

Audit manual

PART THREE

AUDIT SKILLS AND TECHNIQUES

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1. INTRODUCTION

This Section of the Audit Manual provides guidance on the specific types of audit skills and techniques that refer to improvement of the communication skills, preparation of audit reports and action plans and implementation of methods for selecting samples in the audit. Guidance that is described in this part of the Manual should be applied by internal auditors in the institutions from the public sector in the Republic of Macedonia.

All audit staff are expected to familiarise themselves with the procedures set out in the guide and to apply them in the course of their work. In some cases it may be necessary to adapt the procedures to reflect the situation in a particular organisation. Any such changes will be the responsibility of the relevant Chief Internal Auditor who will arrange for local guidance to be prepared and distributed.

Suggestions to improve this Part of the Audit Manual should be made to CIAD in Ministry of Finance.

2. COMMUNICATION SKILLS AND TECHNIQUES

2.1. THE OPENING MEETING WITH MANAGEMENT

2.1.1. Purpose of the meeting

The opening meeting with management is very important. It sets the tone for the entire audit and provides the opportunity to establish the proper atmosphere and to begin building effective working relationships.



At the opening meeting you should:

- explain the role of internal audit (only if it is the first time an audit has been done in the organisation), and to emphasise that the main objective is to provide constructive help and advice to the management
- discuss and agree the scope and objectives of the audit – making it clear that you welcome any questions and also the views and suggestions of management
- ask for the views of management on any problems which may exist in the activities which fall within the scope of the audit. This helps to demonstrate that you welcome their input and that you are not just looking to be critical of what they are doing
- discuss the timing of the audit – and any difficulties which could arise from it (eg the absence of key personnel, new systems development etc). You need to beware of the danger of management raising timing difficulties as a way of having the audit postponed
- establish who are the main people you need to see at the start of the audit. It is also important to agree with management that you can make direct contact with staff, rather than clearing all meetings etc with the line manager
- set out the procedures that will be adopted for:
 - confirming audit findings
 - discussing the draft report
 - issuing the previous and the final report
- explain that all information will be treated in confidence
- establish the normal working hours of staff in the department, where they are located (particularly if some work is done outside of the organisation's offices) and any other office routines – to make it easier to arrange meetings, locate people etc
- make it clear that you will need access to all relevant files and documents
- ask for the use of an office/desk during the course of the audit – if necessary.

A well-conducted opening meeting can ensure that the audit is conducted in a friendly and positive atmosphere. It can make the difference between active cooperation and open hostility.

A record of the opening meeting should be made and filed on the current audit file.

2.2. THE EXIT MEETING

Purpose

The purpose of an exit meeting with the auditee is to develop a mutual understanding of the content of the draft report and of any other audit concerns that are not set out in the report. It is intended to avoid any misunderstandings or misinterpretations of fact by providing the opportunity for the auditee to clarify specific items and to express views on the significant audit concerns, recommendations and other information presented in the draft report.

This meeting should also ensure that the formal response from the auditee does not contain any surprises for the auditor. Additionally, the exit meeting should serve as an opportunity to develop a feeling that the report is offered in a spirit of working together to improve the way things are being done.

Timing

The Chief Internal Auditor should contact management to determine a suitable time and location for the exit meeting.

Attendees

Attendees should include anyone who may be able to object to the validity of the report's contents and anyone having responsibility for the area or the situation needing corrective action - whether or not they personally would take the action or would be affected by the action.

Discussion

The exit meeting can be either a difficult confrontation or an open and courteous discussion. The discussion topics at each exit meeting will vary depending upon the specific audit concerns identified and who is attending the meeting. At a minimum, the auditor should:

- summarize the audit including what was done (objectives, scope, procedures)
- give justification for used approach when ascertaining findings, conclusions and recommendations from the audit
- outline the risks identified
- outline the significant audit concerns and the recommendations for dealing with the associated risk
- indicate the significant audit concerns which have already been corrected, and
- refer to any less significant concerns identified in the audit.

The auditor should be willing and able to discuss all matters in whatever detail is necessary. It is also important to make it clear that all significant audit concerns have been discussed with management and that the report contains no surprises. You may also want to thank them for the cooperation obtained during the audit - if that is appropriate.

