**

**Designing further audit procedures as a response to assessed risks of material misstatements**



In a risk-based approach to auditing, audit procedures not linked to assessed risks will not serve the purpose. The risks identified and assessed at both the financial statement and the assertion levels are transferred to the Risk Response audit working paper template **AWP 5.8**.

Before suggesting how the requirements of ISSAI 2330 can be met, it is important for auditors to understand different categories of further audit procedures as provided in ISSAI 2330.4 and detailed below:

**Test of controls:** An audit procedure designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level.

- These tests are necessary when the auditor's risk assessment includes an expectation of the operating effectiveness of controls, requiring the testing of those controls to support the risk assessment; and where substantive procedures alone do not provide sufficient appropriate audit evidence, requiring tests of controls to obtain audit evidence about their operating effectiveness.
- Considering **Illustration 5.6**, let us look at how the auditor can design the test of control as provided in **Illustration 5.8** below. This is linked to material misstatement at the assertion level. Here, the auditor needs to link the risk and control activity to audit assertion to design a test of control procedures.

**ILLUSTRATION 5.8:**  
**Designing test of control against identified risk and control activity**

Risk	Control activity	Test of control procedure	Financial Statement Assertion
Travel claim of an employee being paid at incorrect rates.	An independent check should be performed of standing data (eg: government approved travel claim rates) to travel claim processed by an employee.	Inspect the travel claim of an employee for evidence of independent check being performed.	Accuracy <i>(checking if rates of travel claim were applied correctly).</i>

**Substantive procedure:** An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details (particular classes of transactions, account balances or disclosures); and substantive analytical procedures.

Following the reasoning from **Illustration 5.8** above, let us look at how the auditor can design substantive audit procedures as shown in **Illustration 5.9** below:

**ILLUSTRATION 5.9**  
**Designing substantive audit procedure (test of detail) against identified risk**

Risk	Control activity	Test of control procedure	Substantive audit procedure	Financial Statement Assertion
Travel claim of an employee being paid at incorrect rates.	An independent check should be performed of standing data (eg: government approved travel claim rates) to travel claim processed by an employee.	Inspect the travel claim of an employee for evidence of <i>independent check</i> being performed.	Obtain printout of standing data (eg: government approved travel claim rates) and <i>compare</i> with the rates being applied in travel claim of an employee.	Accuracy <i>(checking if rates of travel claim were applied correctly).</i>

As can be seen from the above, both tests of controls and substantive audit procedures deal with addressing the risks of material misstatements at the assertion level. The difference is that the test of controls deals with evaluating the operating effectiveness of internal controls that are supposed to prevent and detect material misstatements at the assertion level, while the substantive procedure is a detailed test that needs to be designed and performed on classes of transactions, account balances or disclosures, irrespective of whether internal controls exist or not. The basis for designing and performing tests of controls will depend on internal controls put in place by the entity.

- Substantive procedures include the **testing of details** of components, classes of transactions, account balances or disclosures—e.g. reconcile general ledger expense account totals to purchase journal; reconcile (a sample of) quantities on purchase invoices to goods received. They also include **substantive analytical procedures**—e.g. calculating the average inventory holding period and comparing to

the prior year (ratio analysis); calculating the percentage increase in revenue and comparing to forecast and to prior year (trend analysis); performing a calculation to test the reasonableness of interest received as, for instance, the average bank balance against average interest rate for the year (proof in total).

- In summary, **test of details** includes tracing figures to relevant supporting documents to determine the validity of transactions, proper classification, and completeness. **Substantive analytical procedures** consist of comparing financial information in the financial statements with other reliable information or with the auditor's expectation, to determine if reported information is accurate. The unexpected variations or differences identified by performing analytical procedures may lead to further review and investigation. An example of substantive analytical procedures is illustrated in **Illustration 5.10**:

#### ILLUSTRATION 5.10 Substantive analytical procedures

Financial Statement Assertion	Account balance	Substantive Analytical procedures
Accuracy	Payroll cost	<ul style="list-style-type: none"> <li>→ Define the acceptable tolerance for the difference between the independent expectation of the total 20X1 employee basic salary expense and the actual total employee basic salary expense recognized in the 20X1 financial statements.</li> <li>→ Develop an independent expectation of the total employee basic salary expense for 20X1.</li> <li>→ Determine the actual basic salary expense recognized in the 20X1 financial statements.</li> <li>→ Calculate the difference between the independent expectation and the actual outcome.</li> <li>→ Explain a difference that exceeds the acceptable tolerance.</li> </ul>

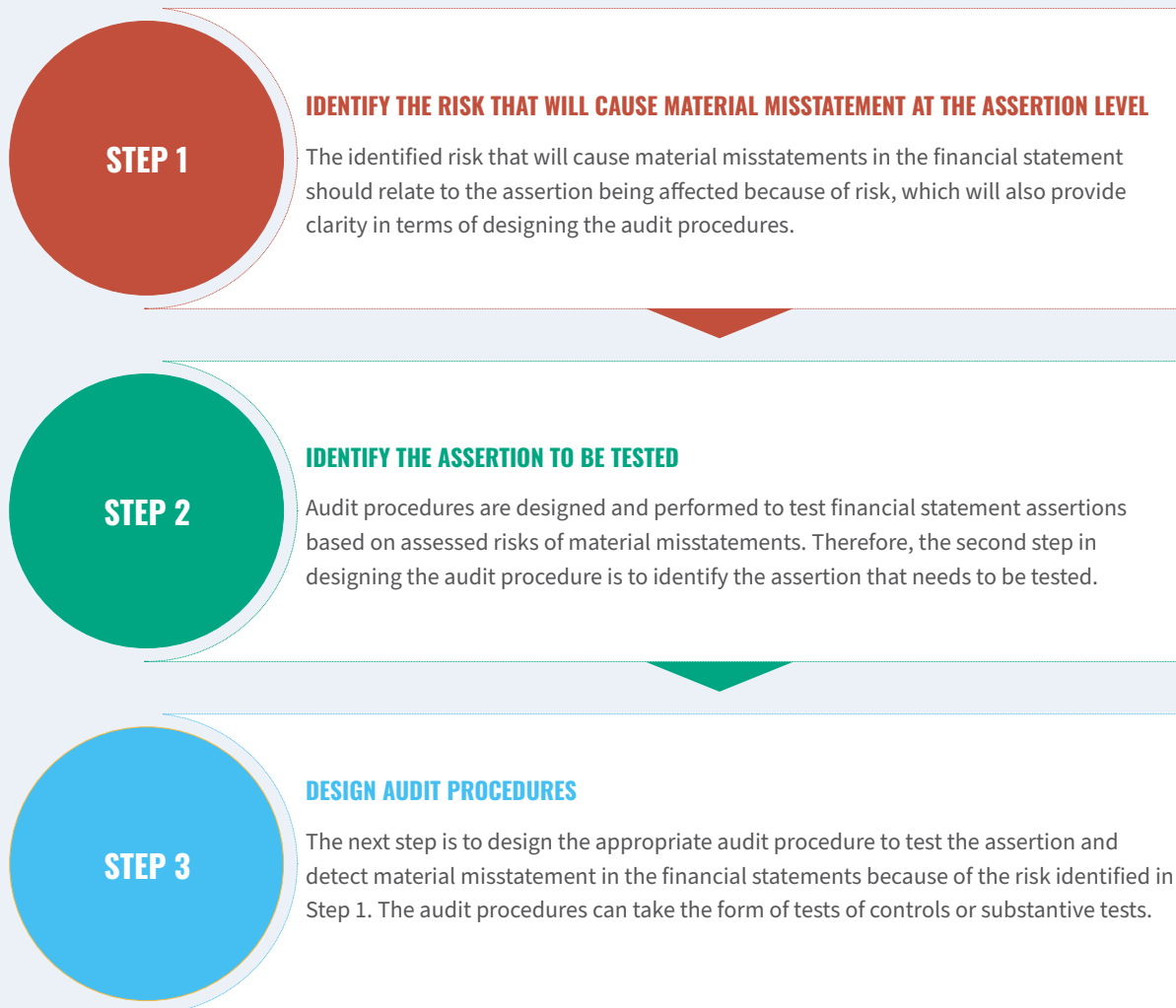
The choice of appropriate procedures is a matter of professional judgement in the circumstances. The factors to be considered in determining the relative mix of tests of details and analytical procedures include the following:

- Nature of the transactions and balances in relation to the assertions involved.
- Availability of historical data or other criteria for use in analytical procedures. It would become an area of concern, if historical data is not available for the financial year in question or the immediately preceding year.
- Availability of records required for effective tests of details and the nature of the tests to which they are susceptible.

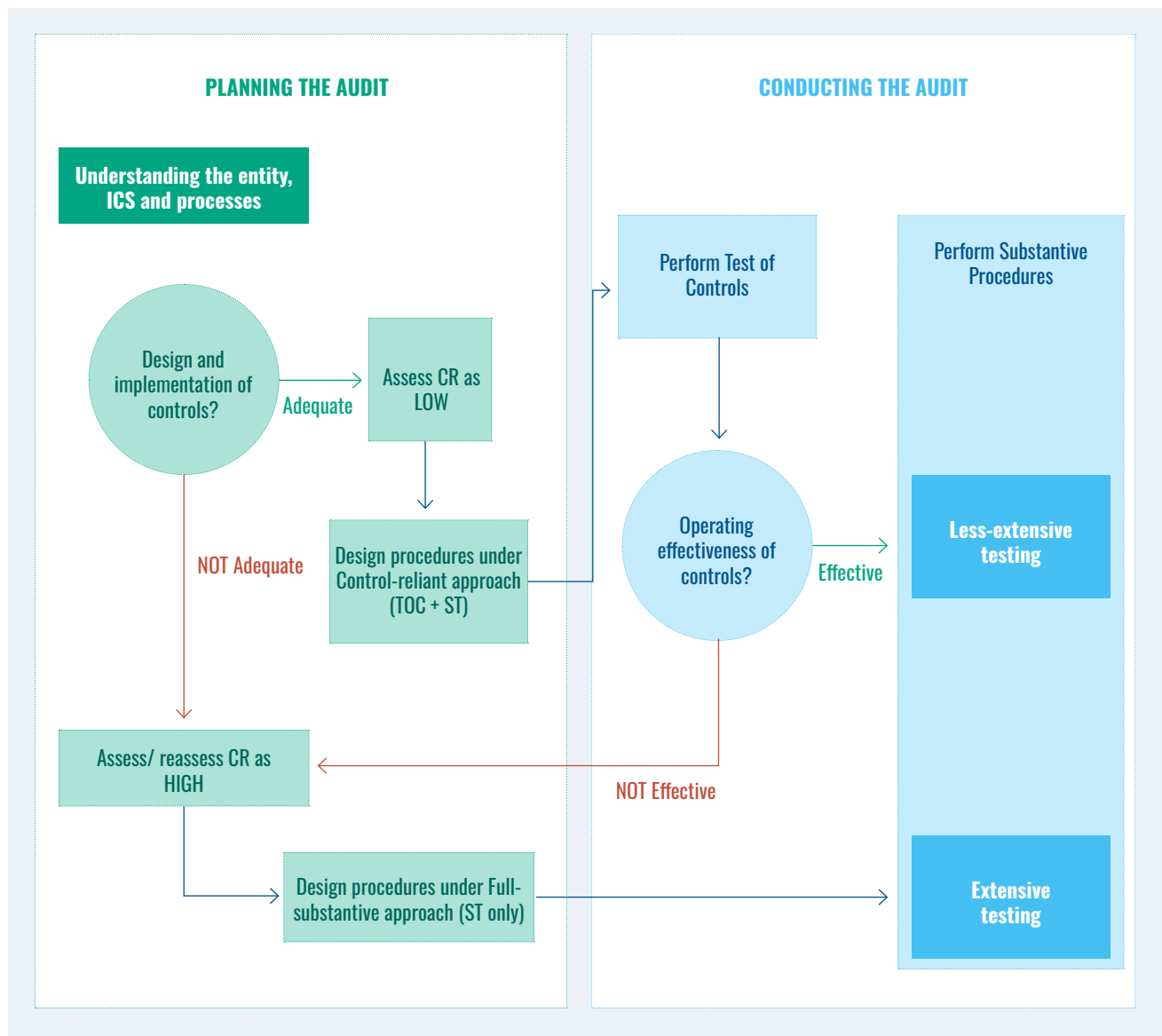
Under different categories of audit procedures as explained above, there are different techniques in designing and performing audit procedures such as examination, inquiry, recalculation, inspection, confirmation of individual items or transactions, inspection and observations.

In designing every “further audit procedure”, it is important to state the assertion to be tested, the audit procedure, and the reason for the procedure. The steps in **Figure 5(f)** below may be followed for designing further audit procedures:

**FIGURE 5(f)**  
**Systematic approach to designing audit procedures**



The relationship of Test of Controls and Substantive Procedures are shown in the illustration below:



The following illustration explains the link between assertion, risk and audit procedure.

#### ILLUSTRATION 5.11

##### Audit assertion, risks and audit procedures

Financial Statement Assertion	Accuracy
Account balance	Closing balance (Cash & Bank)
Risk	Incorrect closing balance of cash
Substantive audit procedure	Obtain an independent bank confirmation letter from the bank and compare the balance provided by the bank with that of closing balance reflected in the Cash Book and the financial statements to ensure that the balance agrees.

While designing the audit procedures, the auditors may take note of the suggestions in **Illustration 5.12** below.

### ILLUSTRATION 5.12

#### Considerations while designing audit procedures

##### Ensure clarity of audit procedure

Audit procedures should be designed in such a way that even a new or junior auditor and a reviewing auditor in an audit team will be able to understand what is to be done. Procedures should not be stated in vague terms such as “Check employee travel claims”. This does not specify what is to be checked in the travel claims. For example, a travel claim would contain many details such as dates of travel, the per diem/daily allowance rates, mileage for use of personal car/payment of taxi fares, time of travel, etc. Therefore, the procedure should specify what needs to be checked in the travel claims.

##### Mention the reason for performing the audit procedure

There should be a purpose for designing and performing the audit procedure. In the travel claim example, an audit procedure stating, “Check employee travel claims” does not mention why the travel claim is to be checked. Instead, this procedure can be designed as “Agree the per diem/daily allowance amount reflected in the travel claim form of an employee with that of the government-approved rates to ensure that the per diem/daily allowance is paid as per the approved government rates”. Designing and performing this procedure confirms that the per diem/daily allowance to an employee was paid as per the government-approved rates.

##### What is the assertion that is being tested?

Audit procedures are supposed to test the assertions made in the financial statements. In other words, the reason for performing the audit procedure as indicated above is to test the assertion. However, it is important for an auditor to understand which assertion will be tested before designing the audit procedure. Using the travel claim example, “Agree the per diem/daily allowance amount reflected in the travel claim form of an employee with that of the government approved rates <sup>(1)</sup> to ensure that the per diem/daily allowance is paid as per the approved government rates <sup>(2)</sup>”. This will confirm the assertion of accuracy of travel expenditure in the financial statement <sup>(3)</sup>.

[<sup>1</sup> audit procedure; <sup>2</sup> the reason for audit procedure; and <sup>3</sup> the assertion]  
Having these three components ensures the completeness of the audit procedure.

##### Commonly used terminologies in designing audit procedures

The terminologies relating to audit such as ‘agree’, ‘cast’, ‘trace’ may be used while designing an audit procedure so that it is very specific.

The word ‘cast’ would mean totalling up a list—for example, cast the travel expenditure reflected in the financial statements. The words ‘agree’ or ‘trace’ would mean matching/reconciling information from two documents/records—for example, agree the per diem claim made by an employee with government- approved rate, or trace total travel expenditure in the financial statements to travel ledger to confirm accuracy.

The illustrations provided for designing audit procedures are further corroborated in in audit working paper template **AWP 5.8**. SAs or auditors can adapt this methodology to document further audit procedures in an audit of financial statements.

The planning phase of the audit of financial statements ends with designing further audit procedures based on risks of material misstatements identified

and assessed at the financial statement and assertion levels. However, the audit procedures designed at the planning phase may change in the conducting phase of the audit, based on new circumstances and situations that may arise in the field and that were not considered while planning. The planning phase of the audit is a very iterative process and should be updated as the audit progresses.



## CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

The principles related to consideration of laws and regulations in an audit of financial statements are discussed in Chapter 2 (refers Paragraph 2.32 to 2.36). This section builds upon those principles and outlines the methodology on consideration of laws and regulations in an audit of financial statements.

In considering laws and regulations in an audit of financial statements, the objectives of the auditor as per ISSAI 2250.11 are:

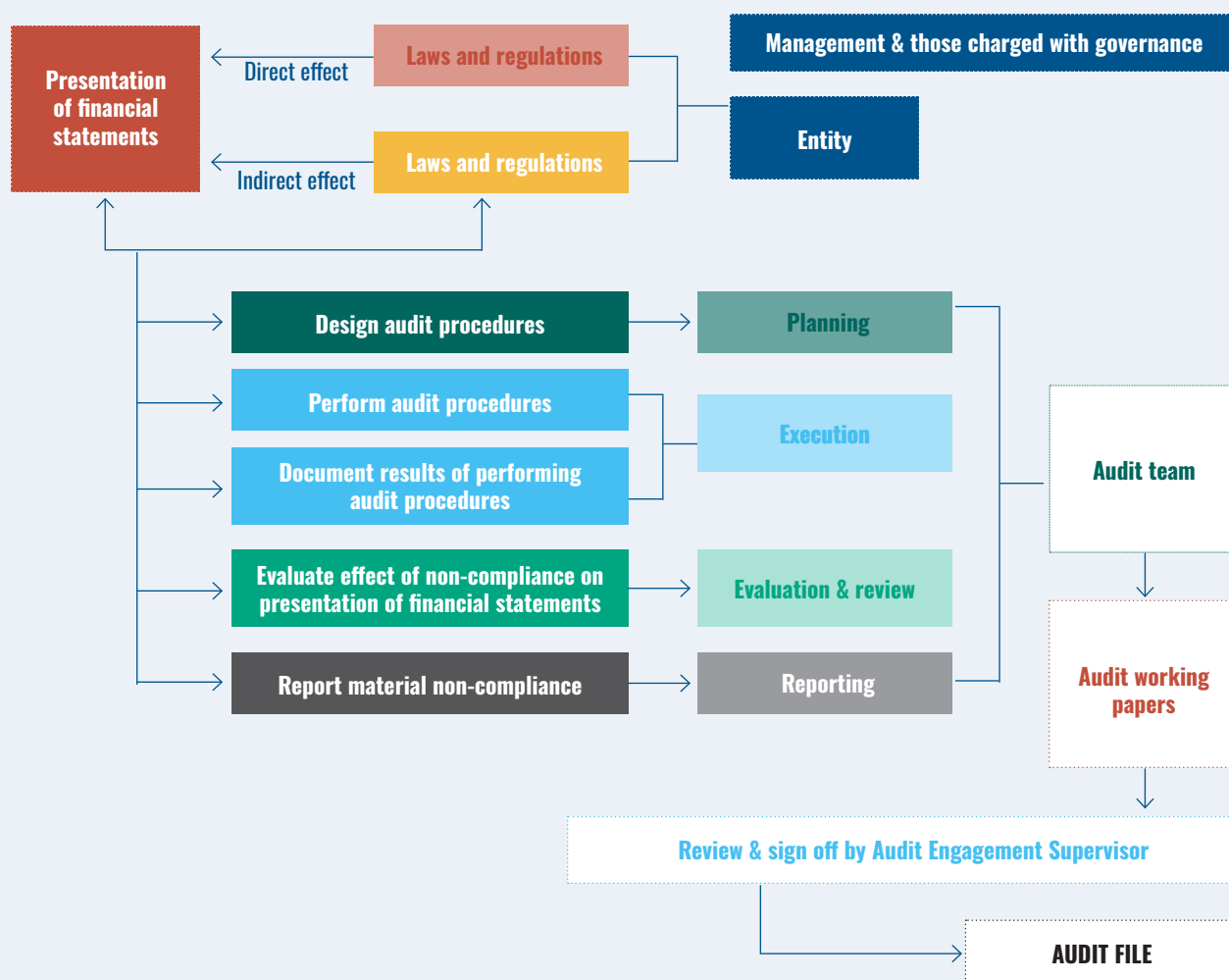
- To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have direct effect on the determination of material amounts and disclosure in the financial statements;

- To perform specific audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and
- To respond appropriately when non-compliance or suspected non-compliance with laws and regulations is identified during the audit.

While some of the applicable laws may have direct effects on the presentation of the financial statements, in other cases effects may be indirect. Non-compliance with both may have a material effect on the presentation of financial statements. **Figure 5(g)** below provides a snapshot of how laws and regulations should be considered by the auditor at the time of planning and performing the audit.

**FIGURE 5(g):**

**Snapshot of consideration of laws and regulations while planning and performing an audit of financial statements**



It is the responsibility of management and those charged with governance to ensure that the entity's operations are conducted in accordance with the provisions of applicable laws and regulations, including compliance with those provisions that determine the reported amounts and disclosures in the entity's financial statements.

