CROWN AGENTS
ACCELERATING SELF-SUFFICIENCY & PROSPERITY

Financial Management of Development Projects
17 May 2019

EXTERNAL AUDIT

Session Introduction

Session Aim

- Define external audit and its examine the governance and control role of the auditor

Session Learning Objectives – by the end of this course, you will be able to:

- Understand external audit and relevant international standards
- Explain the differences between internal and external audit
- Appreciate the risks that audit procedures addresses and how a modern audit is carried out

Session Agenda

Our Learning Journey – how we will achieve our objectives:

1. External audit
2. Traditional vs risk-based audit
3. International audit standards
4. Audit reporting framework
5. Limitations of external audit
6. Session close

Audit - Definition

*“The objective of an audit of **financial statements** is to enable the auditor to express **an opinion** whether the financial statements are prepared, in **all material respects**, in accordance with **an applicable financial reporting framework**.*

*An audit of financial statements is an **assurance engagement**.”*

Audit – Considerations

- Independent evaluation within statutory / regulatory framework e.g.
  - *PFM Act, Fiscal Responsibility Act, etc*
  - *Debt Management Strategy document*
  - *Budget*
  - *Loan agreements*
- Conducted by qualified professional with recognised accreditation
- Assurance to government on its fiduciary obligations

Audit – Considerations

- Unqualified audit opinion means
  - *Financial statements free of material misstatements*
  - *In accordance with relevant legislation*
  - *Usually expressed as "true & fair"*
- Material misstatements include
  - *Error*
  - *Fraud*
- Audit not focussed on fraud
  - *But increasing onus on auditor to be on guard (Anti Money Laundering Acts, etc.)*
- Auditor is a "watch-dog" not a "bull-dog"

Audit – Considerations

- Assurance to other stakeholders
  - *Citizens*
  - *Donors*
  - *Investors*
- Important tool for transparency / accountability
- Public sector audit same as private sector audit
- Close collaboration between INTOSAI and IFAC

Operational risk

- Arise in the normal course of managing (debt) transactions
- Distinct from other risks (e.g. market risk, fraud risk)
- Inhibit efficient operations
- Mitigated by effective internal controls

Operational risks

- Lack of separation of duties or functions
  - *Independent processing, confirmation, review and monitoring*
- Inadequate staff expertise
  - *Supervisors must understand business processes*
- Product risk
  - *Understanding of new / complex derivatives*
  - *System and technology risks*
  - *Failure by staff to stay up-to-date with technology or use new technology without changing their business practices*

Operational risks

- Procedures risks
  - *Lack of written procedures*
  - *Work flow not structured or well designed*
  - *Lack of adequate audit trails*
  - *Most important with complex transactions*
- Disaster recovery risks
  - *Lack of disaster recovery / business continuity planning*

Audit: considerations

- Audit - a service providing an independent and professional assessment and report on the reliability of financial information prepared by one party for use by another party
- Critical aspects
  - *Auditors - independent from those preparing the financial information*
  - *Nature of the work is professional*
- Other Aspects
  - *Monitors compliance, risks, efficiency, and effectiveness*
- Public sector audit similar to private sector audit

Supreme Audit Institution (SAI)

- The auditor of Government reporting to the Parliament
- Highest audit organisation in the country

Audit Legal Framework

- External audit in the Public Sector is often mandated by
- The Constitution
- Separate law(s) on audit service
- Donor / creditor requirements

Reporting the audit opinion

Auditors report their opinion formally in an audit report to:

- A limited company – the report is to the shareholders
- A local authority – the report is to the members
- A government department – the report is to Parliament
- A donor funding projects

Auditing Standards

- Auditing standards prescribe the basic principles and practices relating to the quality and adequacy of the work performed by auditors

- Auditing standards - essential
  - Help to assure the quality and consistency of audit work
  - Strengthen the credibility of auditors
  - Basis in evaluating audit work

Auditing Standards

- Auditing Standards - usually grouped into categories, relating to the:
  - *Auditor (General - Independence and objectivity, Proficiency, Confidentiality)*
  - *Conduct of the audit (Fieldwork - Planning, Supervision, Audit Evidence)*
  - *Audit reporting (Reporting - Various)*
  - *Management and control of the audit (Management and Control - Quality Assurance).*