Avoiding Confrontation

The auditor should be prepared for the possibility of conflict when presenting the concerns in the audit report and should be able to retrieve information, support facts and amplify findings without difficulty or delay. To encourage the avoidance of confrontation during the exit meeting, the auditor should:

Be polite throughout the meeting

Avoid the use of non-personal phrases (e.g., try not to start a sentence with "you" when disagreeing),

Make efforts to get on common ground,
Avoid backing the auditee into “a corner” and
Distinguish the expression of different postures from disagreements.

Addressing Confrontation

First, it is important not to mistake the airing of views with disagreement. Often all that is necessary is to let the auditees express their views. Perhaps they do not really disagree but merely want a chance to justify their position or to explain the reasons for the conditions the auditor found. After they have made their point, they may be perfectly willing to let the wording of the draft stand as written. In some situations, offering to quote the auditee may end the disagreement.

Auditors must react and adjust their approach according to the discussions and facts presented. The auditor must maintain a state of fairness and objectivity, and be concerned only with what is factual and significant. To that end, the auditor should be open to changes that make for more understandable and more accurate reports and do not compromise the audit findings, conclusions and recommendations.

Draft Revisions

The auditor should be willing to accept wording changes or other suggested revisions that they believe are appropriate - as long as the changes do not alter the audit opinion or the focus of the significant audit concern or corrective action. When there is an irreconcilable disagreement and there is no misinterpretation of fact (the facts must be agreed upon), the auditor may then point out that they must report matters as they see them and that they are willing to incorporate the auditee’s views, or response, as well.

2.3. INTERVIEW TECHNIQUES & EFFECTIVE COMMUNICATION

2.3.1. Introduction

Interviews are a key part of the audit process. They are an important way of obtaining and confirming information and facts about the way systems and controls are being operated. At the same time they represent an opportunity to create and maintain good relations between the audit department and its clients, and to impress the client with the professionalism of internal audit.

There are two types of interview – directive and non-directive. The directive interview is intended to obtain specific information about verifiable facts – for example the procedure for paying purchase invoices. In this type of meeting the auditor plans the meeting to establish what information is needed and determines questions which will provide that information. The auditor controls the meeting throughout, setting the tone and pace and keeping the discussion in line with the planned objectives. The advantage of directive interviews is that they give the auditor exactly what he/she wants to know. The disadvantage is that they discover very little else.

In contrast the non-directive interview is intended to achieve understanding and build confidence with the auditee. Direct questions are avoided and the interview is structured only to the extent that the auditor identifies and opens up broad areas of discussion. This approach has the potential to uncover new areas for audit, but they have to be well controlled or they can be very long and time-consuming.

There is no 'best' method of interviewing. The approach depends on the person being interviewed, the nature of the audit, the type of information needed and the time available. In many cases interviews are a combination of the two approaches, starting with a directive approach to get the information needed and ending with a non-directive approach to allow the interviewee to broaden out the discussion.

Whichever approach you take there are a number of things you need to do to maximise the benefit gained from your interviews. The main steps are set out in the following sections.

2.3.2. Planning the interview

If you have a good relationship with the interviewee, or have already met him/her several times, then it may be possible to call in casually and unexpectedly. If not then it is normally best to plan the interview and to make a proper appointment in advance.



In planning for the interview you should:

- decide what the purpose of the meeting is
- decide what information you want from the interviewee
- give adequate notice of the interview – wherever possible. Try to take account of peak workloads in the department when scheduling the interview
- always carry out the interview in the interviewee's office (unless he/she insists otherwise). It is important that the setting for the interview should put the interviewee at ease and preferably be free from interruptions. It should also allow the auditee to talk without being overheard
- tell the interviewee what the purpose of the meeting is
- give advance notice of any specific information you need
- prepare any files or documents you need to take with you
- write down the questions you want to ask.

When you are arranging interviews try not to schedule them one after the other. Allow some time in between so that you can review your notes while the points are still fresh in your mind.

2.3.3. Opening the interview

Resist the temptation to rush straight into the interview. Instead start by making an effort to put the interviewee at ease and establish rapport with him/her. Devote time to some general conversation in order to get the interviewee talking easily. For example, if it's the first time you have met it may be useful to comment on the interviewee's office or the office building in general – but make sure that what you say is sincere. This is particularly important when the interviewee appears apprehensive, or is a junior member of staff.

If, however, the auditee appears pressed for time, general talk may be irritating to them. Open the interview according to the mood of the auditee - but always try to be informal, friendly and natural.