As part of obtaining an understanding of the entity in an audit of financial statements, the auditor needs at the planning stage to identify applicable laws and regulations affecting the entity's operations. In the context of public sector entities, those applicable laws and regulations may be in the form of environmental regulation, public finance act, financial regulation, procurement regulation, employment act, parliamentary resolutions, etc.

In public sector operations, especially in the government, the amounts reflected in the financial statements may be based on laws enacted by the parliament such as budget law, regulations, and other standing orders and circulars issued by the government, the applicable financial reporting framework that provides the basis for preparation of financial statements may be based on laws and regulations. These laws and regulations may have a direct effect on the determination of material amounts and disclosures in the financial statements. Non-compliance with these laws and regulations might have a material effect on the financial statements, as in **Illustration 5.13** below:

### ILLUSTRATION 5.13

#### Non-compliance with regulation having direct effect on the financial statements

Class of transaction	Government Financial Regulation – Travel abroad	Amount paid	Amount entitled as per government financial (eligible for 50% of DSA)	Excess amount paid
Travel	Section 9 states; 'An employee shall be paid 50% of daily allowance per day as per the applicable rate of the country to which the travel has been performed, if the accommodation is provided by the host'	CU5000	CU2500	CU2500

**Case:** An employee of X entity performed business travel abroad to attend a seminar on challenges and opportunities in implementing IPSAS in the government. An invitation from the organiser and host of the seminar stated that accommodation for the entire period of the seminar would be provided by the host. The seminar was for five days and was held in Faraway Land. The daily allowance rate applicable for the government employee in Faraway Land as per Schedule 9 of the financial regulation of the Government of Homeland is CU1000 per day.

**Fact:** Section 9 of the Government Financial Regulation determines the amount of daily allowance to be paid to an employee for attending 5 days seminar in Faraway Land, which worked out to be CU2500. However, an employee was paid CU5000, which was in deviation to Section 9 of the government regulation. Therefore, this is a case of non-compliance with Section 9 of the regulation. In this case, it is assumed that an excess payment of CU2500 will have a material effect on the financial statements. However, in the real scenario, whether an excess payment will have a material effect or not will depend on the materiality determined for Travel (class of expenditure).

An entity is also required in its day-to-day operations to comply with other laws and regulations such as environmental law, employment law, labour acts, etc. that do not have a direct effect on the determination of amounts and disclosures in the financial statements. However, non-compliance with those

laws and regulations may have a material effect on the financial statements. For instance, violation of a provision of environmental law may attract fines and penalties that will have a material effect on the financial statements. See **Illustration 5.14** below:

#### ILLUSTRATION 5.14

##### Non-compliance with regulation having an indirect effect on the financial statements

Class of transaction	Section of Solid Waste Management Act – Environment Authority	Amount of fines & penalties
Miscellaneous (fines & penalties)	Section 55 states; ‘Dumping of solid waste in an area other than the designated ones will result in fines and penalties prescribed by the Environment Authority’.	CU50000

**Case:** In a routine monitoring of office premises and public places by the Environment Officers from the Environment Authority during the year, it was observed that the X entity had dumped e-waste across the road about 100 metres from its office premises, instead of dumping in the designated area about 20 kilometres away from the city. The X entity was penalised for violation of Section 55 of the Solid Waste Management Act and issued a demand notice to pay CU50000 to the Environment Authority by 31 July 2018. The notice further states that failure to pay the penalty within the given deadline will attract penal interest of 15%.pa. The rate of penalty was in accordance with the Schedule of rates of fines and penalties prescribed by the Environment Authority in 2014. In accordance with the demand notice, the X entity paid the penalty by issuing bank cheque No.000100 dated 25 July 2013 for CU50000 in favour of the Environment Authority. The penalty amount of CU50000 was booked under Miscellaneous account – fines & penalties.

**Fact:** The payment of CU50000 to the Environment Authority and booked under the Miscellaneous account is not a payment that was incurred for the normal course of business in the X entity. The payment was on account of violation of the law. The payment of CU50000 not only has a material effect on the financial statements in terms of the amount (to be compared with materiality set at the planning stage of the audit), but the violation of law is by nature material. The environmental law itself may not have a direct effect on the presentation of the financial statements, but violation of the law—non-compliance—would have an effect, as stated in this case.

For those laws and regulations that will have direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding compliance with those laws and regulations, such as the Ministry of Finance rules, as given previously in **Illustration 5.13**.

The auditor needs to design and perform audit procedures to gather sufficient appropriate audit evidence regarding compliance with the laws and regulations. The procedures could be in the form of an inquiry

of management and, where appropriate, those charged with governance, and inspection of documents within and outside of the entity. An example is provided in **Illustration 5.14** where the documents can be obtained from the Environment Authority to see whether there were any instances of non-compliance by the entity with relevant environmental laws. The audit procedure for the case in **Illustration 5.13** above can be designed as presented in **Illustration 5.15** below:

### ILLUSTRATION 5.15

#### Audit procedures to detect non-compliance with laws and regulations

Class of transaction	Financial Statement Assertion	Audit procedures	Conclusion
Travel (Travel abroad)	Accuracy	Extract five samples of travels made abroad by the employees from the travel ledger and agree that the Daily Subsistence Allowances paid were in accordance with rates prescribed by Clause 9 of the Rules on Travel abroad issued by the Ministry of Finance.	Out of five samples tested, the payment for one employee was made in excess by CU2500. The travel expenditure has been overstated to that extent in the financial statement.

**Purpose:** The objective of performing this procedure is to see that the payment for travel abroad was made in accordance with the rules issued by the Ministry of Finance. By performing this procedure, it ensures the accuracy of expenditure booked against travel abroad in the financial statements. Besides ensuring the correct treatment of travel expenditure in the Books of Accounts of an entity, the management is also responsible to ensure that the expenditure incurred for the purpose complies with the rules issued by the Ministry of Finance.

**Evidence:** The audit procedure, conclusion of audit procedure performed, extract of Clause 9 & Schedule 9 of Ministry of Finance Rules, printed extract of five samples of travel abroad for five employees (generated from the entity's accounting system) are the audit evidence.

## Journal Entry Testing

Testing the journal entries is one of the important areas that the auditors need to integrate in the audit procedures, especially when identifying or addressing issues that may relate to fraud. The relevant ISSAI requirements on this procedure are shown below:

Paragraph 33(a) of ISSAI 2240 states that irrespective of the assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

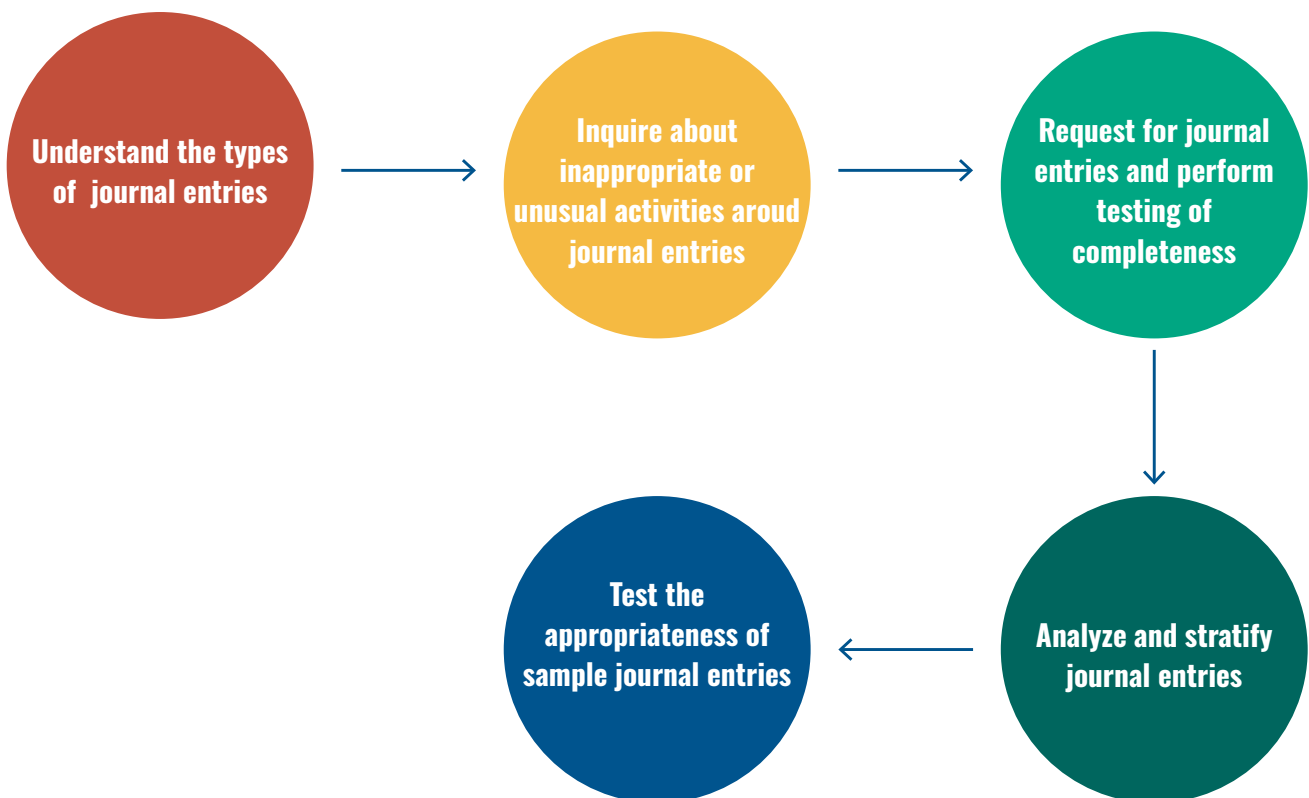
- a.** Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
- b.** Select journal entries and other adjustments made at the end of a reporting period; and

- c.** Consider the need to test journal entries and other adjustments throughout the period.

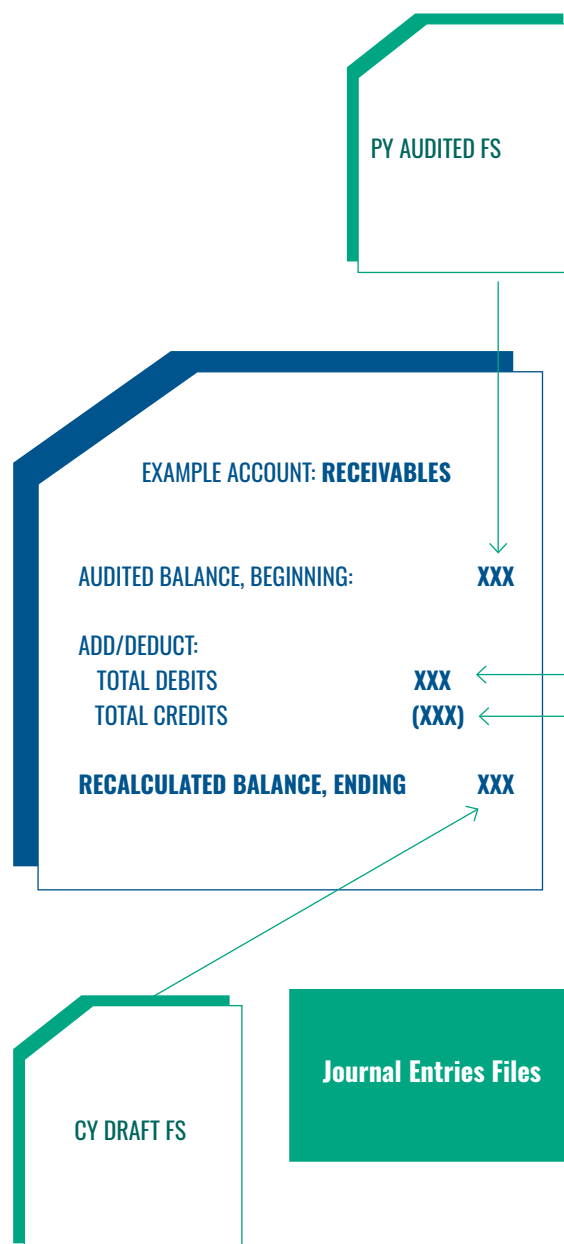
Paragraph 26(a)(ii) of ISSAI 2315 requires understanding of controls over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

Paragraph 20(b) of ISSAI 2330 requires the examination of material journal entries and other adjustments made during the course of preparing the financial statements as part of substantive procedures.

SAIs may have different approaches and requirements in conducting the journal entry testing, which may be done using automated tools or other data analytics software. Nonetheless, the general procedures enumerated below may be used in supplementing the SAI's procedures:



1. Obtain understanding of the different types of journal entries in the audited entity's financial reporting process. For instance, audited entity's using IT systems may have both system generated entries and manual entries. It is also important to understand the different journal entries to record routine and non-routine transactions. This will help the auditor in defining the population that will be used, or the need for stratification, when selecting items for testing. On each type of journal entry, the auditor should understand how the journal entry is processed, including the controls surrounding the journal entries, and the individuals involved. Knowledge with these will help auditors pinpoint specific risk areas.
2. Inquire with the individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments, if there is any.
3. Request for complete file of journal entries data, and before performing any specific testing, determine whether the journal entries are complete in terms of all the transactions that transpired during the year to arrive at the ending balances, including other important attributes about each entry (e.g., preparer ID, dates, approval). This can be done using data analytics software or simple spreadsheets. However, there will be difficulty in testing the completeness of the provided journal entries when the audited entity is using manual entries. When year-end balances do not reconcile with the recalculated year-end balances using the audited balances at the beginning of the year plus/minus total transactions during the year, the auditor should investigate and inquire with the management since ensuring correctness, completeness and reliability of the journal entry data will affect the effectiveness of journal entry testing. Among others, differences may be caused by slide or transposition error in the recording (e.g., the difference is evenly divisible by 3 or 9).



After ensuring the completeness of journal entry data, the auditor should perform analysis to identify journal that may have higher likelihood of being fraudulent or erroneous where focus of the testing can be made. The understanding made in the first step will help in setting the criteria or threshold for this analysis, or in making stratification. Examples of factors to consider in the analysis and groupings/stratification of journal entries include:

- Type of journal entries (e.g., routine, non routine)
- Journal entries made near the end of the reporting period (e.g., entries made 1 week before and after the reporting period)
- Post-closing adjustments
- Journal entries prepared/approved by individuals that are not normally expected to be involved in the recording or approval process
- Journal entries that are above testing threshold
- Journal entries that are recorded at unusual day (e.g., during week end) or unusual time of the day (e.g., during midnight)
- Journal entries with amounts that are made in even thousands or millions, or in round numbers of consistent ending numbers
- Journal entries recorded in unusual frequency (as management may have knowledge that auditors are using certain thresholds during testing, some transactions may have been broken down into several transactions)
- Journal entries with unusual description (e.g., *recorded per instruction of...*) or with no or unclear description
- Journal entries with unusual debit and credit pairings

The result of the analysis and groupings/stratification will provide information to the auditor in deciding the best strategy of selection of items for testing (e.g., number of samples to be drawn, samples selections method to apply).

Select items and test the appropriateness of journal entries. The auditor considers risk and materiality in choosing sample items, and the selection is based on the SAI sampling policy. The auditor should also introduce the element of unpredictability in the selection. For instance, while particular focus can be placed on risky areas based on the stratification above, random selection can also be applied on regular journal entries (i.e., without particular criteria in selection). The focus of the procedure on each sample includes testing the:

- Appropriateness of the supporting documents
- Proper authorisation
- Correctness of accounting based on the rationale of the transactions
- Correctness of recording

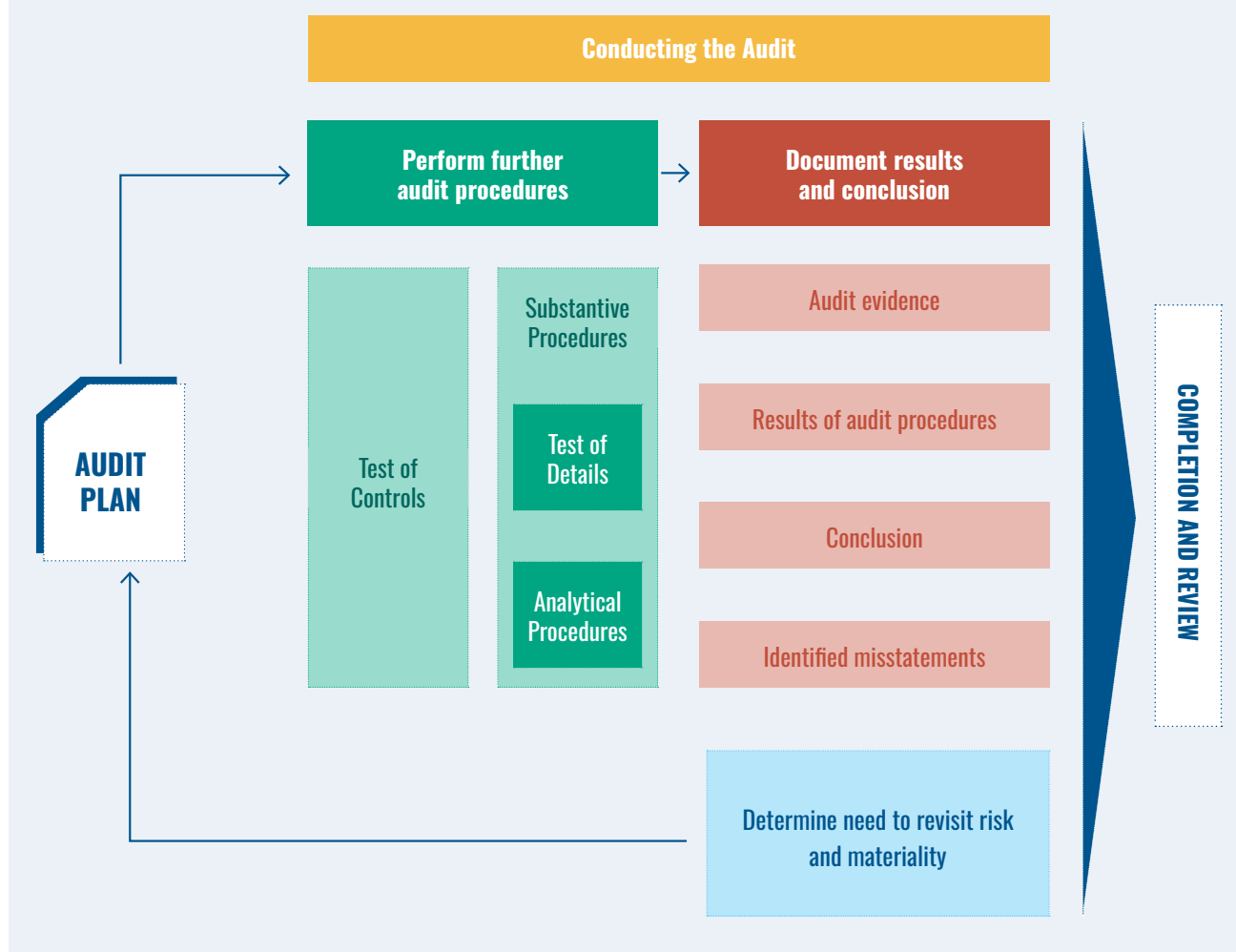
## CHAPTER 6

## CONDUCTING AN AUDIT

The conducting phase of an audit covers performing the audit procedures and gathering audit evidence. **Figure 6(a)** provides a snapshot of the conducting phase of the financial audit process:

**FIGURE 6(a)**

**Snapshot of conducting phase of an audit (performing audit procedures and gathering audit evidence)**





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## PERFORMING FURTHER AUDIT PROCEDURES AND DOCUMENTING THE CONCLUSION

The auditor performs audit procedures to gather audit evidence, which would form the basis of the auditor's conclusion. The auditor is required to gather sufficient appropriate audit evidence. While the sufficiency is related to quantity of audit evidence, the appropriateness relates to the quality in terms of relevance and reliability.

After performing the audit procedures, the auditor needs to record the conclusions arrived at and should also indicate therein whether the purpose of the audit procedures has been met. The act of

documenting the conclusions also ensures that the auditor has performed the audit procedures designed at the planning stage, and the documentation serves as audit evidence. In other words, properly documented, the conclusion is evidence that the audit procedures have been performed.

Considering the above example, it is very important for auditors to record the conclusion of audit procedures performed irrespective of whether the procedures generated audit observations.

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### ILLUSTRATION 6.1:

#### The importance of documenting conclusion from the audit procedures performed

The SAI ABC (real situation) in 2014 engaged a team from SAI XYZ of another country to conduct the SAI PMF assessment. While reviewing the audit file of one financial audit conducted in 2013, the assessment team found that the audit team had designed the audit procedures based on the assessed risk of material misstatement in the audit planning document. However, the assessment team did not find any evidence of audit procedures performed by the auditors since no conclusions were recorded against each procedure designed at the planning stage. The assessment team interviewed the audit team to ask whether they had performed said audit procedures and the audit team responded that the audit procedures were performed accordingly as designed. When asked whether conclusions arrived at were recorded, the team responded that conclusions against each procedure were not recorded. The team submitted that the audit observations were regarded as their conclusion. As a result, the rating was very low under Domain C of the SAI-PMF assessment report.

