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Auditing For Compliance With Authorities — A Public Sector Perspective

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PREFACE

The objective of the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) is to develop programs aimed at improving public sector financial management and accountability. To that end, the IFAC PSC issues Guidelines, Statements on Practice and Studies. Studies are undertaken by the Committee to provide information that contributes to public sector financial reporting, accounting or auditing knowledge.

The objective of this Study is to highlight the different aspects of the audit for compliance in the public sector which, in different countries, may be subject to very different mandates and objectives than in the private sector. International Standard on Auditing (ISA) 31, "Consideration of Laws and Regulations in an Audit of Financial Statements," should generally be applicable to the audit of financial statements of public sector entities but in many countries auditors of public sector entities have additional audit and reporting responsibilities with respect to the audit of compliance with authorities.

Because of the variety of authorities, their provisions may be conflicting with one another: they may be subject to differing interpretations, and/or subordinate authorities may not adhere to the directions or limits prescribed by the enabling legislation. For example, a ministerial directive may give an interpretation of the purview of an entity that goes beyond the authority granted by legislation. As a result an assessment of compliance with authority in the public sector requires considerable professional judgement. The auditor may need to consult with an independent legal counsel.

This Study does not deal with auditor responsibility toward criminal acts which depends on the legislation of the country considered. All instances of fraudulent or criminal acts that have been identified during an audit should be reported in the manner required by this legislation.

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CHAPTER 1

INTRODUCTION

.001 In any organisation, management is responsible for ensuring compliance with the laws, regulations, and other authorities applicable to its activities. Compliance or authority auditing, therefore, is an important element of auditing in the public and private sectors. Compliance auditing, however, takes on added significance in the public sector because governments and other public sector entities operate with and within a regulatory framework.

.002 In a democratic system of government, accountability to the public and, particularly, to its designated representatives, is an overriding aspect of the management of a public sector entity. Public sector entities are usually established by legislation and their operations governed by various authorities derived from the legislation. Management of public sector entities are accountable for operating in accordance with the provisions of the relevant laws, regulations and other authorities governing them. Since legislation and other authorities are the primary means by which legislators control the raising and spending of money by the public sector, auditing for compliance with relevant authorities is usually an important and integral part of the audit mandate, or terms of engagement, for most audits of public sector entities.

.003 In addition to being accountable for complying with relevant authorities, public sector entities are also accountable for the fair presentation of information in financial reports and the effective, economical, and efficient use of resources to achieve agreed objectives. A close relationship often exists between audits of these various aspects of accountability. For example, it is necessary to consider compliance with applicable laws and regulations when assessing the fair presentation of the government's financial statements. Legislation may also require that financial statements submitted to the legislature present a comparison of amounts appropriated with amounts spent. Compliance may also be relevant when assessing an entity's performance. For example, when eligibility requirements are established for the operation of, say, a welfare agency, the effectiveness of the agency will be affected by whether or not such requirements are observed.

.004 In many jurisdictions, public officials, legislators, and the general public have been devoting increasing attention to the accountability of governmental and other public sector entities. In some jurisdictions, authority requirements imposed on public sector entities have increased. In other jurisdictions, authority requirements have been relaxed to facilitate achievement of results. Auditing for compliance with authority, however, remains an important function for public sector auditors everywhere.

.005 For the purpose of this Study, the public sector includes international organisations, national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards, commissions, and enterprises). In that context, sub-units of these entities, such as government departments or a specified government programs, are considered as public sector entities. The public sector so defined is subject to a high degree of control through legislation and other authorities.

CHAPTER 2

TYPE AND EXTENT OF AUTHORITIES

.006 In general, public sector entities are subject to more numerous and specific authorities than are private sector organisations. The nature of applicable legislation, regulations, and other authorities ranges from statutory to detailed administrative requirements and guidelines. The authority framework consists of a hierarchy of authorities which, depending upon the jurisdiction, could include items such as:

- international law (E.U. law for example);
- the constitution;
- legislation enacted by legislative bodies;
- regulations made by the government or regulatory bodies pursuant to statutory authority;
- state, regional, or municipal by-laws within the purview of the respective legislative bodies and governments;
- constituting instruments of non-departmental public entities;
- decisions of ministerial or executive committees;
- provisions attached to grants or included in contracts; and
- jurisprudence by courts.