It is a matter of judgement when it is the right time to start the interview proper. The main thing is to do this when the interviewee is relaxed enough and in the right mood. This switch needs to be

done tactfully – eg you could say: “I’m concerned that I may be taking up too much of your time, perhaps I could ask you

Before starting the main part of the interview it is useful to check how much time the interviewee has available. This allows you to adjust your approach, speed and focus if necessary.

2.3.4. The interview

It is important not to conduct the interview like an interrogation. Keep in mind at all times that the auditee should do most of the talking and that you need to listen carefully.



During the interview it is worth remembering:

- that you should not talk down to the interviewee no matter how junior the person is
- to maintain a helpful, pleasant and interested manner – even if the interviewee is unpleasant and uncooperative
- to look at the interviewee when he/she is talking and when you are asking questions. Avoid staring, which can cause embarrassment or tension, by looking away briefly from time to time
- to smile, nod your head in agreement etc whilst the interviewee is talking to show attention, interest and agreement
- to avoid doing anything that may indicate you disagree with, disapprove of or don’t believe anything said
- not to comment unfavourably or challenge anything said. However, you should ask for clarification and explanation where necessary
- not to get involved in an argument
- to be alert for reactions which may indicate that he/she is unsure of or doesn’t understand what has been said
- to think carefully about the answers you are given. First, to decide what is fact and what is opinion, and second to decide the future direction of your questioning.

Keeping the discussion on the right track

You need to be prepared to accept that a certain amount of time will be wasted in any interview – mainly because interviewees will not keep to the point. Some are more likely to wander off the point than others. It is essential that you try not to introduce any digressions into the interview or encourage the interviewee to make any digressions.

When you need to get the interviewee back onto the point it is important to try to do so tactfully. Controlling such digressions can be a major problem. If you do it too obviously you run the risk of upsetting the interviewee and losing their cooperation. If you don’t control them you will waste time and probably not get all the information you need. Try at all times to show a keen interest in what is being said and avoid all signs of frustration or impatience.

Closing the interview

Once you have achieved everything you want of the interview, then you need to take the initiative in bringing it to an end. However, if the interviewee is obviously willing to talk and is giving you useful information do not stop just because you have taken up the scheduled time – useful information can sometimes be lost that way.



In closing the interview follow the normal rules of courtesy and common sense. Always:

- thank the interviewee for their time and their help
- ask them to tell you if after the meeting they think of anything else which is important or relevant
- confirm any action points agreed during the interview – e.g agreement to provide documents, further information etc
- leave yourself the opportunity to go back for further information or clarification by saying something like: "It's possible that I may need to clarify something when I go through my notes. If so would you mind if I called you or came to see you again for a few minutes?"

2.3.5. After the interview

Try to read through your notes as soon as possible after the interview. Make any amendments to the notes and identify any additional information or clarification needed.

If you have agreed to do something or to provide something to the interviewee make sure you do this as soon as possible. If you don't do so it will damage your credibility and your relationship with the interviewee.

2.3.6. Things to remember about effective communication

Verbal communication

You will only get the information you need if both you and the interviewee attach the same meaning to the questions you ask and to the answers he/she gives. It is very easy to interpret words and phrases in a different way from that intended by the speaker. In order to reduce the risk of misunderstandings it may be helpful:



- to think carefully about each question you ask, and try to phrase them in a clear and unambiguous way
- to keep each question as short as possible
- to use short, simple, familiar words to maximise the chance that the interviewee will interpret them correctly
- to avoid the use of jargon and technical terms that the interviewee may not understand
- to avoid the use of vague, general or imprecise words (such as quickly or often) or abstract words (such as successful) which can be interpreted in a number of different ways
- to avoid asking questions which could produce an emotional reaction from the interviewee (eg "what do you think is causing the poor performance of your department?").

Non-verbal communication

Non-verbal communication is an important part of the communication process, and interviewers often forget to watch for and respond to non-verbal messages which are given out by the interviewee.

Examples of things to look out for are:

- the head nodding to signify understanding and acceptance
- the frown that signifies lack of understanding or confusion
- the set expression of the face or mouth that indicates disagreement
- the flickering of the eyes that signifies uncertainty about how to answer – or unwillingness to answer.

Don't forget that you too send out non-verbal messages, and you can make use of them to help the interview to run smoothly and effectively. For example, you can use facial expressions, your eyes, movements of the head and body, smiles and hand gestures to show enthusiasm for the audit and agreement with the points being made by the interviewee. Non-verbal messages can help to make what you are saying more acceptable to the interviewee (eg if you ask a question in a rather forceful way which could cause offence, a smile at the end of the question can help to make it more acceptable). You can also try to encourage and compliment the interviewee – for example, nodding your head slowly whilst the interviewee is talking shows that you are both listening to and understanding what is being said.