With reference to **Illustration 5.6** in Chapter 5, one of the control activities put in place by the entity for checking the accuracy of travel claim rates being paid is to perform an independent check of standing data to travel claim processed by an employee.

Using an example from **Illustration 5.6**, a possible way for the auditor to record the conclusion, based on performing the test of control, is provided in **Illustration 6.2**:

**ILLUSTRATION 6.2:****Documenting the conclusion reached upon performing a test of control**

<b>Risk</b>	Travel claim of an employee being paid at incorrect rates.
<b>Control activity</b>	An independent check should be performed of standing data (eg: government approved travel claim rates) to travel claim processed by an employee.
<b>Test of control procedure</b>	Inspect the travel claim of an employee for evidence of <i>independent check</i> being performed.
<b>Conclusion</b>	<b>Positive conclusion:</b> <i>An independent check was performed by the designated staff in the entity. The internal control is operating effectively.</i>
	<b>Negative conclusion:</b> <i>An independent check was not performed for travel claim rates being paid.</i>
<b>Financial Statement Assertion</b>	Accuracy (checking if rates of travel claim were applied correctly).

*Note: The conclusion could be of two types. Positive conclusion is where the control activity is operating effectively, and Negative conclusion is where the control activity is not operating effectively. Negative conclusion would normally lead to formulating audit observations and recommendations to be communicated to the management and those charged with governance.*

After performing the test of control, the auditor should record the conclusions in audit working paper **AWP 6.1**, which will be signed off by the reviewer upon verification that control- testing procedures were performed.

An auditor applying the financial audit ISSAIs when auditing financial statements must understand the audited entity's internal controls that are relevant to the preparation of the financial statements. At a minimum, the auditor must evaluate the design and implementation of the internal controls identified in processes that may have a material effect on the financial statements during the planning stage. This means identifying these internal controls and evaluating if they were properly designed to effectively mitigate the risk they were designed to address. This also means evaluating if such internal controls were actually implemented (that the controls are actually being performed). It is necessary to do this because poorly designed internal controls or a failure to implement internal controls can give rise to risks of material misstatement of the financial statements. The evaluation of design and implementation of internal controls can be documented using audit working paper **AWP 5.6**. The auditor must test the operating effectiveness of internal controls when

the auditor decides that this is the appropriate audit response to an identified risk or when the auditor simply cannot obtain sufficient appropriate audit evidence from other audit procedures performed. Testing the operating effectiveness means testing to make sure the control is being performed effectively by the audited entity.

Audit working paper template **AWP 6.1** suggests the way the auditor can perform procedures for testing the operating effectiveness of controls and can document the procedures performed and conclusions arrived at.

Regardless of performing tests of controls and arriving at a conclusion on the operating effectiveness of internal controls, the auditor should perform substantive procedures for **material components** and classes of transactions, account balances or disclosures because the auditor's risk assessment is judgemental and may not be sufficiently precise to identify all risks of material misstatements. Additionally, there are inherent limitations to internal control, including the risk of management override, the possibility of human error, and the effect of systems changes.

ISSAI 2330.6 requires the auditor to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks of material misstatement at the assertion level. The travel claim example

in **Illustration 6.3** illustrates how the auditor can document the conclusion reached by performing substantive audit procedures and how they address the risks and audit assertion identified.

### ILLUSTRATION 6.3

#### Documenting the conclusion reached upon performing substantive audit procedures

<b>Risk</b>	Travel claim of an employee being paid at incorrect rates.
<b>Control activity</b>	An independent check should be performed of standing data (eg: government approved travel claim rates) to travel claim processed by an employee.
<b>Test of control procedure</b>	Inspect the travel claim of an employee for evidence of <i>independent check</i> being performed.
<b>Substantive Audit procedures (test of details)</b>	Obtain printout of standing data (eg: government approved travel claim rates) and <i>compare</i> with the rates being applied in travel claim of an employee.
<b>Conclusion</b>	<b>Positive Conclusion:</b> <i>The rates applied in an employee's travel claim agreed with the standing data (government approved travel claim rates).</i>
	<b>Negative conclusion:</b> <i>The rates applied in an employee's travel claim did not agree with the standing data (government approved travel claim rates). There was a difference of XX amount between the two records.</i>
<b>Financial Statement Assertion</b>	Accuracy (checking if rates of travel claim were applied correctly).

Note: The conclusion could be of two types. Positive conclusion is where the travel claim rates in two records agree, and Negative conclusion is where there were differences, and hence misstatements in the financial statements. The negative conclusion, depending on the materiality level would then have an impact on audit opinion on the financial statements.

The auditor needs to perform substantive audit procedures to gather substantial and corroborative audit evidence. The way the auditor can perform and document the substantive audit procedures is suggested in audit working paper template **AWP 6.2**.

Certain conditions or circumstances may indicate the possibility of a material misstatement. Examples include:

- analytical procedures that disclose significant differences from expectations (see below);
- significant differences between the reconciliation of a control account and the subsidiary records or between a physical count and a related account;
- confirmation requests that disclose significant differences or yield fewer responses than expected;
- transactions selected for testing that are not supported by proper documentation or not appropriately authorized;

- supporting records or files that should be readily available but are not promptly produced when requested; and
- audit tests that detect errors that apparently were known to the entity personnel but were not voluntarily disclosed to the auditor.

When the foregoing conditions or circumstances exist, the substantive procedures as originally planned may not be sufficient to detect material misstatements that might have occurred. The auditor should consider whether the initial assessment of the risk of material misstatements and the planned substantive tests are still appropriate. Additional substantive tests should be performed as necessary to determine whether material misstatements have occurred and to quantify the amount of such misstatements. The choice of appropriate procedures, including the extent of performing a combination of analytical procedures and tests of details, is a matter of professional judgement.

## EXTERNAL CONFIRMATIONS

External confirmation is a substantive test of detail that involves obtaining information directly from a third-party. Therefore, this type of audit procedure yields very reliable audit evidence. External confirmation is a direct written response to the auditor from a third party, in paper form or by electronic or other medium.

External confirmation procedures to obtain audit evidence are guided by ISSAI 2505, which provides, among others, that corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from evidence within the accounting records or from representations made by management.

In the public sector, external confirmations can be used to obtain evidence about bank account balances, payables; and receivables (common areas).

Confirmation from third parties is an important audit procedure because ordinarily, evidential matter obtained from independent sources outside an entity may provide greater assurance of reliability than evidence secured solely within the entity.

The auditor is expected to exercise controls to provide reasonable assurance that the confirmation requests are directed to the third parties it has selected. This requires the following:

- Control over the preparation and sending the requests (either personal delivery, by mail, fax or email);
- Investigation of the reasons for addressing requests to specific individuals within an entity;
- Mailing of requests in envelopes bearing the auditor's return address so that any items undelivered by the post office are returned to the auditor for redirection, if possible;
- Investigation of undelivered requests; and
- Alertness to replies that are suspiciously uniform in some respect, e.g., handwriting, address, etc.

The external confirmation can be a positive or negative confirmation. The differences between the two are in the formulation of the content of the

confirmation letter and an indication of whether and how the third party should respond to such a request from the auditor. The templates of positive and negative confirmation letters are provided in audit working paper templates **AWP 6.3** and **AWP 6.4**.

A positive external confirmation request requires the respondent to respond to the auditor in all cases regardless of whether the party agrees or disagrees with the balance reflected in the confirmation request. The auditor may also use positive confirmation requests that do not state the amount (or other information) on the confirmation request (i.e., blank confirmation) and ask the confirmation party to fill in the amount or furnish other information. A response to a positive confirmation request generally provides more reliable audit evidence. A negative external confirmation request requires the respondent to reply only in the event of disagreement with the balance reflected in the letter.

Confirmation exceptions may be given to the entity's management for investigation after the auditor establishes control by making a copy or other record of the confirmation reply. If the entity personnel investigate exceptions, the auditor should inspect, at least on a test basis, the evidence explaining and reconciling the exceptions.

The auditor should determine whether significant and/or frequently recurring exceptions may be indicative of a pattern of errors in the unconfirmed accounts. The auditor should also exercise professional scepticism when dealing with unusual or unexpected responses to confirmation requests. (e.g. significant change in the number or timeliness of responses to confirmation requests relative to prior audits), or a non-response when a response would be expected. These circumstances may indicate previously unidentified risks of material misstatement due to fraud.

When the auditor does not receive replies to confirmation requests, alternative audit procedures to the non-respondents should be carried out to obtain the evidence necessary to reduce audit risks to an acceptably low level. The nature of alternative procedures

to be performed varies according to the account and the assertion. The auditor should apply alternative procedures to each of the items that make up the entire balance of the confirmations that were not received.

The most common example of confirmation procedures is the confirmation of bank balances. The auditor confirms the year-end cash balance by direct correspondence with all banks for which the entity has had accounts during the period. Confirmation procedures provide evidence that the cash in the Statement of Financial Position or Receipts and Payments exist at the year-end and that it is owned by the entity.

Bank confirmation requests ask a bank to provide independent confirmation of the entity's account balances and other information held by the bank on behalf of the client, including securities, treasury management instruments and documents. The information contained in the confirmation relates to the normal banking activities. An example of Bank Confirmation Request format is presented in audit working paper template **AWP 6.5**.

## Analytical procedures

"Analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigations as are necessary to identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount (**ISSAI 2520.4**). It is mandatory for auditors to perform analytical procedures at the planning and completion stage of the audit.

Analytical procedures may be used for the following purposes:

- As part of risk assessment procedures (ISSAI 2315);
- As a substantive procedures (ISSAI 2520); and
- As an overall review of the financial statements (ISSAI 2520).

Analytical procedures performed during audit planning and as an overall review would generally consist of relatively simple methods applied at aggregate levels, such as financial statements balances. Those performed as substantive audit procedures may include higher-precision analytics, depending on the effectiveness and efficiency of these tests relative to other audit procedures.

ISSAI 2520 provides guidance for the performance of analytical procedures as substantive audit procedures. In performing analytical procedures either as substantive analytical procedures or to assist when forming an overall conclusion, public sector auditors may also consider such relationships as the following:

### a. Comparisons

- Expenditure versus budget or appropriations;
- Benefit payments, such as child support and pensions versus demographic information;
- Tax revenues versus demographic information or economic conditions or indicators;
- Interest as a percentage of national debt compared to the government borrowing rate;
- Results accomplished in relation to expenditure, where performance information is included as part of the financial statements; and
- Government grants for economic and social development, e.g. grants for low-income farmers and grants for school buildings versus economic and demographic indicators.

### b. Proof in total, i.e. when the auditor predicts the value of a balance and compares it to the reported balance

### c. Consideration of relationships, e.g. payroll costs to number of employees

In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. The level of assurance desired from analytical procedures is affected by the following factors:

## Nature of account balance or assertion

Analytical procedures may be effective and efficient tests for account balances or assertions, when potential misstatements would not be apparent from an examination of the detailed evidence or when detailed evidence is not readily available.

## Plausibility and predictability of the relationship

There needs to be a high level of predictability if using analytical substantive audit procedures to address risk at the assertion level. If the predictability is low, then this audit procedure might become ineffective and not relevant.

Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts or accounts indicating the financial position, since income statement accounts or similar statements represent transactions over a period, whereas balance sheet accounts or accounts indicating the financial position represent amounts at a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable.

## Availability of data

Data may or may not be readily available to develop expectations for some account balances or assertions.

## Reliability of data

Factors influencing the auditor's consideration of the reliability of data for the purposes of achieving audit objectives include whether:

- data was obtained from independent sources outside the entity or from sources within the entity;
- sources within the entity were independent of those responsible for the amount being audited;
- data was developed under a reliable system with adequate controls;

- data was subjected to audit testing in the current or prior year; or
- expectations were developed using data from a variety of sources.

## Precision of the expectation

The expectation should be precise enough to provide a level of assurance such that differences would be identified that may be potential material misstatements, individually or accumulated with other misstatements. As expectations become more precise, the range of expected differences becomes narrower and, accordingly, significant differences from the expectations are more likely to indicate misstatements. Any of the following may be used to improve the precision of analytical procedures:

- Increase the level of detail; or
- Analyse results over shorter time periods.

The auditor should consider how much difference from the expectation can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determining the acceptable amount of difference involves considering the possibility that a combination of misstatements in the specific account balances or classes of transactions or in other balances or classes could aggregate to an unacceptable amount. Reconsidering the methods and factors used in developing the expectation and inquiring of entity management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidence.

In cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the account balance or assertion by performing other audit procedures, to be satisfied whether the difference is a likely misstatement. In designing other procedures, the auditor should consider that unexplained differences might indicate a material misstatement.



## SELECTING ITEMS FOR TESTING

Application of audit procedures often involves the selection of items for testing to gather audit evidence from a population. The auditor should determine the appropriate means of selecting items for testing to gather audit evidence. These include one or combination of the following:

**Selecting all items (100% examination).** This is appropriate when

- the population constitutes a small number of large-value items;
- there is a significant risk and other means do not provide sufficient appropriate audit evidence; and
- the repetitive nature of calculation or other process performed automatically by an information system makes 100 per cent examination cost effective, for example, using computer-assisted audit techniques (CAATs).

**Selecting specific items.** This is appropriate for

- high-value or key items that could individually result in a material misstatement. When identifying high value items, the auditor may use the suggested approach in calculating and using the testing threshold in this handbook;
- cases when the auditor wants to cover all transactions over a specific value. In some practices, the auditor may set certain percentage of the total monetary amount of the population that will be tested, and select all items above this amount for testing. The concept is similar with high value items, except that the threshold is determined differently.
- any unusual or sensitive items or financial statement disclosures;
- any items that are highly susceptible to misstatement;
- items that will provide information about matters such as the nature of the entity, the nature of transactions and internal control; and
- items to test the operation of certain control activities.

**Use of audit sampling (selection of items from the population).** This is appropriate for

- reaching a conclusion about an entire set of data (population) by selecting and examining a representative sample of items within the population, which is possible when the auditor uses both statistical and non-statistical methods of audit sampling.

The decision would depend on the judgement of the auditor, and on the circumstances. The application of any of the above-mentioned methods or a combination of them may be appropriate in certain cases.

## USE OF SAMPLING

Audit sampling involves the application of audit procedures to less than 100% of items within a class of transactions or account balance, such that all sampling units have a chance of selection. It enables the auditor to obtain and evaluate audit evidence about some characteristics of the selected items to form, or assist in forming, a conclusion about the population from which the sample is drawn. The determination of sample size may be made using either statistical or non-statistical methods.

- *Statistical sampling* is an approach to sampling that applies random selection of the sample items and uses probability theory to evaluate sample results, including measurement of sampling risk. Probability aids an auditor in designing an efficient sample, in measuring the sufficiency of evidence obtained and in evaluating the sample results.
- *Non-statistical sampling* is a method by which the auditor uses professional judgement to select the sample items (ISSAI 2530.A12) and to evaluate results from the sample. In exercising professional judgement, the auditors use their knowledge, skills and experience to diligently perform the gathering of evidence in good faith and with integrity. The exercise of professional judgement allows auditors to obtain reasonable assurance that any material misstatements or significant inaccuracies in data are likely to be detected.

Although a properly designed non-statistical sampling application can provide results that are as valid as those from a properly designed statistical sampling, there is one key difference: statistical sampling explicitly measures the sampling risk associated with the sampling procedure.

The use of sampling offers many benefits. For example, it:

- expedites review of working papers;
- enables the auditors to draw valid conclusions and attain the objective of obtaining reasonable risk reduction and not absolute certainty;
- allows the auditors to combine substantive test results from other tests, such that evidence obtained from one source can be corroborated by evidence obtained from another source to provide increased risk reduction; and
- reduces audit costs. The cost of examining every entry in the accounting records and all supporting evidence would be uneconomical.

The use of sampling in audit is guided by **ISSAI 2530**. Specifically, **ISSAI 2530.6** requires that when designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.

## KEY STEPS IN THE AUDIT SAMPLING PROCESS

Whether the sampling method is statistical or non-statistical, and regardless of the sampling technique applied, the auditor can follow the key steps below in the audit sampling process:

**STEP 1. Design the audit sample.** The auditors should consider the objectives of the audit procedures and the attributes of the population from which the sample will be drawn. They should

- determine test objectives;
- define deviation (test of controls)/error (test of details) conditions;
- define the population from which the sample will be drawn. In some practices, audit sampling is applied on adjusted population where high

value and key items are segregated from the entire population and tested separately;

- determine the sampling method and the selection technique; and
- define sampling units, i.e. individual items that the population comprises.

**STEP 2. Determine sample size.** Sample size is affected by the level of sampling risk the auditor is willing to accept. The lower the acceptable risk to the auditor, the greater the sample size will be. The sample size can be determined by the application of a statistically based formula or through the exercise of professional judgement. Among the factors influencing sample size are the following:

- Confidence level or reliability factor. The greater the auditor's required degree of reliability or confidence that the results of the sample are in fact indicative of the actual incidence of error in the population, the larger the sample size needs to be.
- Extent to which the risk of material misstatement is reduced by the operating effectiveness of controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of risk of material misstatement will be and the larger the sample size needs to be.
- Assessment of the risk of material misstatement. The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be.

Tolerable deviation rate (for test of controls), i.e. a rate set by the auditor of deviation from prescribed internal control procedures. The auditor seeks to obtain an appropriate level of assurance that the set rate of deviation is not exceeded by the actual rate of deviation in the population; the lower the deviation rates the auditor is willing to accept, the larger the sample size needs to be. (Tolerable rate of deviation as defined by ISSAI 2530.5j is *a rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population*)



- Expected population deviation rate (for test of controls). The higher the rate of deviation the auditor expects, the larger the sample size needs to be, so the auditor can be able to make a reasonable estimate of the actual rate of deviation.
- Use of other substantive procedures (for test of details). The more the auditor is relying on other substantive procedures addressing the same assertion, the smaller the sample size can be and vice versa.

Tolerable misstatement (for test of details). The smaller the error the auditor is willing to accept, the larger the sample size needs to be. *(Tolerable error or misstatement as defined by ISSAI 2530.5i is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population).* The testing thresholds may be used as the equivalent of tolerable misstatement for audit sampling purposes.

- Expected misstatements (for test of details). The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size will be and vice versa.

The SAI needs to establish its policy in determining sample sizes, including considerations when there is a need to extend the original sample size.

For instance, the sample size for test of controls may be defined depending on frequency of the application of controls (see column 5 of **AWP 5.5** and column 8, Table B of **AWP 5.8**). For example:

Frequency of controls	Suggested sample sizes
Manual control, performed daily or many times per day	24
Manual control, performed weekly	15
Manual control, performed monthly	6
Manual control, performed quarterly	2
Manual control, performed annually	1
Application control	1

Normally, these sample sizes for test of controls would mean that the auditor does not expect any deviation from the samples. For test of details, the SAI may devise a statistically based formula to determine the sample sizes, which considers the factors discussed above.

There are different formula available in sample size calculation. This may vary from highly complex to mere simple calculations. Irrespective of the formula that will be used, it is important that such is specified in the sampling policy. An example of sample size calculator in Test of Details for random selection and systematic selection is provided in **AWP 6.7**. Additional guidance is provided within the workbook. Take note that for MUS, the suggested sample size is provided in **AWP 6.6**.

**STEP 3. Select the sample.** Select the sample in the expectation that all sampling units in the population have chance of selection. Among the sample selection techniques are random, systematic, or monetary unit sampling. Each SAI can adopt its own audit sample selection techniques to be uniformly applied by auditors and to avoid bias in selecting the sample. The application of sampling techniques may differ from one audit to another. The auditor may stratify the population, if necessary, before applying the sample selection methods below:

**a. Random Selection:** This may be applied using random number generators or random number tables. This method provides an equal chance of selection to all sampling units in the population. Basically, the auditor needs to list all the items in the population with their reference (e.g., invoice number) as their unique identification. If the items are not prenumbered in sequence, the auditor may assign unique numbers to facilitate the selection. For instance, if there are 500 items in the population wherein the invoice numbers are not in sequence, the auditor may just assign number 1 to 500 as shown below:

Unique No. assigned by the auditor	Invoice No.
001	AB0038702
002	AB0038783
003	AB0039576
004	AB0039577
005	AB0040432
006	AB0042904
...	...
500	AB0099564

The auditor then generates a set of unique random numbers corresponding to the determined samples size. The auditor may generate random numbers using the tools available online or in the SAI (e.g., random number generator tool) or the random number generator in Excel. However, the SAI needs to have a clear guideline when using random generator online or in excel to create audit trail and implement controls as numbers are constantly changing, and merely saving screenshots is prone to alterations.