Types of audit

- Compliance audit
  - *Focuses on individual transactions after the fact/event – authorisation, validity, value for money, documentation, and compliance with laws, regulations and government policies*
- Financial audit
  - *Involves audit work to establish whether financial statements are presented fairly, and whether financial and accounting systems and controls that produce the financial statements are sound*

Types of audit

- Performance audit
  - *Involves audit of entity's programmes and activities relating to economy (acquisition at most economical cost), efficiency (productivity), and effectiveness (objectives being met)*
- Other Audits
  - IT *systems*
  - *Procurement/contract*
  - *Environmental*
  - *Forensic audits*
  - *Reviews*
- May be statutory or non-statutory

SAIs have the right to conduct all types of audits

Limitations of audits

- Reasonable Assurance – cannot detect all errors or irregularities – prevention and detection responsibility of management, not auditor
- Denied or restricted access to data and records – can audit only that observed
  - *Documents lost/misplaced*
  - *Apparent attempt to avoid disclosure of illegal, corrupt, or politically embarrassing activities*
  - *National security interest limitations*

Limitations of audits

- Lack of co-operation from management – cannot obtain clarity or sufficient explanation
  - *Deliberate/reluctant*
  - *Inexperience*
  - *Change of personnel*
- Limitations my be exacerbated by new technology (IFMIS)

Internal audit vs. External audit

Internal audit	External audit
Auditor part of the organisation	Auditor independent external party
Part of management function	Responsibility to owners
Reporting to management	Reporting on to owners
Scope of work comprehensive: to assist entity achieve its strategic and operating objectives	Narrow scope determined by terms of reference (.e.g. opinion on accuracy of financial statements)
Focussed on future: improvement of internal control and other processes	Focussed on historical events and assertions
Fraud detection is a clear objective	Fraud detection not a primary concern
May provide inputs into external audit process if required	May rely on work of internal auditors following assessment of their work

Public sector internal / external audits

- Scope of work
  - *SAI - responsible for auditing whole of government*
  - *Internal audit - responsible for auditing all aspects within the individual ministry or body where they are located*
- Auditing Standards followed
  - *SAIs – usually those promulgated by INTOSAI*
  - *Internal auditors – usually those promulgated by the Institute of Internal Auditors (IIA)*

Parliamentary Scrutiny of the Budget

- Audit Reports - to Parliament (Public Accounts Committee - PAC)
  - *Those audited called in to answer to audit queries and necessary recommendations made or those of the SAI endorsed*
  - *PAC Report - forwarded back to the whole house of Parliament for final seal of approval*

External Audit – Terms of Reference

- Terms of reference for should include:
- Audit objective
- Audit scope
- A list of project financial statements to be audited
- Summary reports to be audited
- Designated accounts to be audited
- Audit reports to be produced
- Other general requirements

Project audit: typical requirements

- Project's financial accounts to be audited by acceptable auditor
- TOR accepted by donor (e.g. World Bank)
- Audit within six months of year end
- Assessment of adequacy of accounting and internal controls
- Adequate accounting records have been maintained
- Expenditures are eligible
- Adequate documentation maintained to support claims for reimbursement

Engagement letter

- Prepared by audit and sets out responsibilities of both parties
- Describes scope of the audit including reference
  - *Applicable legislation*
  - *Regulations*
  - *Standards and ethical requirements of professional bodies to which the auditor belongs*
- Complaints procedure
- May include timetable
- May include the form of any reports or other communication of results of the engagement
- Caveat about inherent limitations of an audit and of internal control
  - *Unavoidable risk that some material misstatement may remain undiscovered*
- Request for unrestricted access to records, documentation and other information for the audit.