.007 This structure of authorities constitutes a basis for legislative control over the source, allocation, and use of public resources. Legislation may delegate broad financial and administrative powers to governments, ministers, agencies, and enterprises which in turn may establish authorities that must be complied with by the entities concerned. Such authorities are subordinate to the enabling legislation and must comply with the directions, conditions, and limitations set out in that legislation.

.008 The nature and extent of authorities vary according to the type of entity subject to audit. Some entities are subject to more extensive requirements than others. In addition, in certain jurisdictions, statutory requirements may impose a stricter level of compliance than directives, which would normally allow for greater flexibility in the decision making process. In other jurisdictions, however, the situation may be reversed. For example, in some countries, legislation is "enabling" whereas decisions of Cabinet and other executive bodies are more stringent. Therefore, the nature and extent of legislation, regulations and other authorities applicable to an entity will affect the manner in which the audit of the entity should be conducted.

CHAPTER 3

SCOPE OF THE AUDIT

.009 The auditor of a public sector entity is normally required by legislation to consider and report whether the audited entity in carrying out its activities and operations, has complied with relevant authorities. Such a requirement is normally included in the mandate of Supreme Audit Institutions. Because of the variety of audit requirements to which public sector entities are subject, auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. If a proposal, contract or engagement letter is issued, the terms of the engagement should clearly specify the responsibilities imposed on the auditor to conduct compliance with authority work.

.010 Audit mandates for conducting compliance with authority work, and the expertise and effort required to do so, vary considerably. For example, some mandates actually require the auditor to express an opinion on whether the entity has complied with specified authorities or whether certain transactions were carried out in compliance with specified authorities. Other mandates require the auditor to express an opinion on whether the transactions that have come to the auditor's attention in the course of discharging other audit responsibilities were carried out in compliance with specific authorities. And, in some countries, other mandates require the auditor to report instances of non-compliance with authorities that have been observed when discharging other audit responsibilities. The auditor needs to clearly understand the exact nature of the audit responsibilities and the audit report needs to be unambiguous and consistent with the scope of the work performed.

.011 It is the responsibility of the management of the audited entity to ensure compliance with applicable authorities. This responsibility encompasses identifying the requirements with which the entity must comply, implementing internal control systems designed to provide reasonable assurance that compliance is achieved, and taking appropriate action whenever a breach of legislation or other authorities occurs. Management, as well as the government and public, look to auditors to provide assurance or other information on the discharge of these responsibilities.

.012 It is the responsibility of the auditor to understand the nature and extent of the particular authorities affecting the activities and operations of the audited entity in the context of the specific mandate for conducting compliance with authority work. The auditor would then consider the impact of such requirements on the scope and conduct of the audit so as to design the audit work to provide reasonable assurance of detecting abuses or irregularities that could significantly affect the audit objectives.

.013 There may be instances where a report or other information prepared by a government that complies with authorities is, in the auditor's opinion, misleading to readers. For example, legal requirements for the preparation of a financial report may be in conflict with appropriate standard accounting principles. Such conflicts may arise in countries where government accounting principles and the basic structure of internal controls over financial transactions are embodied into law. In a country where accounting rules and principles have a legal status, they would prevail over standards issued by a professional body. However, where, in the auditor's opinion, complying with legally mandated rules results in a report or other information that is likely to mislead readers, the auditor would qualify his or her opinion or, at a minimum, clearly refer to the matter in the audit report.

CHAPTER 4

CONDUCT OF THE AUDIT

.014 When conducting an audit for compliance with authorities, the auditor should have regard to the general principles of audit in International Standard on Auditing 1, "Objective and General Principles Governing an Audit of Financial Statements."

.015 At the planning stage of the audit, the auditor should become sufficiently knowledgeable about the authority framework pertaining to the audited entity to enable the audit to be planned so that all relevant responsibilities are fulfilled. In particular, the auditor should gain an understanding of the hierarchy of authorities flowing from legislation that are related to the matter or matters under examination. A variety of sources exist for information on requirements of legislation and other authorities, including the audited entity itself and sponsoring or supervisory bodies. In order to identify significant pertinent authorities, the auditor should consider, in particular, the general duties of the entity, its major discretionary powers, and any limitations on the scope of its activities.

.016 The nature and extent of authorities to be considered will depend on the nature of the audit mandate to be carried out. For example, when compliance is regarded as a separate test, the specific authorities with which compliance is to be tested will often be spelled out in the audit mandate or terms of engagement of the auditor. When an audit of financial statements is performed, the auditor should, as a minimum, consider those authorities which, if violated, would cause the financial statements to be materially misstated. However, additional requirements may flow from the audit mandate or the engagement letter, such as a requirement to audit for compliance with relevant authorities all transactions selected for the financial statement audit. Because of the comprehensive nature of public sector auditing, a compliance with authority element is generally a part of any type of audit of a public sector entity, including the financial statement audit or performance audit.