**b. Systematic Selection:** The auditor selects samples based on the computed sampling interval. The sampling interval is computed by dividing the population items with the sample size.

For instance, if there are 500 items in the population and the sample size is determined to be 25, then the sampling interval is computed as follows:

$$\begin{aligned}\text{Sampling interval} &= \text{Total items in the population} / \text{sample size} \\ &= 500 \text{ items} / 25 \text{ sample units} \\ &= 20^{\text{th}}\end{aligned}$$

The starting point is normally determined using random numbers. For instance, the random number generated for the starting sample unit is 32nd, then the samples are determined as follows:

$$\begin{aligned}\text{1st sample} &= 32^{\text{nd}} \text{ (thru random number generator)} \\ \text{2nd sample} &= 52^{\text{nd}} (32 + 20) \\ \text{3rd sample} &= 77^{\text{th}} (52 + 20) \\ \text{4th sample} &= 97^{\text{th}} (77 + 20) \\ \text{And so on...}\end{aligned}$$

**Important note:** When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population. Otherwise, the auditor will not be able to select representative samples, and thus, distorting the result of the evaluation.

**c. Monetary Unit Sampling.** This is applicable only for test of details. Since this method provides greater chance for larger items to be selected, this is normally applied when the audit objective relates to overstatements. If the focus of the audit objective is on understatements, or if there are numerous zero or negative-valued items in the population, the auditor is not encouraged to use this method. SAIs can either adapt the Monetary Unit Sampling (MUS) method provided in audit working paper template **AWP 6.6** or their own method. The pivot table function in MS Excel can be used for stratifying the population. Further guidance on stratification of population can be referred from Appendix 1 of ISSAI 2530.

ISSAI 2530 also introduced haphazard selection and block selection. However, SAIs are not encouraged to use these two selection methods as these are prone to bias and that the structure of the sample population may not support the objective of these methods.

**STEP 4. Perform the audit procedures.** The auditor should perform audit procedures appropriate to the test objective on each item selected, as follows:

- For tests of controls, the auditor selects the sample units and examines them to determine whether they contain deviations from the controls relevant to an audit. Some auditors find it practical to select a single set of samples for more than one test objective and to select several extra sampling units for possible replacement. If the auditor is unable to apply the planned audit procedures because the selected item is unavailable, and no alternative procedure can be done to test whether the control was applied as prescribed, the item should be considered a deviation from the control for purposes of evaluating the sample. In a case where a large number of deviations are found in testing the first part of the sample, the auditor may reassess the level of control risk and consider whether it is necessary to continue the test to support the reassessed level of control risk. For instance, the auditor sets the tolerable deviation rate of one instance, and after testing five samples, there are already two instances of deviation noted, subject to the guidelines in the evaluation in the succeeding paragraphs, the auditor may decide to discontinue the testing and conclude that controls are not operating effectively.
- For tests of details, in instances where the auditor was not able to apply the planned audit procedures to selected sampling units because supporting documentation was missing, how the unexamined items are treated would depend on their effect on the evaluation of the sample. Unlike in test of controls, the auditor continues the testing despite that misstatement is identified in the initial sample units. This is to determine its extent that will affect the projection of errors during the evaluation stage of the samples. In the course of the audit, the auditor may identify anomalous misstatement in the sample. This type of misstatements is a misstatement that is not representative of misstatements in a population, thus, it is evaluated separately and excluded from the projection.

**STEP 5. Evaluate the sample results.** After testing the sample units and summarizing the observed deviations/errors, the auditor shall evaluate the results to reach an overall conclusion, as follows:

**a. Consider the nature and causes of deviations/errors:**

- Test of controls
  - For test of controls, it is important to determine whether the control exceptions are random occurrence or systematic.
  - When deviation noted is systematic, the auditor determines whether there are compensating controls to test instead, despite that the deviation is below the tolerable rate of deviation. Otherwise, the auditor needs to reassess the control risk to “HIGH” in AWP 5.8, resulting in extensive substantive testing as if the auditor did not initially intend to rely on controls. The result of testing the compensating controls will define the final assessment for control risk.
  - If the deviation rate exceeded tolerable rate of deviation but is considered a random occurrence, the auditor may extend the sample size. If further exceptions are noted on the extended sample size, the auditor may decide to test compensating controls. The result of testing the compensating controls will define the final assessment for control risk. Take note that the suggested sample sizes above indicate that the tolerable deviation rate is zero.

- Test of details

- For test of details, the direct effect of identified errors on the financial statements should be considered by the auditor in the evaluation of the results. It may be possible that errors have a common feature or trend. In such case, the auditor may decide to identify all the items in the population that possess the common feature and extend audit procedures in that stratum. It is also possible that such errors may be intentional and may indicate the possibility of fraud. The auditor needs to determine whether or not the misstatement found is an anomaly. ISSAI 2530.5(e) defines anomaly as misstatement that is not a representative of misstatements in the population. As such, this type of misstatement is excluded from the total misstatement that will be projected.

**b. Calculate and project misstatements.** Take note that this only applies to test of details. The sample deviation rate is also the projected deviation rate for test of controls. For the purpose of projection, the auditor may offset misstatements but with caution as significant understatements may counter the effect of significant overstatements and vice versa. If there are significant understatements and overstatements, offsetting may not be appropriate, and projection may be separately done for overstatements and understatements. There are two general approaches in projecting misstatements for test of details:

- The Ratio Method: Under this method, the value of misstatements from the sample is divided by the total monetary amount of the samples tested. The result is then multiplied by the monetary amount of the adjusted population to get the projected misstatements. Take note that the misstatements only pertain to those found in the samples and do not include those from high value or key items, and those anomalous misstatements since these should not be projected.
- The Difference Method: Under this method, the value of misstatements from the sample is divided by the number of items tested (instead of the value). The result is then multiplied by the total number of items in the adjusted population to get the projected misstatements.
- The choice of the approach to use will depend on the auditor's expectation about misstatements. When the auditor expects that the amount of misstatements is related closely to its size (i.e., the bigger the transaction, the bigger the potential misstatements), the ratio method is normally used. On the other hand, when the auditor expects that the amount of misstatement, because of its nature, is constant and does not have relationship with the size of the transaction but on the unit itself, the difference method may be used.

**EXAMPLE:**

<b>Total monetary value of the population:</b>	\$500,000
<b>Total number of items in the population:</b>	900 items
<b>Amount of high value and key items tested:</b>	\$100,000
<b>Number of high value and key items:</b>	5 items
<b>Amount of sample units tested:</b>	\$150,000
<b>Number of samples tested:</b>	70 items
<b>Net misstatements found:</b>	
From high value and key items -	\$1,000
From samples tested -	\$900 (including \$100 anomalous misstatements i.e., book value of the one invalid transaction)

## Projected misstatements are computed as follows:

### Ratio Method

<b>Projected misstatements =</b>	(Amount of misstatements in the sample / amount of samples tested) x Adjusted Population
<b>=</b>	$[(\$900 - \$100) / (\$150,000 - \$100)] \times (\$500,000 - \$100,000 - \$100)$
<b>=</b>	$(\$800 / \$149,900) \times \$399,900$
<b>=</b>	<b>\$2,134.22</b>
<b>Estimated misstatements in the population =</b>	Anomalous misstatements + projected misstatements
<b>=</b>	$\$100 + \$2,134.22$
<b>=</b>	<b>\$2,234.22</b>
	<p>Note:</p> <p>7. Anomalous misstatement of \$100 is deducted from the misstatements that will be projected</p> <p>8. The amount of high value and key items is deducted from total population to get the adjusted population. Projection is made on adjusted population.</p> <p>9. Estimated misstatements include the projected and anomalous misstatements. This amount will be used in evaluating the results of audit sampling. Misstatements from high value and key items will be evaluated separately during evaluation of misstatements as part of factual or judgmental misstatements as the case may be.</p>

### Difference Method

<b>Projected misstatements =</b>	(Amount of misstatements in the sample / no. of samples tested) x No. of items in the adjusted population
<b>=</b>	$[(\$900 - \$100) / (70 \text{ items} - 1 \text{ item})] \times (900 \text{ items} - 5 \text{ items} - 1 \text{ item})$
<b>=</b>	$(\$800 / 69 \text{ items}) \times 894 \text{ items}$
<b>=</b>	<b>\$10,365.22</b>
<b>Estimated misstatements in the population =</b>	Anomalous misstatements + projected misstatements
<b>=</b>	$\$100 + \$10,365.22$
<b>=</b>	<b>\$10,465.22</b>
	<p>Note:</p> <p>10. Anomalous misstatement of \$100 is deducted from the misstatements that will be projected, as well as from the total items used for projection.</p> <p>11. The number of high value and key items is deducted from items in the population to get the items in the adjusted population. Projection is made on items in the adjusted population.</p> <p>12. Estimated misstatements include the projected and anomalous misstatements. This amount will be used in evaluating the results of audit sampling. Misstatements from high value and key items will be evaluated separately during evaluation of misstatements as part of factual or judgmental misstatements as the case may be.</p>

When MUS is used, projection and evaluation of results require more complicated procedure, which may differ among SAI practices. The projection and evaluation should be defined in the SAI policy. An example projection for MUS is done by taking into account the following considerations:

- MUS is effective for audit objectives that relate to overstatements. Thus, if there are significant understatements found in the sample, the auditor needs to first reassess whether the use of MUS is appropriate before proceeding with the projection. Significant understatements suggest that MUS will not assist the auditor in obtaining persuasive evidence. If there understatements but are considered not significant,

the auditor can proceed with the projection.

- Projection for MUS is done on item per item basis:
  - If the recorded amount is greater than the sampling interval, the actual misstatement for that item is also its projected misstatement
  - If the recorded amount is less than the sampling interval, the misstatements is projected by dividing the misstatements by the recorded amount, then multiply by the sampling interval
  - The total of the individual projections will be the total projections for the MUS

#### EXAMPLE:

**Assume that the sampling interval is \$842,945.00**

Sample No.	[A] Recorded/ transaction amount	[B] Audited amount	[C=A-B] Misstatement	[D= (C/A) x \$842,945.00 Projection
24	\$ 323,584.00	\$ 320,254.00	\$ 3,330.00	\$ 8,674.74
92	455,183.00	452,000.00	3,183.00	5,894.54
126	996,215.00	969,215.00	27,000.00	27,000.00
598	139,452.00	125,984.00	13,468.00	81,409.97
<b>TOTAL</b>				\$122,979.25

#### Note:

- As mentioned, projection for MUS is done on item per item basis. The auditor needs to list all sample items with identified misstatements. In our example, there are four items found with misstatements.
- Sample numbers 24, 92, and 598 have recorded amounts that are less than the sampling interval, thus, normal projection is calculated. On the other hand, sample number 126 has a recorded amount above the sampling interval, thus, the actual misstatement in the sample will be treated as its projected misstatement. Projecting the misstatement will distort the result as it results in a much lesser amount.

Reach an overall conclusion. The auditor should evaluate the sample results to determine whether the preliminary assessment of the relevant characteristics of the population is confirmed or needs to be revised, and what the effect of the sample result is on both the test objective and other areas of audit.

#### **For test of controls**

- If the actual deviation rate is greater than the tolerable deviation rate, reassess the control risk to HIGH (i.e., control is not operating effectively). Thus, the auditor cannot rely on control.
- If the actual deviation rate is less than the tolerable deviation rate, the initial assessment of control risk is retained (i.e., control is operating effectively). The auditor can rely on control, which will result in less extensive test of details.
- This evaluation is made after considerations of the possible extension of sample or testing of compensating controls discussed above.

#### **For test of details**

- If the estimated misstatements in the population (i.e., projected plus anomalous misstatements) exceeded tolerable misstatement, the auditor concludes that the sample does not provide a reasonable basis for conclusions about the population that has been tested. As a result, the auditor may:
  - request management to investigate to further identify other potential misstatements and to make necessary adjustments
  - tailor the nature, timing and extent of further audit procedures to obtain further evidence
- The closer the projected misstatement plus anomalous misstatement is to

tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also, if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement.

- If the estimated misstatements in the population do not exceed the expected misstatements and the tolerable misstatement, the auditor concludes that the audit sampling has provided a reasonable basis for conclusion about the population that has been tested. The auditor can request management to correct actual misstatements found, otherwise, the projected misstatements are carried forward in the evaluation of misstatements. These misstatements however are not expected to materially misstate the financial statements.
- In some audit practices, the evaluation of the sampling results also consider allowance for sampling risk. Given that the projection only provides the best estimate of the actual misstatement in the population, considering the sampling risk in the projection (i.e., +% or -%, but normally certain +% to the projection) can add some precision in the evaluation. However, this is normally defined in the sampling policy.

#### **STEP 6. Document the sampling procedures.**

The auditor should document the sampling plan and procedures in the form of working papers. Take note that the projected misstatements will be carried forward to AWP 7.1 for further evaluation.



**CASE STUDY:****How additional testing affects the projection and evaluation**

Assuming that the tolerable misstatement for our example used in Ratio Method is \$2,300.00, the auditor may not be comfortable to take the associated sampling risk since the estimated misstatement of \$2,234.22 is close to the tolerable misstatement (i.e., risk that the actual misstatements in the population exceed the tolerable misstatement). If the auditor decided to extend the samples to gather more audit evidence, the auditor needs to project and reevaluate the result. For example:

Description	Original Samples	Original plus extended samples
<b>Monetary amount of adjusted population</b>	\$400,000	\$400,000
<b>Monetary amount of samples tested</b>	\$150,000	\$300,000
<b>Misstatements found, excluding anomaly</b>	\$800	\$800
<b>Projected misstatements</b>	\$2,134.22	\$1,066.76
<b>Anomalous</b>	\$100	\$100
<b>Total estimated mis-statements</b>	<b>\$2,234.22</b>	<b>\$1,166.76</b>

- Assuming that the auditor extended the testing and tested additional samples totalling \$150,000, then the total amount of the samples tested amounts to \$300,000 (original samples of 150,000 plus new samples of 150,000).
- There were no additional misstatements found, thus the \$800 amount is unchanged.
- Using the ratio projection of estimation, the projected misstatement is now computed as:
- $(\$800 / (\$300,000 - \$100)) \times (\$400,000 - \$100) = \$1,066.76$
- After extending the samples, the evaluation is performed again based on the overall results of the sample (i.e., both the original and extended samples). Since the revised total estimated misstatement amounts to \$1,166.76 which is now significantly below the tolerable misstatement, the high sampling risk before extending the sample size is reduced.
- There may be instances that after extending the sample size, further misstatements may be identified which can result to higher projected misstatements. In such cases, high sampling risk still exists, and the auditor needs to obtain more audit evidence by designing and performing other audit procedures.

In addition to extending sample size, the auditor may also lower the testing threshold, which will result in more high value items that will be tested. Assuming that by lowering the testing threshold, additional \$50,000 will be tested and that there were no misstatements found in the high value items, the projection is affected as follows:

Description	Original Samples	Original plus extended samples
<b>Monetary amount of adjusted population</b>	\$400,000	\$350,000 (\$400,000-\$50,000)
<b>Monetary amount of samples tested</b>	\$150,000	\$300,000
<b>Misstatements found, excluding anomaly</b>	\$800	\$800
<b>Projected misstatements</b>	\$2,134.22	\$933.38
<b>Anomalous</b>	\$100	\$100
<b>Total estimated mis-statements</b>	<b>\$2,234.22</b>	<b>\$1,033.38</b>

- The auditor may decide to extend testing by increasing sample size, lowering testing threshold or both.



# COMPLETION AND REVIEW

ISSAI 2220 “Quality Management for an Audit of Financial Statements”, besides requiring all audit work to be reviewed throughout the entire audit process, calls for the auditor to be satisfied at the completion stage that sufficient appropriate audit evidence has been obtained to support the conclusions reached and the issuing of the auditor’s report (ISSAI 2220.32). This is done through a review of the audit documentation, together with the final version of the financial statements and discussion with the audit team.

The audit engagement manager/supervisor (or any other designation used by SAI) is expected to play a very important role at this stage of the audit, notwithstanding the review that he/she is supposed to perform at every stage of audit for quality purposes. Inadequate review and evaluation at the completion stage of audit may result in expressing an inappropriate audit opinion on the financial statements.

Other ISSAI require specific procedures to be performed at the completion and review stage, such as final analytical procedures (ISSAI 2520), subsequent events procedures (ISSAI 2560), going-concern procedures (ISSAI 2570), obtaining of management representation (ISSAI 2580), and communication with management or those charged with governance (ISSAI 2260).

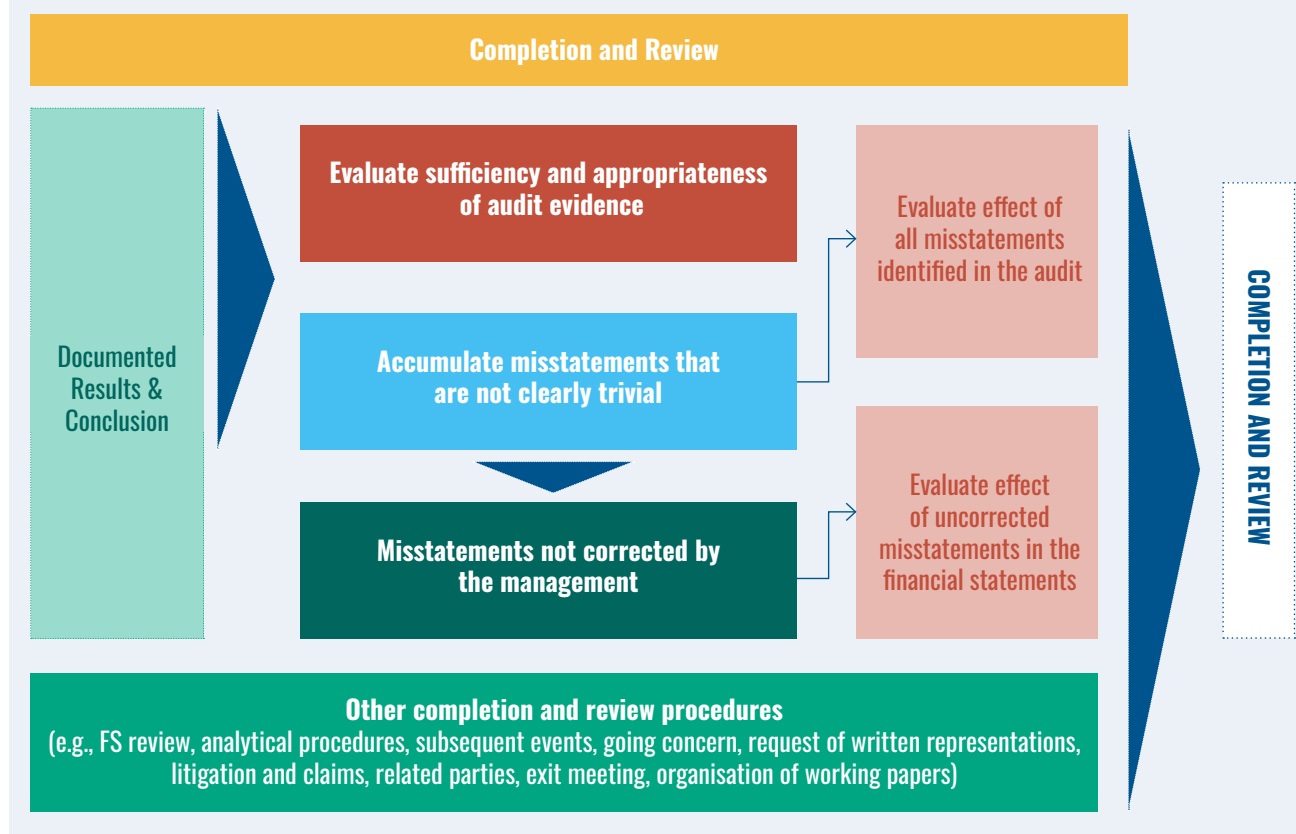
The audit file becomes the basis for review, as it contains the audit evidence. Typically, the audit file should contain, the identified and assessed risks, financial statement assertions tested, audit procedures performed, conclusions arrived at through the audit procedures performed, and documents supporting those conclusions. This becomes the basis to conduct the review against the final version of the financial statements provided by the entity.

In this regard, the reviewer needs to revisit the audit plan (can be inferred from audit working paper **AWP 5.8**), where the auditor is supposed to record the audit procedures and audit working papers **AWP 6.1** and **AWP 6.2** in the conducting phase of the audit on the conclusion reached upon performing those procedures and to reassess whether adequate audit procedures have been designed and performed.

As for documents supporting the conclusions arrived at by the auditor upon performing audit procedures, traditionally the copies of documents obtained from the entity and third parties are considered audit evidence. The audit evidence needs to be supported by the record of work performed by the auditor - the audit documentation.

**Figure 7(a)** provides a snapshot of the completion and review stage of audit. Some additional steps are suggested, which are not the requirements of ISSAIs but are considered best practices that may be adapted by the SAIs. This will be explained in detail in subsequent paragraphs.