Engagement letter

- Arrangements regarding the planning and performance of the audit
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit
- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter
- Description of any other letters or reports the auditor expects to issue to the client
- Assurances of mutual confidentiality regarding letters and reports to be issued unless otherwise agreed
- Basis for fees and billing arrangements
- When relevant
  - *Involvement of other auditors or other experts*
  - *Involvement of internal auditors and other client staff*
  - *Arrangements regarding predecessor auditor*
  - *Restriction of the auditor's liability when such possibility exists*
  - *Reference to any further agreements between the parties*

Independence and the external auditor

- The powers, responsibilities and appointment of external audit in both the public and private sectors are determined by statute
- Independence of the external auditor from management is guaranteed, in theory, by the fact that it is not management which appoints the auditor

Auditing Project Arrangements

- Lender requires borrower and implementing agency to have annual financial statements audited in accordance with standards acceptable to the lender
- Audit includes:
  - *Assessment of adequacy of accounting and internal control*
  - *Determination of maintenance of adequate documentation of all transactions*
  - *Verification of eligibility of transactions*

Auditor’s Opinion On A Project

- Auditor is generally required to:
- Provide opinion on annual financial statements of entire project, including statement of expenditure and special account
- Prepare a management letter
- Ensure that the financial statements cover all project resources and expenditures, regardless of funding sources

Donor Remedies

Where:

- Audited financial statements are not received when due
- Opinion indicates deficiencies in accounting, internal control or reliability of financial statements
- Lender considers scope or quality of audit unacceptable

Non-compliance Remedies

Donor may:

- Not extend closing date
- Delay negotiations or board presentation of any new credit benefiting defaulting entity/ministry until:
  - *Acceptable audited financial statements are received*
  - *A remedial action plan is agreed*
- If acceptable audited SA financial statements are not received within specified period donor may withhold replenishment of funds

Further Remedies

- If acceptable audited financial statements are not received after an agreed period after due date lender may suspend all disbursements on the credit/grant
- If audited financial statements reveal major deficiencies in internal control, or inadequate evidence that funds have been used for only eligible expenditures the lender may suspend all disbursements on the credit/grant until satisfied that adequate remedial action has been taken

Auditing: approach

- The auditor should make an

  *"assessment of the nature and degree of **risk of misstatement** at both the financial statement level and the account balance or class of transactions level"* ISSAI 5440

- Basis for determining further audit procedures to reduce the risk of material misstatement to acceptably low level

Risk mitigation process

1	Identify what risks require mitigation	**A Risk Assessment Procedure** What risks have been identified that should be addressed by controls
2	Document relevant internal controls	**Understand Internal Controls** From inception to financial reporting Address each of the 5 IC components
3	Assess internal control implementation	**A Risk Assessment Procedure** Ensure controls are actually operating as designed
4	Assess internal control design	**Match Risks with Controls** Identify key controls for testing Identify material control weaknesses

Place reliance on effective controls to mitigate risk

Risk of material misstatement

- Broken down into:
  - *Inherent risk*
  - *Control risk*

Inherent risk

- Risks that are inherent to the nature and circumstances of the entity
- It describes the susceptibility of an assertion to material misstatement assuming there are no internal controls
  - *e.g. Items subject to complex calculations or accounting estimates are likely to have a higher inherent risk than others*
- External circumstances may create business risks which increase the inherent risk of some assertions
  - *e.g. technological developments may render some stock obsolete, increasing the inherent risk of stock valuation*

Control risk

- The risk that a misstatement that could occur in an assertion and that could be material will not be prevented, or detected and corrected by the entity's internal control
- There will always be some control risk as no internal control system is infallible

Audit approach

- Auditor obtains an understanding of the entity and its environment in order to:
  - *Identify risks*
  - *Identify relevant controls that relate to the risks*
  - *Identify the relevant classes of transactions, account balances, and disclosures in the financial statements*
- Relating the identified risks to what can go wrong at the assertion level
- Considering whether the risks are of a magnitude that could result in a material misstatement of the financial statements
- Considering the likelihood that the risks could result in a material misstatement of the financial statements

Required risk assessment procedures

- Enquiries of management and others within the entity
- Analytical procedures
  - *Identify unusual transactions or trends which may indicate material misstatements*
- Observation and inspection
  - *Observation of entity activities and operations*
  - *Inspection of documents (such as business plans and strategies), records and manuals*
  - *Reading reports (such as quarterly management reports and minutes of management meetings)*