.017 In performing the audit, the auditor should review and assess whether the entity's operation is in compliance with the significant pertinent legislation and other authorities that he or she has identified. Some of the areas that could be considered would include:

- organisational structure (for example: do appointments to the governing board conform with the provisions of enabling legislation?, have the specific funds required by law been established?);
- policies and procedures governing the acquisition, management, and utilisation of the entity's resources (for example: contracts and grants procedures; revenue or debt policy);
- policies detailing program eligibility requirements;
- internal control systems designed to ensure compliance (for example: budgetary control system; control of deposits and investments); and
- transactions (for example: are expenditures in excess of the legally appropriated amounts?; is personnel compensation in accordance with relevant legal and regulatory provisions, particularly with respect to higher executive levels?).

.018 The auditor should design the audit tests and procedures necessary to comply with the audit mandate and, if applicable, with the engagement letter. Depending on the specified audit objectives, the audit may focus on results, i.e., instances of non-compliance, or on the systems and practices designed to control and monitor compliance with authorities, or both. If focussing on results the audit would include tests and procedures to

provide reasonable assurance of detecting instances of non-compliance. If it is focussing on the systems and practices, tests and procedures would be designed to assess the internal control framework established by management to minimize the occurrence of non-compliance.

.019 In any audit for compliance, the auditor should be alert to situations which indicate fraudulent acts. Where fraud is suspected, sufficient tests should be conducted to determine whether there are reasonable grounds to support the suspicion and, if so, to report to the appropriate body. The manner in which fraudulent or criminal acts should be reported depends on the legislation of the country considered. Legal advice should be sought if appropriate.

CHAPTER 5

REPORTING

.020 In many jurisdictions, the auditor is required to prepare a written report on the examination of compliance with applicable authorities. Depending on the audit mandate and related examination, the report could take the form of:

- an opinion on whether the entity complied with specified authorities;
- an opinion on whether the transactions that have come to the auditor's attention in the course of discharging other audit responsibilities were carried out in compliance with specified authorities;
- an opinion on whether management's assertion with respect to their compliance with authorities is fairly presented; or
- a report of instances of non-compliance observed.

.021 Depending on the audit mandate, or terms of engagement, the auditor's findings and conclusions may be included in a separate report (a compliance audit report), in a report on financial statements (a financial audit report), or a report on economy, efficiency, and effectiveness (a performance audit report).

.022 When long-form reports are published, as is generally the case in compliance audits, separate reports may have to be prepared for the audited entity, its governing board, the relevant minister or ministers, supervisory bodies, and/or legislative bodies. In such cases, only the more serious weaknesses or actual breaches of legislation and other authorities revealed by the audit would be reported to the higher level of government. Other findings may be conveyed to lower levels of government (including officials of the audited entity) in separate communications.

.023 Subject to the audit mandate, the auditor must exercise professional judgement in assessing the significance of non- compliance. Significance and materiality are synonymous concepts; however, significance is often used in the context of auditing for compliance because it is embedded in legislation and practice in the public sector. One of the criteria in assessing significance is the monetary amount involved. But it cannot always be measured in monetary terms. Qualitative and quantitative considerations include the cumulative effect of immaterial items, the needs of the users of the report, the nature of the pertinent authorities, and the degree of public interest in the matter. What is considered to be significant for purposes of forming the overall audit opinion may be different than that which is considered to be significant to include elsewhere in the auditor's report. Further, in some countries, auditor's may be required to report all instances of non-compliance observed without regard to a concept of significance.

.024 When an audit opinion is called for in a specific compliance audit, the auditor should ascertain whether the non- compliance significantly affects the opinion on compliance of the entity's operations with the specified legislation. Where the auditor considers that the non-compliance would be significant, a qualified opinion should be issued.

.025 When expressing an audit opinion on the fair presentation of financial statements, the auditor should determine whether any non-compliance that has been identified materially affects the opinion on the fairness of presentation of the entity's financial position and result of operations.

.026 In public sector audits, the threshold of significance in the compliance environment maintained by the entity or of an actual breach of the authority framework would usually be lower than in audits in the private sector because of the public accountability of the entity and the visibility and sensitivity of its activities.

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