**FIGURE 7(a)**  
**Snapshot of completion and review stage of audit**



In the context of an ISSAI financial audit, a **misstatement** is a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Upon performing audit procedures on classes of transactions, account balances, or disclosures of a financial statements, the auditor is expected to arrive at either positive or negative conclusions. —Both the conclusions need to be recorded in the auditor's working papers.

ISSAI 2450 prescribes the requirements for evaluation of misstatements identified during the audit, which is done at the completion stage of audit: all misstatements identified, other than those that are clearly trivial, should be accumulated during the audit for the auditor/reviewer to evaluate both their effect on

the audit (performing further audit procedures) and the effect of any **uncorrected** misstatements on the financial statements (implication for the auditor's opinion). Misstatements can be recorded in a working paper **AWP 7.1**.

#### **Effect of identified misstatements on the audit**

This evaluation covers all the identified misstatements, irrespective of whether the misstatements are corrected or not. The purpose is to determine whether the initially designed overall audit strategy and audit plan need revision. Since the nature and causes of the identified misstatements may not be an isolated occurrence, especially when the root cause is systemic, the auditor may need to revisit the planning documents to determine whether there is a need to tailor or design additional procedures to address the risk of undetected misstatements. By analysing the nature and causes of the misstatements, the auditor may focus procedures on specific areas affected by the root cause of the misstatements.

## Effect of uncorrected misstatements, if any, on the financial statements

Prior to evaluation, the auditor needs to determine the need to revise the materiality based on the actual financial results. In most cases, materiality is computed during planning using the best estimate of the amount of the chosen benchmark as the actual amount may not be available during the time.

The uncorrected misstatements are evaluated, individually or in aggregate, to determine whether they are material to the financial statements. In doing so, the auditor considers both the size and nature of the misstatements, and the effect of uncorrected misstatements related to prior periods. Using AWP 7.1, the auditor needs to evaluate the effect of:

- *individual misstatement to the relevant classes of transactions, account balances or disclosures.* If during planning, the auditor considered that materiality for particular class of transactions, account balance or disclosure is applicable for the audit engagement, then the auditor needs to determine whether the uncorrected misstatements for the particular account have exceeded this materiality threshold.
- *misstatements in the qualitative disclosure.* This highly involves the auditor's professional judgement to assess the significance of the inaccurate, incomplete or omitted disclosures in relation to the requirements of the applicable financial reporting framework.
- *the aggregate uncorrected misstatements in the financial statements in relation to the overall materiality.* In aggregating the misstatements, the auditor takes into account the following:
  - If the auditor assessed a misstatement to be material individually, the auditor may still consider that the financial statements are materially misstated despite that other type of misstatements in other aspects of the financial statements can zero out the effect of such individual misstatement when aggregated. Thus, this highlights the importance of having two levels of evaluation – individual and in aggregate.

- Misstatements within the same account balance or class of transactions may be offset. Prior to offsetting, the auditor needs to assess the risk of undetected misstatements (See ISSAI 2450.A19). Depending on the nature and cause of the misstatements, the auditor may determine that there could be other undetected misstatements (especially when using audit sampling) that, despite that these misstatements are immaterial, could materially affect the account when aggregated. This requires analysis and classification of misstatements per account. For instance, if there are more than one misstatement in the cash in bank account, the auditor may list the cash in bank account in AWP 7.1 (column 2), and link all the related findings in column 4. The evaluation may be made on the net misstatement on the account depending on whether offsetting is appropriate.
- Classification misstatements may or may not be considered material even if these exceed the quantitative materiality threshold(s). The auditor needs to consider the qualitative characteristics of the classification misstatements. For instance, the auditor consider how the classification misstatements affect the line items, sub-totals, key ratios, and whether the classification misstatements affect more than one financial statement. If the classification misstatements, even if above materiality, are considered not material, the same maybe listed in the summary, but the monetary effect may be excluded when aggregating the misstatements.
- For the purpose of evaluation at the aggregate level, the revised overall materiality is generally used. However, this does not preclude the auditor to consider other materiality levels that could have been computed had other benchmarks been used, if they are also considered important to the users of the financial statements. Take note that overall materiality during planning was determined

for purpose of planning, and does not necessarily need to be the only threshold that will be considered for evaluation.

- When using AWP 7.1, the auditor may list misstatements in order of **findings with proposed journal entries**, or **per account basis**. The latter can help auditor in analysing the aggregate effect of misstatements on each account.
- *Misstatements by their nature*. There may be instances that the misstatements, even below materiality, can materially affect the financial statements. Circumstances that may affect the evaluation include the extent to which the misstatement:
  - Affects compliance with regulatory requirements;
  - Affects compliance with debt covenants or other contractual requirements;
  - Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
  - Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
  - Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information to be included in the entity's annual report (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users.

**EXAMPLE:**

Assuming that the auditor was able to identify and accumulate the following misstatements, which were not corrected by the management:

- Unrecorded collection of \$26,000
- Transposition error in recording of cash collection of \$152,000 instead of the correct amount of \$125,000
- Unrecorded payments to suppliers of \$75,000

Materiality thresholds are as follows:

- Overall Materiality – \$500,000
- Materiality for particular class of transaction, account balance and disclosure (receivable) – \$40,000

The auditor may utilise AWP 7.1 in summarising the findings per account:

**Cash**

- Unrecorded collection – 26,000 understatement
- Transposition error – 27,000 overstatement
- Unrecorded payments – 75,000 overstatement
- Net effect – ???

**Receivables**

- Unrecorded collection – 26,000 overstatement
- Transposition error – 27,000 understatement
- Net effect – ???

**Accounts Payable**

- Unrecorded payments – 75,000 overstatements

In deciding whether the individual misstatement within the same account may be offset, the auditor considers the risk of undetected misstatements, even immaterial, which when aggregated with other misstatements could result in material misstatement.

**Case No. 1**

Assuming that the auditor concludes that there are other undetected misstatements relating to unrecorded collection, the auditor may consider that offsetting is not appropriate. This conclusion, however, may require the auditor to tailor further audit procedures to identify these misstatements if these can materially affect the financial statements. As such, the effect of misstatements amounts to 128,000 in cash, 53,000 in receivables and 75,000 in payable.

At the aggregate level, these misstatements are not material to the financial statements in relation to the overall materiality of \$500,000. However, since specific materiality was computed for receivables which suggests that users of the financial statements have particular interest on such account, the evaluation also needs to consider the misstatements on that account in relation to the computed materiality of \$40,000. Since the misstatements of \$53,000 exceeded the materiality, it is expected that the opinion will still be modified despite that overall materiality level has not been exceeded.

**Case No. 2**

This conclusion will be different when the auditor concludes that offsetting is appropriate. Assuming that the auditor concludes that there is no risk of undetected misstatements, and that the users are more interested in the totals (e.g., total assets) as these are used in their ratio analysis, offsetting may be done as the affected errors will not affect the totals whether or not the errors are corrected. In this case, the net effect will be overstatement of \$75,000 in total assets and liabilities. Given the overall materiality levels, these misstatements are not material to the financial statements.

ISSAI 2450 also requires all misstatements to be communicated to management on a timely basis, along with a request to amend the identified misstatements.<sup>12</sup> The reviewer goes over the misstatements identified during the audit and checks whether they were communicated to management on a timely basis.

Typically, the auditor provides management with a list of misstatements, quantifying the amount of each misstatement and proposing necessary action and adjustment in the financial statements. Taking the example of difference in travel claim rates applied for an employee's travel claim, the auditor may propose making good the difference and carry out necessary accounting adjustment in the Books of Accounts.

When management makes the necessary adjustments to the books of accounts and the financial statements, the auditor should check that the adjustments have been made correctly. The auditor then needs to record the revised conclusion on the audit procedures performed, based on the verification of adjustments made by management. The necessary adjustment entries and further supporting documents should be documented by the auditor to support the revised conclusion based on audit procedures performed.

In response to identified misstatements, the auditor may need to perform further audit procedures, for example to determine whether difference in rates were found in other travel claims (considering the above example), i.e. whether further misstatements exist. The reviewer may direct the auditor to increase the sample size of travel claims, perform further audit procedures, and arrive at a conclusion.

## OTHER COMPLETION PROCEDURES

### Review of financial statements

The auditor is required to perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. Some of the good practices in reading and reviewing the financial statements include:

- Cross-referencing – this includes agreeing the information in the financial statements with the underlying accounting records and the auditor's working papers.
- Internal consistency checking – this includes comparing the consistency of information within the financial statements, matching of the figures and information between the face and notes, and validating accuracy of information.
- Footing – this involves recalculation of figures.
- Accomplishing disclosure checklist – the auditor may use disclosure checklist (e.g., IFRS/IPSAS disclosure checklists) to assist in reviewing the appropriateness and completeness of disclosures
- Reviewing other information in accordance with ISSAI 2720 if applicable

### Analytical procedures

ISSAI 2520.6 states that the auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. The conclusions arrived at upon performing analytical procedures at the end of the audit is to corroborate conclusions formed during the audit of individual components or individual elements of financial statements. The analytical procedures performed at the end of the audit may be of a similar design to those performed during the planning phase.

<sup>12</sup> The common understanding is that the auditor communicates with the management throughout the entire audit process, and therefore the misstatements identified and detected during the audit should have been communicated for correction and rectification.

For example, the auditor may compare the results of the current year to those of the prior year to ensure that all significant variances are understood based on the information obtained during the audit process. The result of substantive analytical procedures during the conducting stage of the audit will provide useful information in analysing the balance and movement of the account during the analytical procedures near the end of the audit. The auditor may then compare the draft financial statements after considering the adjustments during the audit, with the final financial statements prepared by the management.

Also, because financial statements contain notes to accounts as required by different FRF and other legislation used by the entity, the auditor needs to audit the notes for compliance with the applicable FRF. Notes are technically equivalent to financial statements, and therefore the auditor must ensure that sufficient appropriate audit evidence is obtained to gain comfort over those notes.

The new audit procedures designed and performed need to be documented in the analytical procedure template suggested as audit working paper template **AWP 7.2** in this Handbook. It should be clearly indicated in the working paper that these procedures were performed at the end of the audit.

## Subsequent events procedures

‘Subsequent events’ affect the presentation of the financial statements and consequently the auditor’s opinion, to the extent that management is required to amend the financial statements and the auditor to amend the auditor’s report. Subsequent events are the events occurring between the date of the financial statement and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report. Hence, ISSAI 2560 “Subsequent Events” requires that auditors perform audit procedures to obtain sufficient appropriate audit evidence that all subsequent events that require adjustment to, or disclosure in, the financial statements have been identified.

Based on the FRF used by the entity to prepare the financial statements, management is supposed to identify any subsequent events and how they

were dealt with in the financial statements (e.g., IAS 10; IPSAS 14). The auditor needs to see whether management has established adequate procedures to identify relevant subsequent events. The auditor needs to review whether those events are adjusting or non-adjusting events, with reference to the applicable FRF used by the entity to prepare the financial statements. Adjusting events after the reporting date are those that provide evidence of conditions that existed at the reporting date. Non-adjusting events after the reporting date are those that are indicative of conditions that arose after the reporting date.

## Going-concern procedures

The going-concern assumption is that the entity will continue in business for the foreseeable future. Hence, when preparing financial statements, the entity’s management uses assumptions as to whether it believes the entity will be able to continue as a going concern.

This assumption significantly impacts the financial statements of the entity, because entities that are not a going concern report on a different basis from those that are (e.g., assets and liabilities would be recognised at their liquidation value rather than their expected value in the future).

The going-concern assumption is adopted unless evidence indicates otherwise. That is why ISSAI 2570 “Going Concern” states that the auditor shall remain alert throughout the audit for evidence of events or conditions that may cast doubt on the entity’s ability to continue as a going concern.

The auditor needs to perform audit procedures (eg. review cashflow forecast to meet its liabilities) on the going concern assumptions used by management in preparing the financial statements, including obtaining evidence that can be used to assess the appropriateness of management’s going-concern assumptions and forming a conclusion as to whether that evidence indicates any material uncertainties about the entity’s ability to continue as a going concern. In fact, the going-concern assumption involves judgements about events occurring in the future, which are inherently uncertain.



Management is supposed to prepare the financial statements on a going-concern basis on the assumption that the entity will continue its operations for the foreseeable future, which is 12 months from the date that the auditor's report is signed.

The concept of the going concern assumption in the public sector, especially in government, may be less relevant than in the private sector, since public finance is mobilised through taxes and other sources of non-tax revenue.

Going concern risks may arise, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatization. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern in the public sector may include situations where the public sector entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by the public sector entity (ISSAI 2570.A2).

Where there is significant uncertainty about the entity's ability to continue as a going concern and this has been disclosed in the entity's financial statements, the auditor will include "Material Uncertainty Related to Going Concern" section wording in the Emphasis of Matter paragraph to direct users' attention to the applicable note in the financial statements and state that such may cast doubt on the ability to continue as going concern. If the auditor does not agree with management's assumption regarding going concern, it shall modify its opinion in the audit report.

## Written representations

Written representations, often referred to as management representations, are one form of audit evidence on their own, or one that corroborates another audit evidence obtained by the auditor.

ISSAI 2580 also requires the auditor to perform certain audit procedures on management representations by the end of the audit. The auditor should ensure that the date of written representations is as close as possible to, but not after, the date of the auditor's report. The auditor cannot express an opinion on the presentation of the financial statements on a date before the date of the written representations, because those representations are audit evidence. The representations should cover all the periods covered in the audit opinion, depending on the nature of comparative information presented in the financial statements.

Audit working paper template **AWP 7.3** provides a sample of written representations, which needs to be adapted according to the needs of the SAI or the auditor. The sample provides an overview of what the written representations need to include. Depending on the governance structure of the entities audited by SAIs of different jurisdictions, the SAI's management should decide and communicate to the entity what party should sign the written representations.

## Litigation and Claims

Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel. If applicable, the auditor can also review the legal expense accounts. The objective of these audit procedures is to identify litigation and claims that may have material effect in the financial statements in terms of accounting and disclosure.

## Review of related party relationships and transactions

The financial reporting framework often has specific reporting requirements on the audited entity regarding related parties which will affect auditor's work (e.g., IAS 24, IPSAS 20). In some SAls, there may be regulations requiring reports on remunerations of the key personnel in the audited entity. For this purpose, ISSAI 2550 supplements how the auditor identifies, assesses, and responds to risk of material misstatements with the following requirements:

- Understand the relationship and transactions. The auditor needs to identify related parties, the nature of relationships and whether there are transactions during the audit period. To assist in identifying who the related parties are, the auditor may refer to the definition in the applicable financial reporting framework.
- Determine whether the relationship or transactions lead to significant risk of material misstatements, especially when the transactions are not conducted in normal terms and conditions.
- Understand management controls to identify, account, disclose or authorise relationships and transactions.
- Respond to the risks arising from related parties and transactions.

## Communicating deficiencies in internal control to those charged with governance and management

In accordance with ISSAI 2265, the auditor is required to communicate with those charged with governance or management on significant deficiencies observed in internal controls relevant to financial reporting process on the basis of audit work performed (refer control testing section in Chapter 6). This communication needs to be in a written form. The communication with the management and those charged with governance is a continuous process in an audit. ISSAI 2265.A13 states that in determining when to issue the written communication, the auditor may consider whether receipt of such communication would be

an important factor in enabling those charged with governance to discharge their oversight responsibilities in relation to financial reporting process, that includes approval of the financial statements. SAls may have policies as to when such matters need to be communicated to those charged with governance and management for taking appropriate action.

## ORGANISATION OF AUDIT WORKING PAPERS

ISSAI 2230 "Audit Documentation" requires that the documentation of the review process include who reviewed the completed audit work and the date and extent of that review. In the working papers suggested in this Handbook as various Exhibits, designated rows and columns were created to record '*who performed the audit work*' and '*who reviewed the work completed*'. The evidence of review at different levels also ensures that the due process for quality of ISSAI financial audit has been followed in the audit.

The documentation of working papers with specific numbering is suggested in **AWP 7.4**. SAls may adapt this practice.

The following are some of the good practices in preparing audit working papers:

- Indicating complete details of dates and sign-offs of the performer and reviewer of audit work. This will promote accountability of work and facilitate tracking of the work progress.
- Clear labelling/coding, referencing and cross-referencing among lead schedules, supporting documents, and audit evidence. Using the numbering in AWP 7.4 for example, assuming that you have used 5200 series for substantive audit procedures, you may use coding scheme such as:
  - 5200\_A – Cash Lead working paper
  - 5200\_B – Receivables Lead working paper
  - 5200\_C – Inventories Lead working paper
  - and so one

If you have several procedures, you may use sub coding. In receivables for instance:

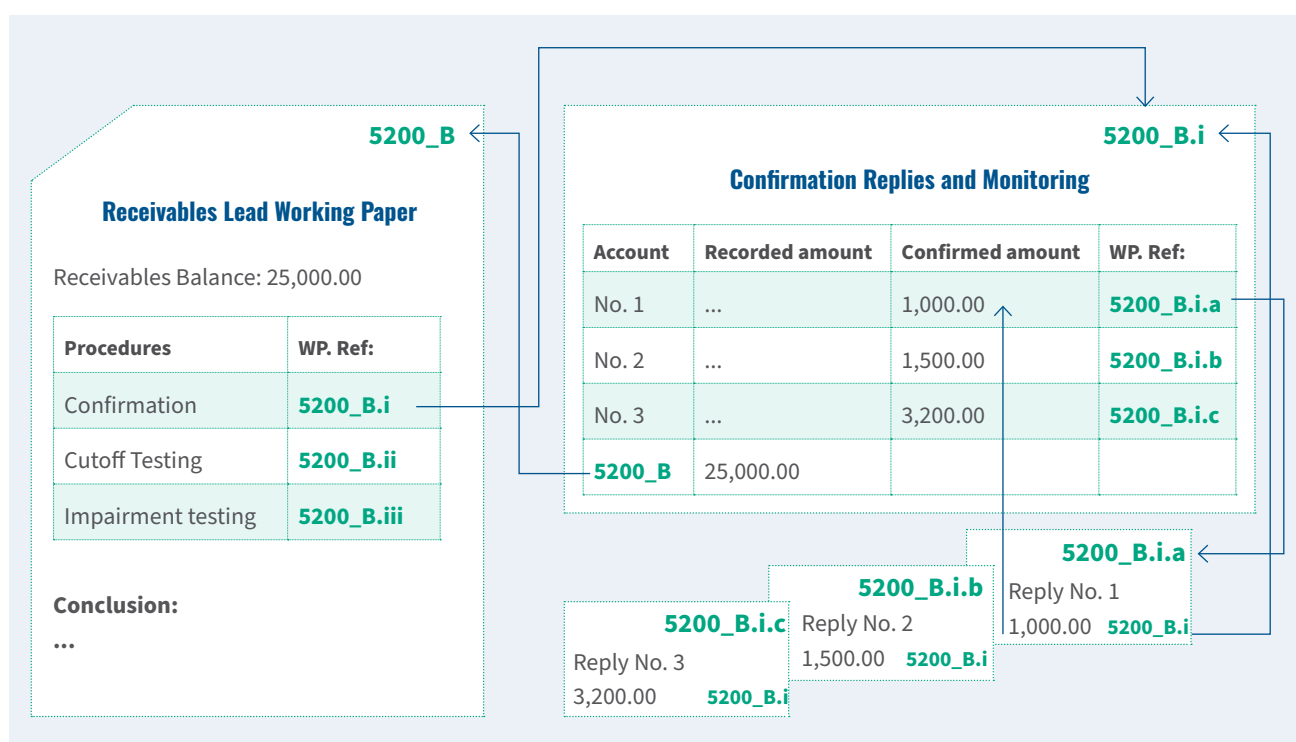
- 5200\_B.i – Confirmation procedures
- 5200\_B.ii – Cut-off testing
- 5200\_B.iii – Impairment testing
- and so on

You may also assign codes to the evidence obtained. For instance, you have received

confirmation replies, you may assign codes as follows:

- 5200\_B.i.a – confirming party no. 1
- 5200\_B.i.b – confirming party no. 2
- and so on

Each working paper needs to be labelled using the codes you have set, and provided with references to the related working papers. This may be illustrated as follows:



- Proper and consistent use of tick marks and legends. Having a standardised audit tick marks will facilitate common understanding of the working papers within the SAI. Examples of tick marks are as follows:

<b>FS</b>	Agreed to balances in the financial statements
<b>^, &lt;</b>	Footed/cross footed
<b>PBE</b> <b>01/01/2023</b>	Evidence provided by the entity on the specified date dd/mm/yyyy
<b>€</b>	Recalculated using the prescribed rates
<b>imm</b>	Immaterial
<b>R</b>	Vouched to the supporting documents
<b>S</b>	Further investigations waved

- Documenting the identifying the characteristics of the specific items tested (see ISSAI 2230.9(a)). It is important that the reference of the evidence tested is documented. For instance, the auditor may specify the voucher number, official receipt number or any unique identification of the document. To establish audit trail, the auditor also needs to document how such items are selected. When selecting high value or key items, or when using audit sampling, the selection process needs to be clearly described. If possible, the audit evidence or copy of audit evidence obtained may be included in the audit file.