Audit approach

Total audit risk

Identified audit risk

LESS

Effective Internal controls

Risk mitigation

EQUALS

Residual risk

Residual audit risk

Translates into sample size

Types of audit evidence

Weak internal accounting system	Substantive testing
Going concern	Cash flow for next year
Accounting estimates e.g bad debts in a bank	Internal control, statistical analysis
Impairment of assets e.g. a mine, a purchased subsidiary	Cash flow for that part of operations
Valuation of investments	Independent valuation, subsequent valuations
Derivatives	Internal control procedures, independent valuation, basis of valuation

Assertions

- 13 financial statement assertions grouped into three categories:
  - *Assertions about classes of transactions and events for the period*
  - *Assertions about account balances at the period end*
  - *Assertions about presentation and disclosure.*

Assertions - classes of transaction and events

- Occurrence
- Completeness
- Accuracy
- Cut-off
- Classification

Assertions - classes of transaction and event

- **Occurrence**: transactions and events that have been recorded have occurred and pertain to the entity
- **Completeness**: all transactions and events that should have been recorded have been recorded
- **Accuracy**: amounts and other data relating to recorded transactions and events have been recorded appropriately
- **Cut-off**: transactions and events have been recorded in the correct accounting period
- **Classification**: transactions and events have been recorded in the proper accounts

Assertions - account balances

Existence

Rights and obligations

Completeness

Valuation and allocation

Assertions - account balances

- **Existence**: assets, liabilities and equity interests exist
- **Rights and obligations**: the entity holds or controls the rights to assets, and liabilities are the obligation of the entity
- **Completeness**: all assets, liabilities and equity interests that should have been recorded have been recorded
- **Valuation and allocation**: assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded

Assertions – presentation and Disclosure

Occurrence and rights and obligations

Completeness

Classification and understandability

Accuracy and valuation

Assertions: Disclosure

- **Occurrence and rights and obligation**: disclosed events, transactions and other matters have occurred and pertain to the entity
- **Completeness**: all disclosures that should have been included in the financial statements have been included
- **Classification and understandability**: financial information is appropriately presented and described, and disclosures are clearly expressed
- **Accuracy and valuation**: financial and other information are disclosed fairly and at appropriate amounts

Substantive testing

- Substantive tests
  - *Those activities performed by the auditor during the substantive testing stage of the audit that gather evidence as to the completeness, validity and/or accuracy of account balances and underlying classes of transactions*
- Account balances and underlying classes of transaction must not contain any material misstatements
  - *They must be materially complete, valid and accurate*
  - *Auditors gather evidence about these assertions by undertaking substantive procedures*

Substantive testing

- Substantive testing is the process of obtaining audit evidence and includes
  - *Arranging for creditors to confirm in writing the details of the amount owing at balance date as evidence that debt stock is complete (completeness assertion)*
  - *Making inquires of management and others about the valuation of debt stocks (valuation assertion)*
- There are two categories of substantive procedures:
  - *Analytical procedures: test of trends and use of ratios*
  - *Tests of detail*
- Analytical procedures are applied in several different audit stages, whereas tests of detail are only applied in the substantive testing stage

Sampling & testing

Audit sampling for testing compliance involves

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

Public sector auditors are more likely than private sector auditors to consider the need to sample non-financial information

As a result of additional public sector objectives, such as testing compliance with regulatory requirements

Audit testing

Assertion	Audit test
Existence and Occurrence	Confirmation with the holder of investments or fiscal agent or custodian of records or trustee
	Inspection of underlying contractual agreements and other supporting documents, confirmations received from creditors, in paper or electronic form, for amounts reported
	Inspection of supporting documents for subsequent payments for related liabilities after the end of the reporting time period
Rights and Obligations	Observation of assets or stock-taking procedures
	Confirmation with the holder of investments or fiscal agent or custodian of records or trustee
	Inspection of underlying contractual agreements and other supporting documents, confirmations received from creditors, in paper or electronic form, for amounts reported

Session close

Let’s wrap up the session:

- Recap of key learning
- Final questions?
- Revisit session objectives – achieved?
- Application of learning – update your action plans
- What’s next?

THANK YOU /

CROWN AGENTS

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