- Describing the results of the procedures performed, and conclusions reached. Whether the procedures resulted in positive or negative observations, describing the result will aid the flow of review within the audit team, as well as engagement quality review and inspection of audits as applicable.
- Inclusion of the documentation of engagement quality review, as applicable. When the audit engagement is selected for engagement quality review, all the working papers of the engagement quality reviewer should form part of the audit team's audit working papers.
- Inclusion of minutes if important meetings within the audit team, management and with those consulted to support the overall result of procedures and conclusions reached.

The period of archiving process (i.e., final assembly of working papers), and the retention period are normally defined in the SAI policy, or in relevant regulations. For instance, the policy or regulation may require completion of the archiving process of both hardcopy and softcopy working papers within 60 calendar days after the date of the independent auditor's report. The retention of these working papers may be affected by the regulation or sensitivity of the audit engagement. For instance, regular audit engagements' working papers may be scheduled for disposal only after 5 years, but those audits of listed entities, or those with critical national issues may only be scheduled for disposal after resolution of the issues, or for a considerably longer period of time.

## AUDIT EXIT MEETING

An audit exit meeting is not a requirement of ISSAI but is often used to ensure that the preliminary auditor's report, audit findings, management's response, and the final version of the financial statements are discussed and agreed with management and, where relevant, those charged with governance. This meeting also reduces the risks of misunderstanding between the management and the auditor at a later stage on issues reflected in the final audit report. Some refer to this as the audit clearance meeting.

Other matters relevant to the audit can also be discussed, such as difficulties encountered during the audit process, so they can be addressed in the next audit, details of any ethical matters that can be clarified with management, etc. If there is expected modification on the opinion, the auditor may also discuss during the exit meeting the circumstances that led to the expected modification and the wording of the modification as required by ISSA 2705.30.

The auditor and management should maintain the minutes of the exit meeting detailing the discussions of the auditor's report and the specific audit findings, and the decisions reached on each discussion point. The minutes should then be dated and signed by representatives of the audit team and the management. The minutes of the audit exit meeting also become audit evidence, which is used as the basis to finalise the audit report.

Upon conducting the audit exit meeting, the audit team prepares the audit report considering the response provided by management and those charged with governance.

## CHAPTER 8

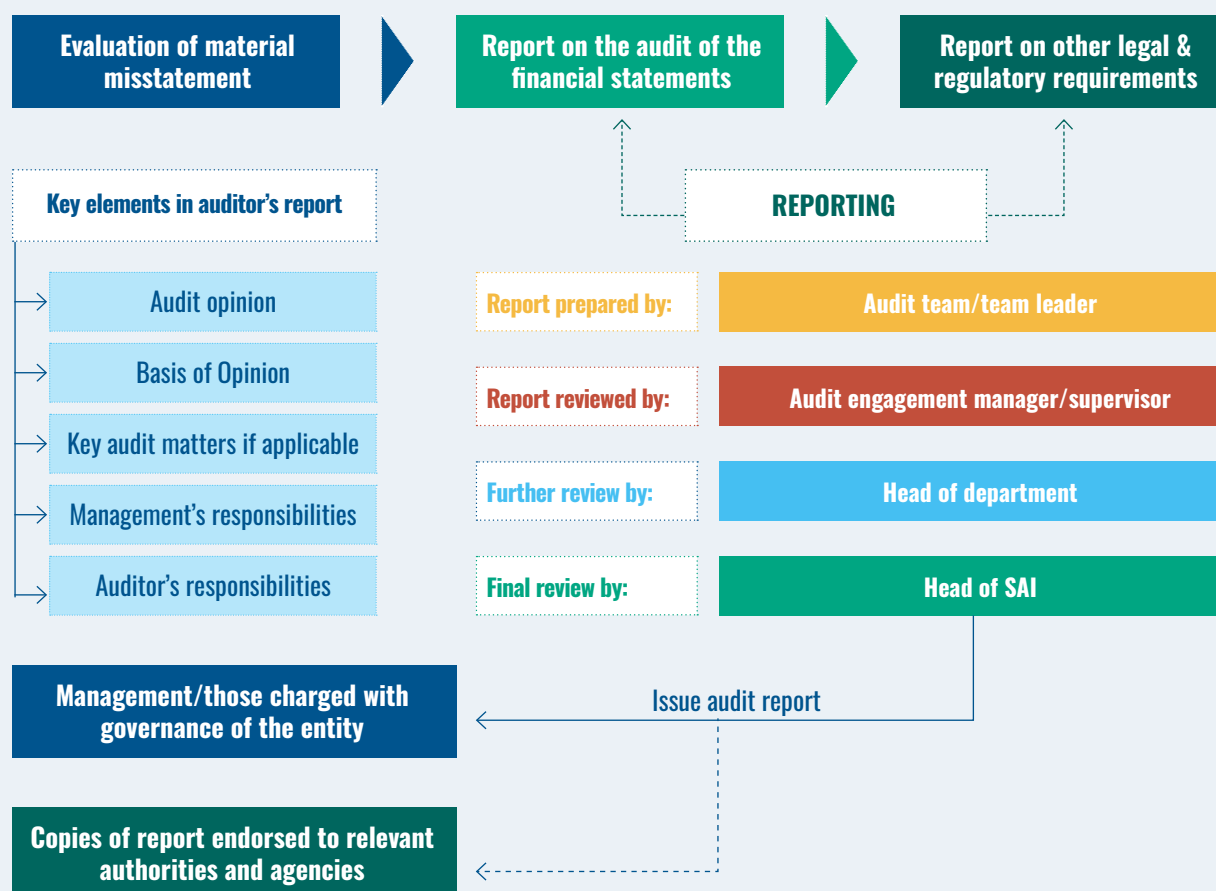
## AUDIT REPORTING

The audit report is the final product of the entire audit process, which is prepared based on sufficient appropriate audit evidence gathered by auditors through performing audit procedures. In this regard, according to ISSAI 2700, the objectives of the auditor are to form an opinion on the financial statements, based on an evaluation of the conclusions drawn from the audit evidence obtained; and to express clearly that opinion through a written report that also

describes the basis for that opinion.

Based on the evaluation of the effect of the conclusions drawn from the audit evidence, the auditor prepares and issues the audit report. **Figure 8(a)** below illustrates an example of a reporting process in a financial audit that can be adapted to the SAI's organisation and division of responsibilities.

**FIGURE 8(a)**  
**Snapshot of audit reporting**

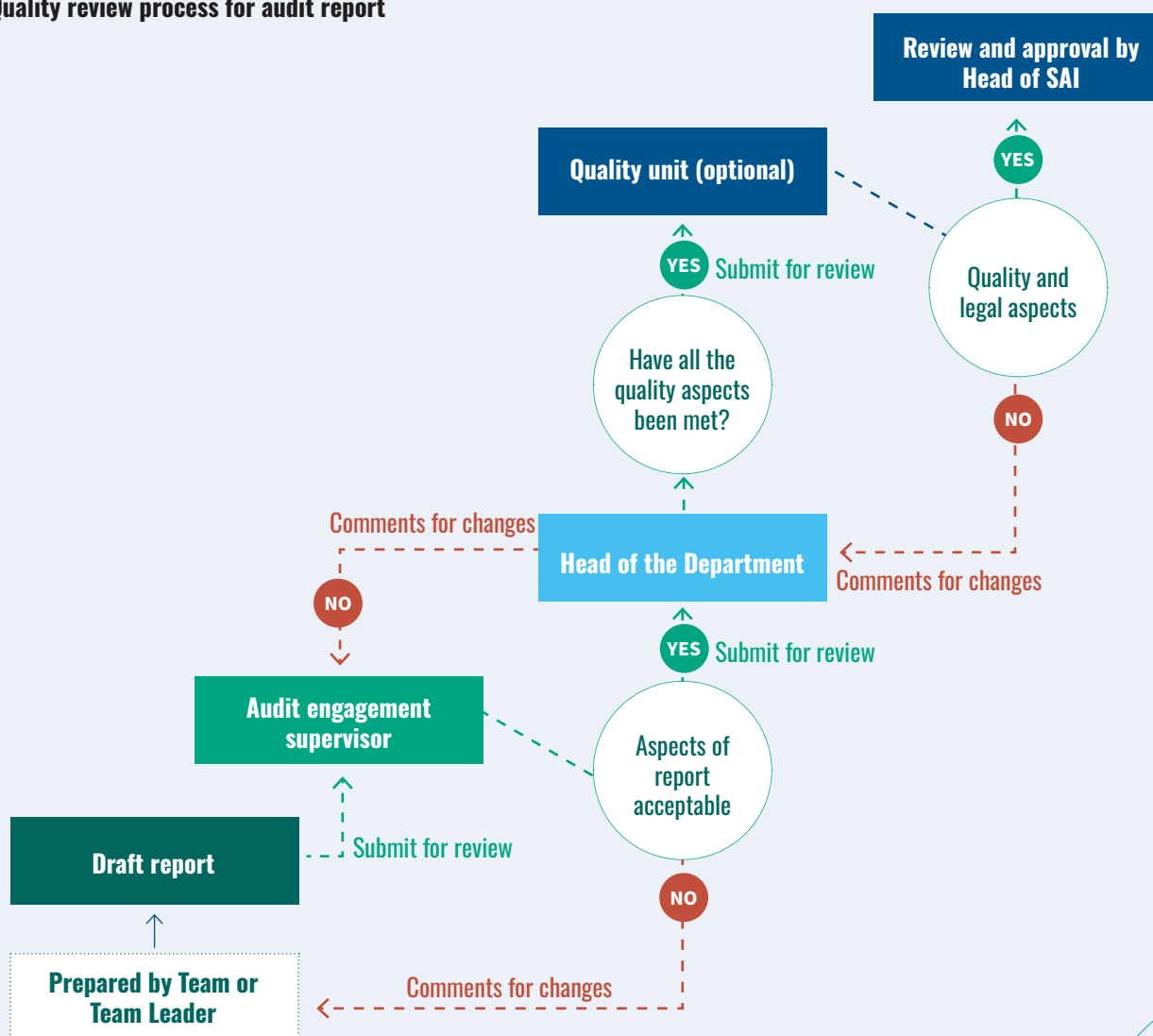


The reporting requirements are provided in ISSAI 2700 “Forming an opinion and reporting of financial statements”; ISSAI 2701 “Communicating Key Audit Matters in the Independent’s auditor’s report”; ISSAI 2705 “Modifications to the Audit opinion in the independent auditor’s report”; ISSAI 2706 “Emphasis of Matter Paragraph and Other Matter Paragraphs in the independent auditor’s report”, ISSAI 2710 “Comparative Information-Corresponding Figures and Comparative Financial Statements; and ISSAI 2720 “The Auditor’s responsibilities relating to other information”. Besides these requirements, SAIs may have additional reporting responsibilities as determined by law and regulation in their respective jurisdictions. This is emphasized in the practice notes to ISSAI and even the respective ISSAIs.

To maintain consistency and achieve an audit report of high quality, the report should go through a quality review process in the SAI as highlighted in **Figure 8(b)** (this is an example, which can be adapted to the SAI’s organisational structure). The figure is self-explanatory and the structure would depend on the review process established in the SAI, based on the system of audit quality management. Take note that the review process will also be affected if the audit engagement is required to undergo engagement quality review. If so, such review needs to be completed and all issues resolved prior to issuance of the report.

The wording of the audit opinion would depend on the FRF used for preparing the financial statements (explained by ISSAI 2200.13), as it broadly determines the form, content and structure of the financial statements.

**FIGURE 8(b)**  
**Quality review process for audit report**



## FORMING AN OPINION ON THE FINANCIAL STATEMENTS

The auditor considers or evaluates the following conditions while forming an opinion on the financial statements:

- Whether the financial statements are prepared in all material respects, in accordance with the applicable FRF.
- Whether the financial statements as a whole are free from material misstatement due to fraud or error. This conclusion should be based on the following (ISSAI 2700.11):
  - Whether sufficient appropriate evidence has been obtained, as required by ISSAI 2330; and
  - Whether uncorrected misstatements are material individually, or in aggregate, in

accordance with ISSAI 2450.

- Consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments (ISSAI 2700.12).

**Illustration 8.1** below will help the auditor carry out the evaluation to form an opinion.

The financial audit is an independent assessment of the financial statements, wherein the auditor expresses an opinion providing reasonable assurance (high level of assurance but not absolute assurance). There are broadly two types of audit opinion:

- unmodified opinion; and
- modified opinion.

### ILLUSTRATION 8.1

#### Auditor's considerations in forming an opinion

<b>Audit evidence</b>	<b>Sufficient appropriate</b>	
	Yes	No
<b>Uncorrected misstatements</b>	<b>Material</b>	
	No	Yes
<b>Significant accounting policies</b>	<b>Disclosed adequately</b>	
	Yes	No
<b>Accounting policies</b>	<b>Consistent with FRF<sup>13</sup></b>	
	Yes	No
	<b>Appropriate</b>	
	Yes	No
<b>Accounting estimates</b>	<b>Reasonable</b>	
	Yes	No

<b>Information presented in the financial statements</b>	<b>Relevant</b>	
	Yes	No
	<b>Reliable</b>	
	Yes	No
	<b>Comparable</b>	
<b>financial statements disclosures</b>	Yes	No
	<b>Understandable</b>	
	Yes	No
<b>Terminology used</b>	<b>Adequate</b>	
	Yes	No
<b>financial statements disclosures</b>	<b>Adequate</b>	
	Yes	No
<b>Terminology used</b>	<b>Appropriate</b>	
	Yes	No

<sup>13</sup> Financial Reporting Framework.



## Unmodified opinion

The audit opinion is unmodified when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The wording of the opinion paragraph of the auditor's report will depend on the type of reporting framework used by the entity in preparing the financial statements, i.e. either the fair presentation framework or the compliance framework. Examples extracted from illustrations provided in ISSAI 2700 are reproduced below:

The description of what the financial statements are designed to present (e.g. financial position, results of operations) in the above illustrative examples will vary depending on the financial reporting framework being applied (IFRS, IPSAS, Cash Basis, etc.).”

The applicable financial reporting framework adopted by the audited entity may be IFRS issued by the International Accounting Standards Board (IASB) or IPSAS issued by the International Public-Sector Accounting Standards Board (IPSASB). However, some entities may prepare the financial statements based on national accounting standards that are consistent with either IFRS or IPSAS or based on neither of them. Typically, the financial statements of

government entities are based on law enacted by the parliament or on rules and regulations issued by the government (finance or treasury department).

A financial reporting framework such as IFRS or IPSAS is deemed to be a fair presentation framework. When the financial statements are prepared in accordance with the fair presentation framework, the auditor should evaluate whether those statements achieve fair presentation. As per ISSAI 2700.14, the auditor's evaluation as to whether the financial statements achieve fair presentation framework should include:

- the overall presentation, structure and content of the financial statements; and
- whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether they achieve fair presentation (ISSAI 2700.19).

Illustrations of an unmodified audit report, where the reporting framework is fair presentation framework is given in **Appendix 8.1** and compliance framework is given in **Appendix 8.2**.

### ILLUSTRATION 8.2

#### Applicable FRF and auditor's opinion

##### Auditor's opinion under a fair presentation framework

1. In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the entity as at 31 December 20X1, the financial performance and its cash flows for the year then ended in accordance with (the applicable financial reporting framework); OR
2. In our opinion, the accompanying financial statements give a true & fair view, in all material respects, of the financial position of the entity as at 31 December 20X1, the financial performance and its cash flows for the year then ended in accordance with (the applicable financial reporting framework)

##### Auditor's opinion under a compliance framework\*

In our opinion, the accompanying financial statements are prepared, in all material respects, in accordance with XYZ law of Jurisdiction X.

\*Compliance with requirements of statutes or law.

## Modified opinion

ISSAI 2700.17 states that the auditor shall modify the opinion in the auditor's report if the auditor:

- concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement (disagreement)—for example, disagreeing with the accounting policies used by the entity or the accounting transactions made in the books of accounts; or
- is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (limitation of scope)—for example, a limitation such lack of access to certain areas of accounting transaction documents or failure by management to produce documents to the auditor.

The extent of the modification in the auditor's opinion will depend on the circumstances and the pervasiveness of the effects of the matter, or its possible effects, on the financial statements. ISSAI 2705 provides the requirements for modifying the opinion in the independent auditor's report; they should be read in conjunction with requirements of ISSAI 2700, as they are interrelated.

## DETERMINING TYPES OF MODIFICATION TO THE AUDITOR'S OPINION

When determining the types of modification to the auditor's opinion, auditors' professional judgement plays a crucial role in determining the pervasiveness of the effects or possible effects of the matter that gave rise to a modification of the auditor's opinion on the financial statements. **Figure 8(c)** provides a decision tree to arrive at different types of modified audit opinion.

As can be seen from **Figure 8(c)**, the matter giving rise to a modified audit opinion could be due to a

material misstatement in the financial statements or an inability to obtain sufficient appropriate audit evidence. In other words, the basis for modification could be a disagreement with management on certain matters in the financial statements or a limitation of scope preventing the auditor from performing further audit procedures to gather sufficient appropriate audit evidence.

If the matter giving rise to modification is due to material misstatement in the financial statements, the auditor needs to assess whether the misstatement is material or pervasive, either individually or in aggregate. If the matter is material and not pervasive, the auditor can express a qualified audit opinion with an "except for" paragraph. This type of audit opinion is very common in the audits conducted by SAIs.

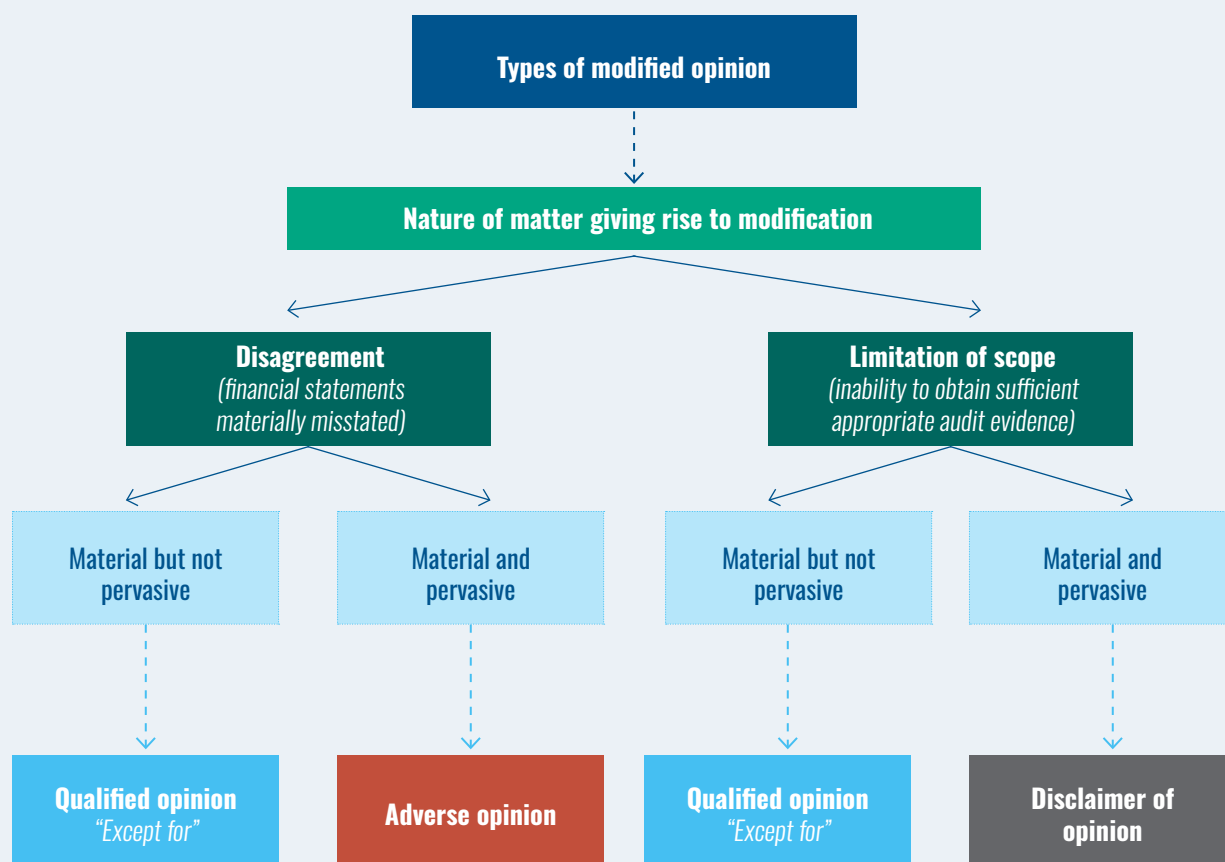
If the matter giving rise to modification as a result of material misstatement is material and pervasive, the auditor should express an adverse opinion.

Similarly, if the matter giving rise to modification is due to the auditor's inability to gather sufficient appropriate audit evidence, the auditor should assess whether the *possible effect of undetected misstatements* is material or pervasive. If the *possible effect of undetected misstatements* is material and not pervasive, the auditor can express qualified opinion with an "except for" paragraph.

If the *possible effect of undetected misstatements* is material and pervasive, the auditor should then disclaim an opinion on the financial statements. In this situation, the auditor is unable to perform further audit procedures to obtain the sufficient appropriate audit evidence that forms the basis for providing an opinion on the financial statements.

How the auditor's judgement about the nature of the matter giving rise to the modification and the pervasiveness of its effects or possible effects on the financial statements affects the type of opinion to be expressed are further illustrated in **Figure 8(d)** below.

**FIGURE 8(c)**  
**Judgement analysis to form different types of modified audit opinion**

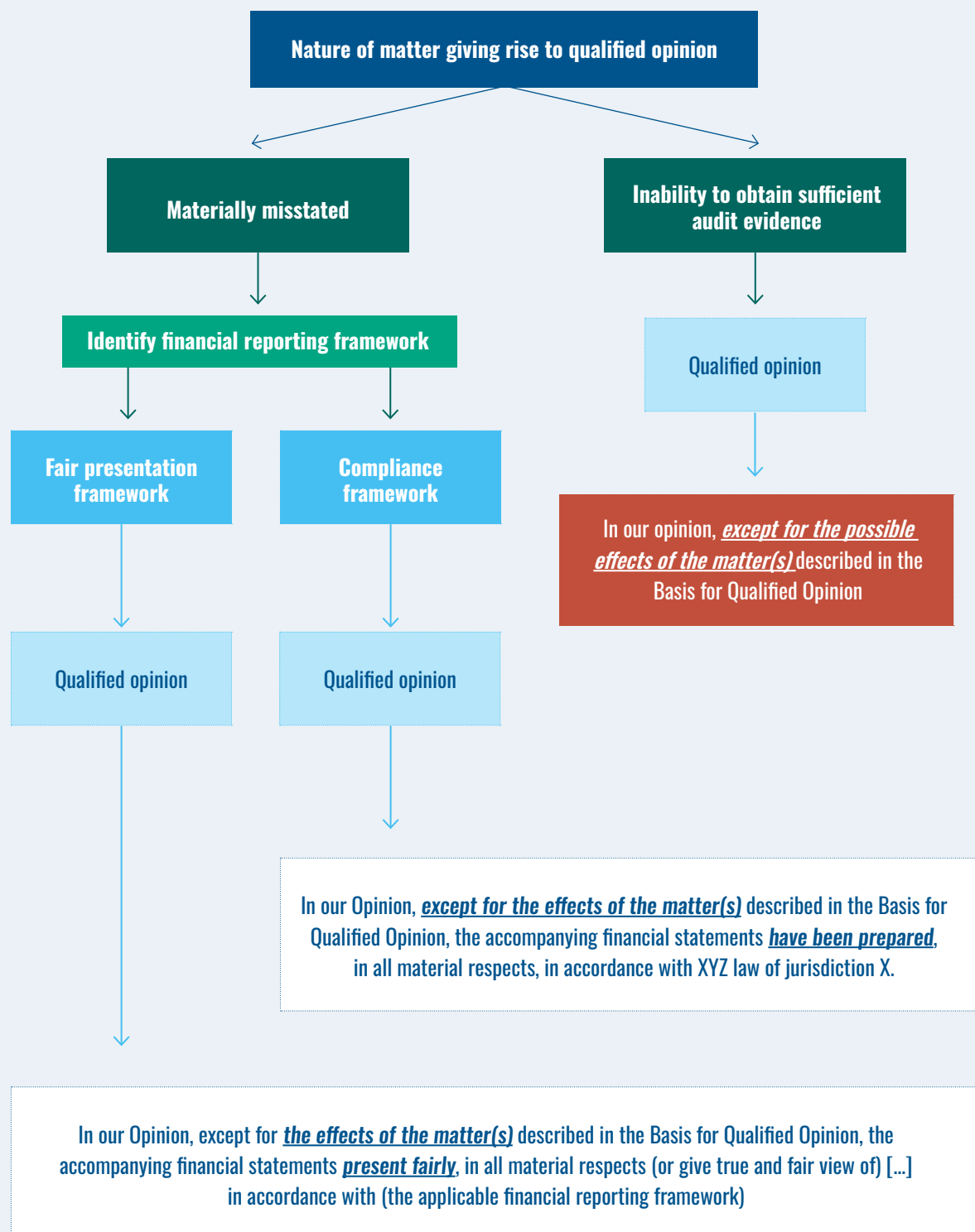


## Qualified opinion

The wording and phrases used in the Qualified Opinion paragraph of the auditor's report is determined by whether the applicable financial reporting framework is a fair presentation framework or a compliance framework. In the case of an inability to obtain sufficient appropriate audit evidence, the auditor is required to amend the Auditor's Responsibility paragraph in the auditor's report. The form and content of a qualified opinion is illustrated in **Figure 8(d)**.

**Appendix 8.3** provides an illustration of Qualified Opinion due to misstatement of the financial statements of a government entity prepared in accordance with a general-purpose fair presentation framework. Similarly, **Appendix 8.4** provides an illustration of Qualified Opinion due to misstatement of the financial statements of a government entity prepared in accordance with a general-purpose compliance framework. **Appendix 8.5** provides an illustration of Qualified Opinion due to auditor's inability to obtain sufficient appropriate audit evidence on an item(s) recognised in the financial statements.

**FIGURE 8(d)**  
**Form and content of auditor's qualified opinion**

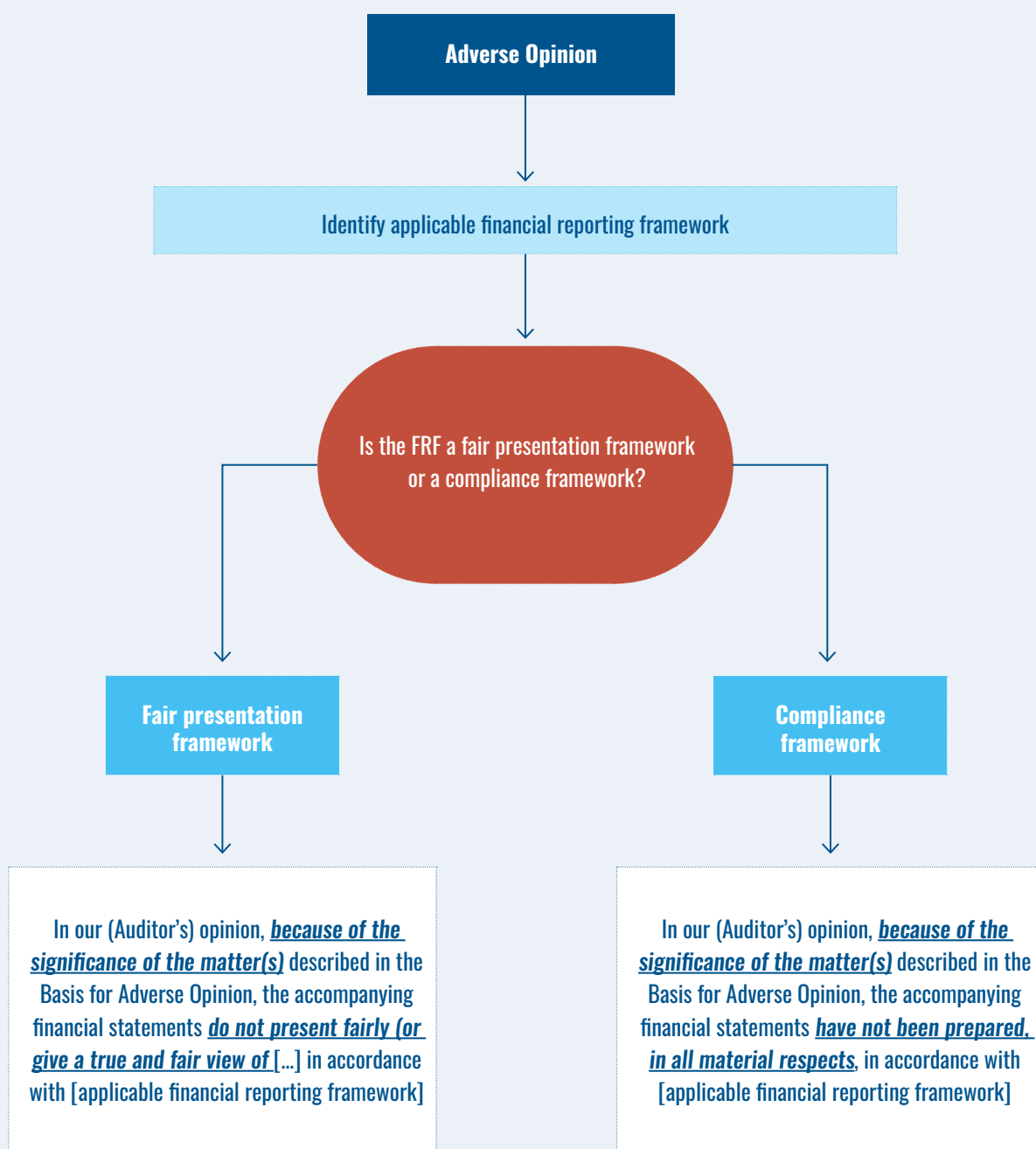


## Adverse opinion

The adverse opinion paragraph under either a fair presentation framework or a compliance framework is illustrated in **Figure 8(e)** below.

An illustration of Adverse Opinion due to misstatement of the financial statements of a government entity prepared in accordance with a general-purpose fair presentation framework is provided in **Appendix 8.6**.

**FIGURE 8(e)**  
**Forming adverse opinion on the financial statements**



## Disclaimer of opinion

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the wording of the Disclaimer of Opinion will be as prescribed in ISSAI 2705. This would also require modifying the standard formulation and wording of auditor's responsibility paragraph as compared to other forms of opinion (refers ISSAI 2705.28).

### Disclaimer of Opinion

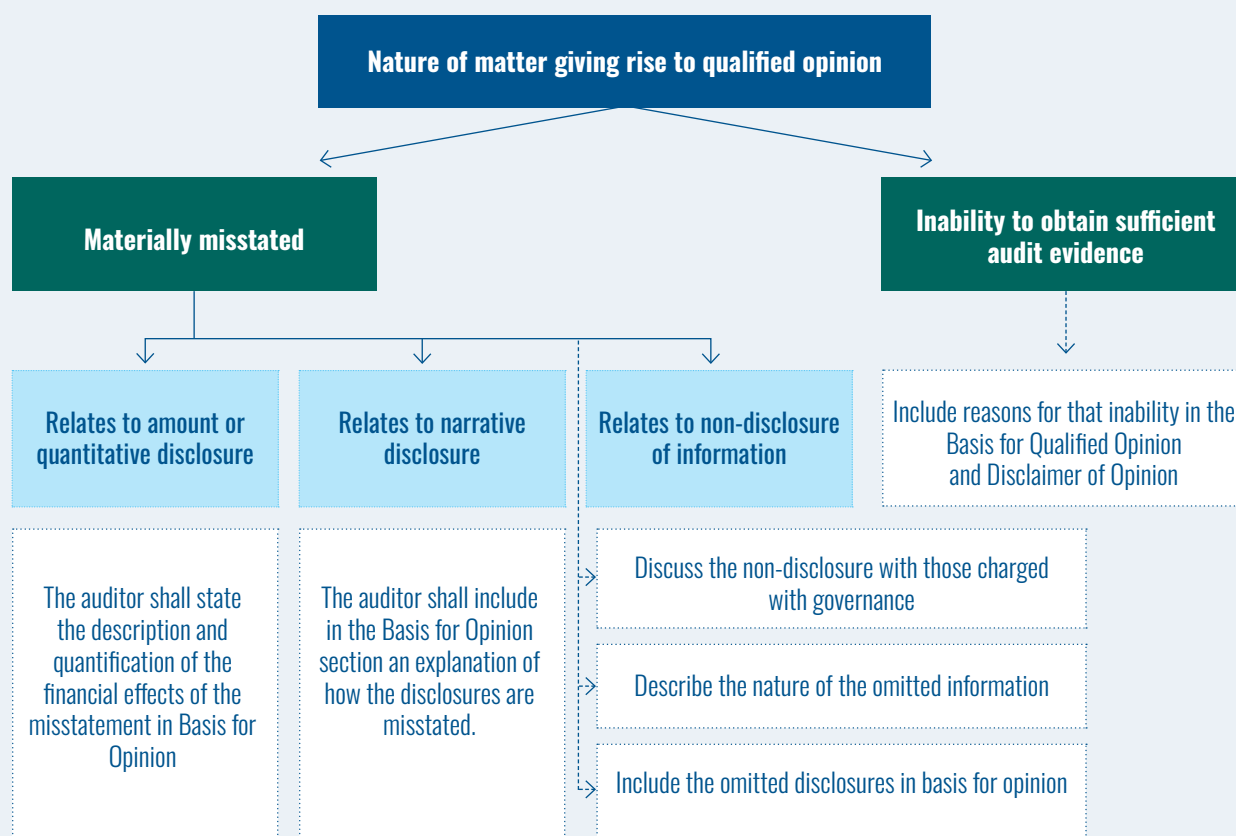
*We do **not express an opinion** on the accompanying financial statements. Because of the **significance of the matter(s)** described in the 'Basis for Disclaimer of Opinion' section, we have **not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements.***

An illustration of Disclaimer of Opinion due to the auditor's inability to obtain sufficient appropriate audit evidence is provided in **Appendix 8.7**.

## Amending the basis for opinion

As required under ISSAI 2705.20, when the opinion is modified the auditor should amend the heading of the basis for opinion as "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," including a description of the matter giving rise to the modification. In the case of inability to obtain sufficient appropriate audit evidence, the auditor is required to amend the Auditor's Responsibility paragraph in the auditor's report. The requirements given under Paragraph 21-27 of ISSAI 2705 are further illustrated in **Figure 8(f)** below:

**FIGURE– 8(f)**  
**Conditions required to be described in basis for opinion**



## Basis for Disclaimer of Opinion

When auditor disclaims an opinion on the financial statements, the auditor is required to amend the description in the Auditor's Responsibility paragraph to include only the following, as required by ISSAI 2705.28:

- A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with International Standards on Auditing and to issue an auditor's report.
- A statement that because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements.
- The statement about auditor independence and other ethical responsibilities required by ISSAI 2700.28(C).

## EMPHASIS OF MATTER PARAGRAPH

An "Emphasis of Matter" paragraph reflected in the auditor's report emphasizes a matter already presented or disclosed in the financial statements. The purpose is to draw the attention of financial statements users to those matters that, in the auditor's judgement, are fundamental to the user's understanding of the financial statements. ISSAI 2706 provides the requirements related to the Emphasis of Matter paragraph. An Emphasis of Matter example is:

*"We draw attention to **note X** to the financial statements, which describes the uncertainty regarding the future outcome of an outstanding litigation against Hospital Y. However, we have not qualified our opinion in respect of this matter."*

The Emphasis of Matter paragraph does not affect the audit opinion and that fact should be clearly indicated in the report (ISSAI 2706.9).

## OTHER MATTER PARAGRAPHS IN THE AUDITOR'S REPORT

The Other Matter paragraphs differs from an Emphasis of Matter paragraph: the former includes matters other than those presented or disclosed in the financial statements that, in the auditor's judgement, are relevant to the user's understanding of the audit and the auditor's responsibilities or the auditor's report (ISSAI 2706.10).

ISSAI 2706 provides the requirements related to Other Matter paragraphs. The need for Other Matter paragraph in the auditor's report may arise in the following situations:

- The auditor is unable to withdraw from an engagement because of its mandate or existing regulations, even though an inability to obtain sufficient appropriate audit evidence due to a management-imposed limitation on the scope of the audit could have a pervasive effect (ISSAI 2706.A10).
- Law, regulation or generally accepted practice in a jurisdiction requires, or permits, the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon (ISSAI 2706.A11).
- An entity prepares one set of financial statements in accordance with a general-purpose framework (for example, the national framework) and another set of financial statements in accordance with another general-purpose framework (for example, IFRS), and the auditor is engaged to report on both sets of financial statements. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include Other Matter paragraphs in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general-purpose framework and that the auditor has issued a report on those financial statements (ISSAI 2706.A13).



- When financial statements prepared for a specific purpose are prepared in accordance with a general-purpose framework because the intended users have determined that general-purpose financial statements meet their financial information needs. Since the auditor's report is intended for specific users, the auditor may consider it necessary, in the circumstances, to include Other Matters paragraph stating that the auditor's report is intended solely for the intended users and should not be distributed to or used by other parties (ISSAI 2706.A14).

An Illustration of auditor's reporting having an Emphasis of Matter Paragraph, and Other Matter Paragraph is given in **Appendix 8.8**. An independent Auditor's report containing a qualified opinion due to a departure from the applicable financial reporting framework and that includes an Emphasis of Matter Paragraph, and Other Matter Paragraph is illustrated in **Appendix 8.9**.

## COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT

ISSAI 2701 defines key audit matters (KAM) as those matters that, in the auditor's judgement, were of most significance in the audit of current-period financial statements.

As per ISSAI 2701, the auditor is required to communicate KAM in an audit of listed companies and can apply voluntarily to audit entities other than listed entities.

KAM are abstracted from matters communicated to management and those charged with governance that, having required significant auditor attention, are considered the most significant in the audit of the financial statements of the current period. The decision-making process for KAM is shown in **Figure 8(g)** below.

**FIGURE 8(g)**  
**The decision-making framework for key audit matters (KAM)**



The intent of communicating KAM is to enhance the communicative value of the auditor's report by providing greater transparency about the audit. It also provides additional information to intended users of the financial statements.

ISSAI 2705 (Revised) prohibits the auditor from communicating key audit matters when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation. A matter giving rise to a modified opinion in accordance with ISSAI 2705 (Revised), or a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISSAI 2570 (Revised), are by their nature key audit matters. However, in such circumstances, these matters shall not be described in the Key Audit Matters section of

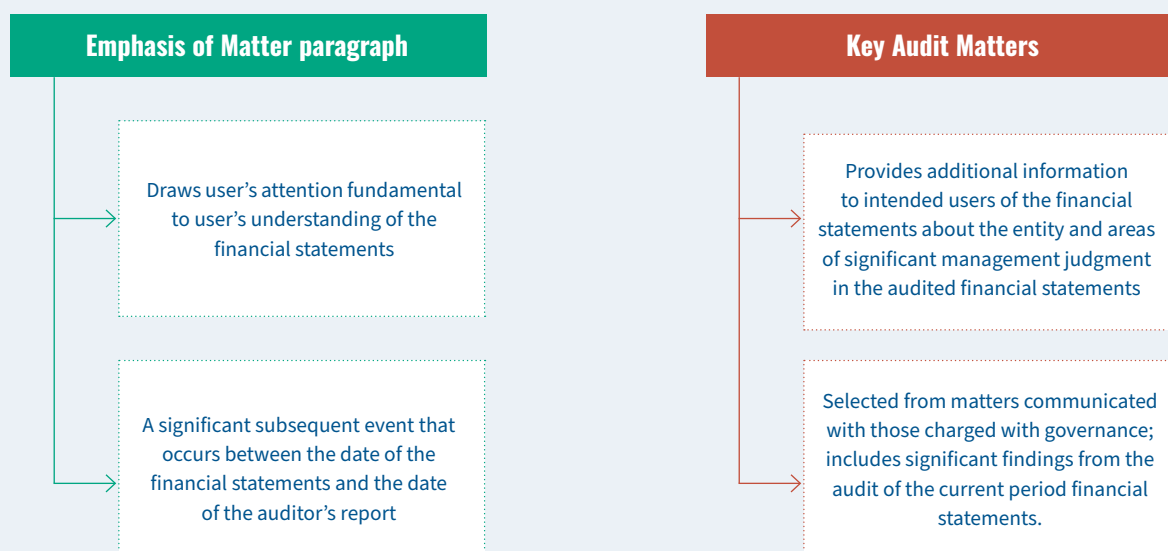
the auditor's report. Rather, the auditor shall:

- Report on these matter(s) in accordance with the applicable ISA(s); and
- Include a reference to the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section.

Placing the separate Key Audit Matters section in close proximity to the auditor's opinion may give prominence to such information and acknowledge the perceived value of engagement-specific information to intended users. The placement of Key Audit Matters, Emphasis of Matter and Other Matter paragraphs depends on the nature of the information and its significance.

**FIGURE 8(h)**

**Relationship between Emphasis of Matter paragraph and Key Audit Matters in the Auditor's Report**



## FORM AND CONTENT OF AUDITOR'S REPORT ON FINANCIAL STATEMENTS

The auditor's report should include the following elements as per ISSAI 2700.20 to ISSAI 2700.49:

- Title
- Addressee
- Auditor's Opinion
- Basis for Opinion
- Going Concern (If applicable)
- Key Audit Matters (only when relevant and applicable)
- Other information (if applicable in accordance with ISSAI 2720)
- Responsibilities of management and those charged with governance for the Financial Statements
- Auditors Responsibilities for the Audit of the Financial Statements
- Other Reporting Responsibilities (If applicable)-to be reported as 'Report on other Legal and Regulatory Requirements'
- Name of the audit engagement supervisor (Name of a person authorised to sign the auditor's report – will depend on SAI specific policies)
- Signature of the Auditor (Authorised SAI Personnel – Audit Engagement Supervisor, or could be Auditor General – will depend on SAI Policy)
- Auditor's Address
- Date of the Auditor's Report

The form and content of the auditor's report will change when there is a modification to the opinion. The contents listed above are suggested where the auditor's opinion is unmodified.

## REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

In the context of financial audits carried out by SAIs and also considering the environment within which the public sector operates, the SAIs may have other reporting responsibilities to report on matters that are supplementary to the auditor's responsibilities under the ISSAIs. As per ISSAI 2700.43, these other reporting responsibilities can be addressed in a separate section in the auditor's report with the heading titled "Report on Other Legal and Regulatory Requirements". If the report contains this section, the auditor's report on the financial statements needs to have a clear heading title "Report on the Audit of Financial Statements" (SSAI 2700.45). The format of presenting the report when it contains "Report on Other Legal and Regulatory Requirements" is suggested in **Appendix 8.1**.

## REPORTING OF IDENTIFIED OR SUSPECTED NON-COMPLIANCE

ISSAI 2250 prescribes three levels of reporting of identified or suspected non-compliance as given below:

- a. Reporting non-compliance to those charged with Governance (Para 23 to 25);
- b. Reporting non-compliance in the auditor's report on the financial statements (Para 26-28); and
- c. Reporting non-compliance to regulatory and enforcement authorities (Para 29).

Instances observed by the auditor of non-compliance with laws and regulations can be reported to management and those charged with the governance, and to other concerned authorities depending on the line of authorities within the entity. The need to report to concerned authorities would depend on the significance and severity of non-compliance that cannot be dealt with at the entity level.

The instances of non-compliance that need to be reported in the auditor's report on the financial statements would depend on whether those non-compliances have material effect on the financial statements. If the auditor concludes that the non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor is required to express either a qualified opinion or adverse opinion in accordance with ISSAI 2705. Similarly, if there is a limitation of scope to evaluate whether the non-compliance may have material effect on the financial statement, the auditor is required to express either a qualified opinion or disclaim an opinion on the financial statements in accordance with ISSAI 2705.

If an instance of non-compliance warrants the attention of the concerned higher authorities (for eg; the parliament), the auditor is required to determine whether the auditor has the responsibility to report to such authorities and may act accordingly. ISSAI 2250.A20 (Considerations specific to Public Sector Entities) provides an explanatory note that the public sector auditor may be obliged to report on instances of non-compliance to the legislature or other governing body or to report them in the auditor's report.

### **Auditor's responsibilities relating to comparative information**

The auditor's responsibilities relating to comparative information will depend on the nature of the comparative information presented in the financial statements. This comparative information is defined by the applicable financial reporting framework (e.g., IFRS, IPSAS) used by the audited entity in preparing the financial statements. The two comparative information are as follows:

- Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.
- Comparative financial statements - Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

The auditor should evaluate whether the financial statements include the comparative information required by the applicable financial reporting framework. The auditor's opinion is presented as follows:

- Corresponding figures – auditor's opinion on the financial statements refers to the current period only
- Comparative financial statements - auditor's opinion refers to each period for which financial statements are presented

Take note that the written representations shall cover all periods referred to in the auditor's opinion.

ISSAI 2710 provides additional requirements when there are unresolved issues that gave rise to modified opinion in the prior year, when there's a change in opinion for the prior year financial statements, and when prior period financial statements are not audited, or audited by another auditor.

## CHAPTER 9

# FOLLOW-UP PROCEDURES

Auditors must always follow-up on material observations they have raised to ensure the issues that have been identified have been resolved by the audited entity. In the context of an ISSAI financial audit, the auditor will typically perform this follow-up as part of the audit process of the subsequent year audit since unresolved prior year issues may represent risks of material misstatement of the financial statements of the subsequent year. As explained in previous sections, public sector auditors may report additional information that is not required to be reported when applying the financial audit ISSAIs to perform the audit. Such additional reporting may require additional follow up activities to be performed.

The audit report as discussed in Chapter 8 may contain a modified audit opinion on the financial statements, key audit matters, audit findings covering deficiencies in internal controls and non-compliance with laws and regulations that may or may not have direct effect on the financial statements.

Follow-up is deemed to be one of SAI's good practices under Principle 3 of INTOSAI-P 20. In addition, ISSAI 100 recognizes that SAIs have a role in monitoring action taken by the responsible party in response to those matters raised in their audit reports.

Follow-up focuses on whether the audited entity has adequately addressed the matters raised by the audit, including any wider implications. Insufficient or unsatisfactory action taken by the audited entity may call for a further report by the SAI.

Besides statutory requirements, one of the purposes of conducting financial audits is to help improve the systems and procedures including the financial reporting process in the entity. By conducting a follow-up, the SAI would also be able to establish

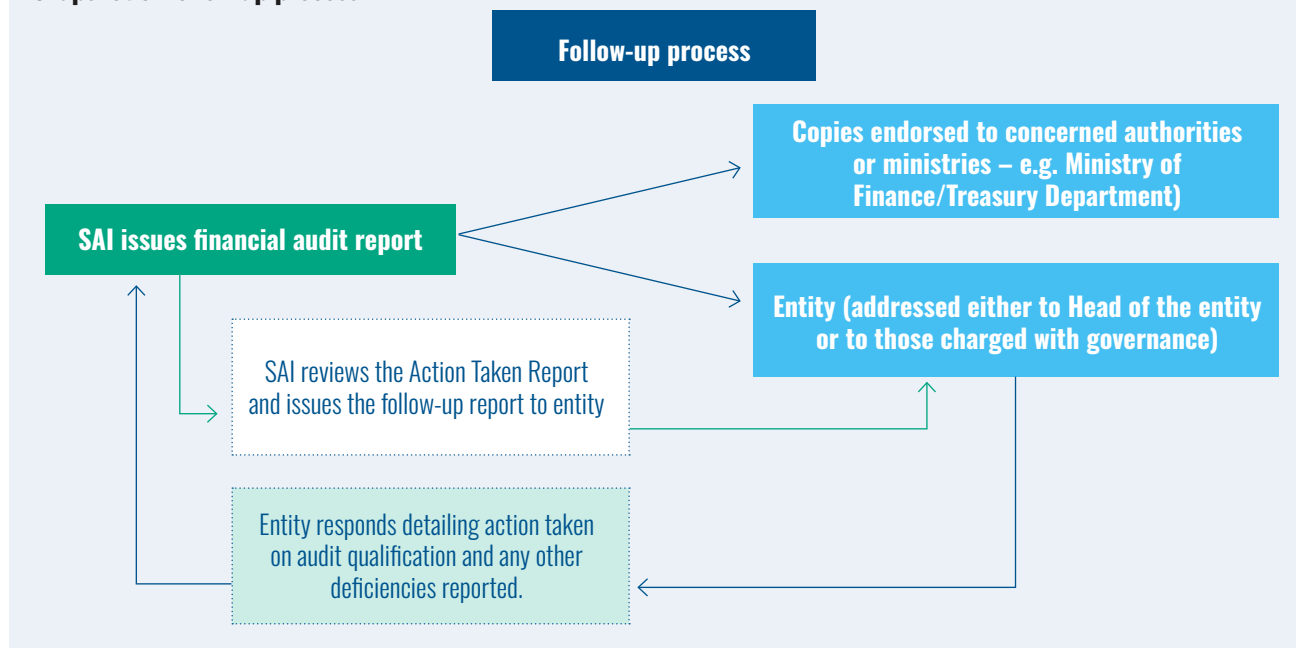
the value added by the financial audit in terms of improvements introduced in the system. Unless this follow-up is put in practice, the SAI cannot gauge whether the desired impact of audit has been effective or not. Therefore, a follow-up audit is one of the important components of the audit process, and that process cannot be complete without it. Further, even management and those charged with governance may not be motivated to take action if there is no follow-up system in the SAI.

Different SAIs may have different follow-up processes depending on SAI model being followed (Court model, Westminster model, Board model, etc.). **Figure 9(a)** provides a snapshot of a suggested follow-up process.

Depending on the issues reflected in the audit report and the requirements of relevant laws, SAIs may be required to endorse copies of audit reports to the concerned authorities or government ministries—say, Ministry of Finance—as well as to management and those charged with governance. However, it should be the responsibility of the Head of the entity or those charged with governance to take action on outstanding audit issues referred to in the audit report.

SAIs and/or laws and regulations may indicate the deadline for auditees to respond to the auditor's report having modified opinion and other deficiencies, for example weaknesses in internal controls that are reported in the form on audit findings, detailing the corrective action to be taken by the entity (suggested as Action Taken Report).

**FIGURE 9(a)**  
**Snapshot of follow-up process**



The SAI reviews the *Action Taken Report on audit findings* and prepares a follow-up report. The follow-up can be done as either a desk review or a visit to the entity for factual confirmation of the response provided by management or those charged with governance. The follow-up report should also go through the due quality review process. This would also depend on how the follow-up function is structured in the SAI, if there is one in place.

It may be appropriate to have an independent follow-up function in the SAI to carry out objective assessment of the action taken by management and to exercise professional judgement. If, for instance, the same functional division/unit or audit team who conducted the audit does the follow-up, it may tend to defend its audit findings and audit qualification, even if management or those charged with governance have taken appropriate action on those audit issues.

Based on different SAI model and the parliamentary structure prevalent in SAI's jurisdictions, the Public Accounts Committee plays an active role in the review and follow-up of the audit reports tabled in Parliament. Therefore, there could be two levels of follow-up of audit findings and recommendations, i.e. one at the SAI level and another at the Public Accounts Committee/parliamentary level.

A template for preparing the summary of follow-up report and detailed follow up report is suggested as **Appendix 9.1**, which may be adapted by SAIs according to their needs and the environment in which they function.

A follow-up of an audit report could be for just one accounting year/fiscal year on which the audit was conducted, and the report issued. However, there could be outstanding issues from earlier years' audit reports (financial or other) regarding the same entity, which may also have to be followed up along with the report recently issued.

Follow-up in the SAI should be a continuous process, until the outstanding audit findings are resolved based on appropriate action taken by management or those charged with governance. After issuance of the initial audit report and upon receiving a first response from management or those charged with governance, the frequency of the follow-up thereafter may be decided by the SAI, or the SAI may have certain regulations or laws guiding this process. However, it is in the best interest of both the SAI and the entity to resolve outstanding audit issues, including any modified opinion on the financial statements, as early as possible.

## CHAPTER 10

# QUALITY MANAGEMENT AT THE ENGAGEMENT LEVEL

ISSAI 140 (revised) sets the organisational requirements in setting-up a system to manage audit quality (e.g., System of Audit Quality Management). At the systemic level, the SAI develops policies and procedures to establish quality risk management process that enables SAI to set its quality objectives, assess quality risks and respond to the assessed risks. The system will also enable SAI to put in place a proactive monitoring and remediation process, and evaluation process for the design, implementation and operation of the entire system. The system consists of the following components:

1. SAI's risk assessment process
2. Governance and leadership
3. Relevant ethical requirements
4. Acceptance, initiation, and continuance of engagements
5. Performing engagements and issuing audit reports
6. SAI resources
7. Information and communication
8. Monitoring and remediation process

The IDI has developed a Playbook to support SAls in setting-up a System of Audit Quality Management (SoAQM), taking into account the requirements in ISSAI 140 (revised).

Key decisions at the organisational level can influence the quality management at the engagement level (e.g., the levels of review to be applied in a particular engagement). ISSAI 2220 deals with the auditor's specific quality management responsibilities at the engagement level. Quality management is not an independent process, but is rather embedded within the audit process. The following shows how the components of the system at the organisational level affect the audit quality management responsibilities at the audit engagement level:



Components	Quality Management Responsibilities at the Engagement Level
<b>1. SAI's risk assessment process</b>	<ul style="list-style-type: none"> <li>→ Implementation of SAI's responses to quality risks that are applicable to the audit engagement. For instance, if a specific quality risk is identified for particular audits, the designed responses may then influence the quality measures under the "performing engagements and issuing reports" component where detailed or more stringent review procedures may be required.</li> <li>→ Design and implementation of responses beyond those in the policies and procedures. This is to reflect the fact that the SAI may not be able to identify all quality risk that may arise at the engagement level, and thus, the audit team may need to design and implement responses to supplement the responses designed at the SAI level.</li> </ul>
<b>2. Governance and leadership</b>	<ul style="list-style-type: none"> <li>→ Audit supervisor/director (identified and authorised by the SAI leadership) taking overall responsibility for managing and achieving quality on the audit engagement</li> <li>→ Audit supervisor/director's sufficient and appropriate involvement in the audit</li> </ul>
<b>3. Relevant ethical requirements</b>	<ul style="list-style-type: none"> <li>→ Understanding of the audit supervisor/director on the relevant ethical requirements</li> <li>→ Audit supervisor/director taking responsibility on compliance of the audit team with relevant ethical requirements (e.g., identification and addressing threats to compliance)</li> </ul>
<b>4. Acceptance, initiation, and continuance</b>	<ul style="list-style-type: none"> <li>→ Implementation of SAI's policies and procedures in acceptance and continuance. For instance, safeguards may have been required for certain mandated audits where issues are identified which will require special audit responses.</li> </ul>
<b>5. Performing engagements and issuing audit reports</b>	<ul style="list-style-type: none"> <li>→ audit supervisor/director taking responsibility for the direction and supervision of the team members and review of their work and audit documentation. In case of a team with no members, review responsibilities may not apply, but the SAI may have other institutional measures such as implementation of peer reviews.</li> <li>→ ensuring sufficient and appropriate audit evidence has been obtained</li> <li>→ ensuring that audit report to be issued is appropriate, and to not date the auditor's report until completion of the required quality mechanisms in the engagement</li> <li>→ ensuring that appropriate consultation has taken place if needed</li> <li>→ when selected for review, cooperation with the engagement quality review to facilitate the review process in accordance with the SAI policy</li> <li>→ Resolving differences of opinion, if any, in accordance with the SAI policy</li> </ul>
<b>6. SAI resources</b>	<ul style="list-style-type: none"> <li>→ ensuring sufficient and appropriate resources are available to the audit team</li> <li>→ ensuring that the audit team has the collective competencies to perform the audit</li> </ul>
<b>7. Information and communication</b>	<ul style="list-style-type: none"> <li>→ Having robust and open communication within the audit team and with relevant stakeholders</li> <li>→ Communication to the SAI of information relevant to the design implementation and operation of the SoAQM (e.g., communication to the SAI about relevant issues or matters on acceptance of audit engagement, resources or monitoring and remediation process)</li> <li>→ Communication to the audited entity, and other stakeholders as appropriate, about the result of the audit</li> </ul>
<b>8. Monitoring and remediation process</b>	<ul style="list-style-type: none"> <li>→ Understanding the SAI's monitoring and remediation process, and its implication on the audit engagement. For instance, there could be deficiencies found on other audit engagements inspected which may also be relevant to enhance the quality in the subject audit.</li> <li>→ When selected for inspection of audits, coordination with the concerned individuals to facilitate the monitoring process</li> </ul>

At the engagement level, audit supervisor/director should establish quality measures specifically to ensure the high quality of each audit product. High quality is achieved when the audit is conducted in accordance with professional standards and applicable legal and regulatory requirements, the auditor's report is appropriate in the circumstances and when the audit contributes value. Different levels of reviews may be implemented at the audit engagement depending on the needs and complexity of the audits, and structure of the audit team. This is normally defined in the SAI's System of Audit Quality Management.

Complex or high-risk audit engagements may require intensive review. When the SAI has sufficient human resources, different levels of reviews may be required to be implemented in the SAI audits. For instance, the audit responsibilities may define that detailed review (first level) needs to be performed by the audit team leader, while high-level reviews (second level and third level) are assigned to audit team supervisor and audit director. Multiple level reviews may, however, not apply to SAIs with limited resources or for non-complex audit engagements (e.g., audits with only one auditor). On these instances, the audit director or audit supervisor needs to integrate other strategies to ensure audit quality (e.g., audit director/supervisor performs close supervision on the engagement; individual assigned to perform the audit has sufficient competence and extensive audit experience; introduction of peer reviews within the audit division).

Subject to SAI policy or when identified as response to quality risk, Engagement Quality Review may also be implemented to have an objective evaluation of the significant judgements made by the audit team and the conclusions reached thereon. The review needs to be completed on or before the date of the auditor's report. The Engagement Quality Reviewer who will be appointed needs to meet the objectivity and independence requirements (e.g., independent from the audit team). This review is not mandatory

except for audits of listed entities or those required by regulations.

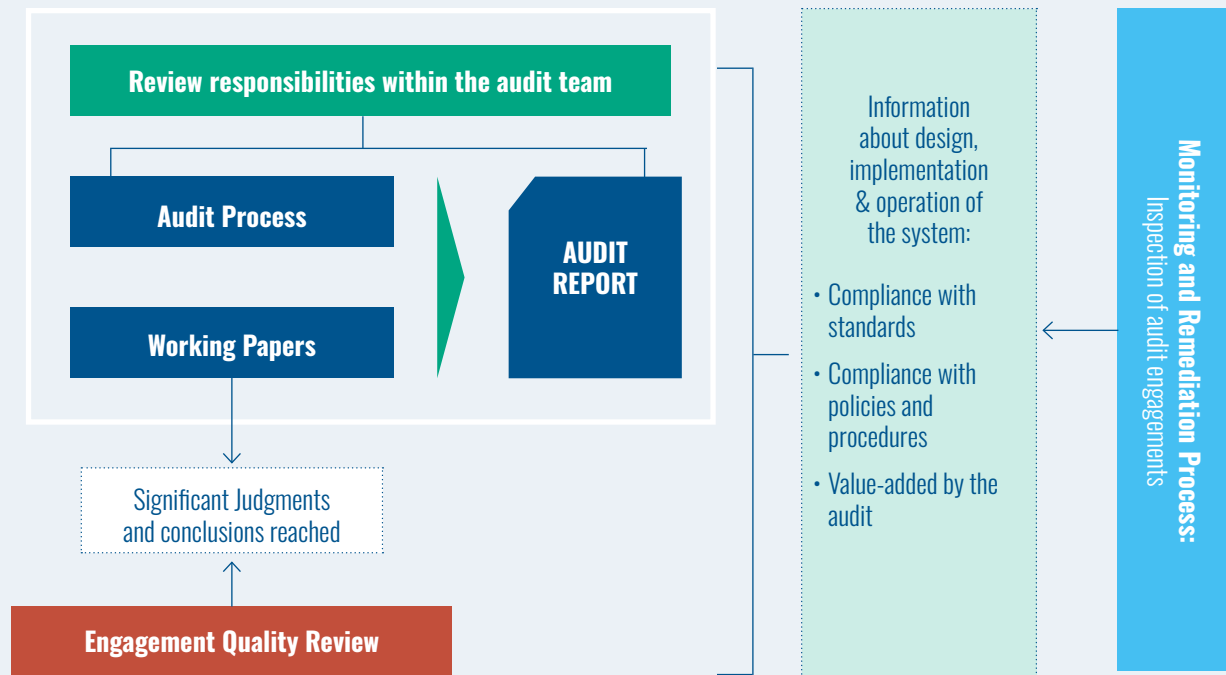
When selected for inspection under the SAI's monitoring and remediation process, the audit engagement may also undergo review that will provide information to the SAI about the design, implementation and operation of the system at the audit practice level. This may involve assessment of compliance with the standards, SAI policies/procedures/methodologies, and whether the audit contributes value. The SAI's selection of audits for inspection may use either the audit engagements or the audit director/supervisor as the sampling unit in the population. Using audit directors/supervisors as the population will nonetheless have advantages over the other option:

- It enforces accountability and responsibility of the audit directors/supervisors in ensuring quality as the results reflect their specific audit practices
- It expands the result of the review since monitoring remedial actions are expected to influence all audit engagements under the subject audit director/supervisor
- It allows flexibility when there are changes in the assignment of audit engagements
- It allows a more focused causal analysis and development of more direct remedial actions to address the specific audit practices of the audit director/supervisor
- It facilitates the conduct of follow-up procedures as the remedial actions are addressed to the same individual irrespective of the audit engagements conducted

The relationship of the different review mechanisms is shown below.

The SoAQM Playbook provides useful tools to assist engagement supervisors/team leaders in discharging their review responsibilities.

**FIGURE 10(a)**  
**Review mechanisms in financial audit**



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