The most important thing to remember is to make sure that your facial expressions, eyes, body movements and gestures cannot be interpreted as indicating a lack of interest in, disagreement with or disapproval of what the interviewee is saying. Also, smiling is an effective way of creating a pleasant, friendly atmosphere and of encouraging the interviewee.

Asking questions the right way

First, remember not to talk too much, this is one of the biggest mistakes made by auditors when they are interviewing.



There are two kinds of questions, the '**open**' question and the '**closed**' question.

Open questions usually force the interviewee to think about the answer, and give the freedom to reply in the way he/she thinks best. They can produce a wide variety of possible answers. Open questions often begin with words like: "why", "how", "what" and "which".

Closed questions allow the interviewee much less choice in his/her reply, often resulting in a "yes" or "no" answer. They have a tendency to produce an answer the interviewee thinks the auditor wants to hear and not the true situation. They allow little room for discussion and make it difficult for the interviewee to develop his/her own ideas. However, they are useful to get specific items of information or to confirm basic facts and figures.

When asking questions it is useful to remember:

- to be as friendly and pleasant as possible, and to smile

- to watch the interviewee's facial expressions to check for understanding or confusion
- not to rush the interviewee to give an answer – keep quiet and glance away if necessary
- if the interviewee is unable to answer the question after a reasonable time, suggest you move on to the next point and come back to it later

When it comes to the questions themselves:

- try to think them out in advance as part of the planning for the meeting
- keep each question clear and concise and limit it to a single point or issue
- use words and language which the interviewee will understand and can relate to
- don't ask too many questions which cover any aspect too broadly
- try to ask your questions in a logical order, but be prepared to follow up points of interest as they arise

The importance of listening

Most people find listening very hard. It is very difficult to listen attentively for more than about 30 minutes, after that our concentration drops. There are many reasons why people don't listen well, including:

- getting distracted by something the interviewee says or does, or the way he/she appears. This could include annoying mannerisms or ways of speaking, their physical appearance or the way they dress
- the temperature of the room, an uncomfortable chair etc
- failing to listen because you are tired or have other things on your mind
- failing to look at the interviewee and losing the benefit of any non-verbal communication.

To improve your listening skills you should:

- look at the interviewee when he/she is talking
- sit up – to increase your mental alertness
- pay full attention and concentrate on trying to understand what is being said
- try not to let yourself get diverted.

Most importantly, don't talk too much. Too often internal auditors waste valuable time by interrupting the interviewee and expressing their own views and opinions at great length. Remember, your main role in these meetings is to get the interviewee to talk.

Taking notes

There are many ways of taking notes and you need to develop an approach which works for you. Some things to consider are:

- asking the interviewer at the start whether they mind if you take notes
- don't make your note-taking too obvious, as it can put the interviewee off
- keep note-taking to the minimum, but making sure you record the key points
- don't look at your notepad except when you are writing
- try to keep your notes intelligible and legible so that you can make sense of them after the meeting
- review your notes as soon after the meeting as possible, and clarify and amplify them wherever necessary

3. AUDIT REPORTING SKILLS

3.1. INTRODUCTION

This section of the Audit Manual is concerned with reports on individual audit assignments. It covers:

- the purpose and function of an audit report
- the types of audit reports and alternatives to them
- some guidance on the structure and content of audit reports

Audit reports should provide an assurance on the system under review; and form the basis of the overall assurance on the internal control system to be provided in reports to the head of the organisation.

It is vital to remember that the audit report is the only tangible product of an audit and, as such, is Internal Audit's 'shop window'. It is the culmination of the planning, time and effort which goes into an audit, and reflects the quality and thoroughness of the audit. The quality of the report will have an important influence on the view of internal audit held by senior management of the organisation. An inadequate audit report may negate the best audit work and finest conclusions. It may also damage the reputation and status of Internal Audit.

3.2. PURPOSE AND FUNCTIONS OF AN AUDIT REPORT

The principal objectives of audit reports are:

- to communicate the problems identified and the causes of those problems
- to explain the effects and repercussions of those problems and quantify them where necessary
- to measure performance - by providing analyses and appraisals - and to highlight areas in which greater efficiency and effectiveness may be achieved, and waste eliminated
- to convince management of the need for change
- to suggest practical and cost effective solutions
- to provide a basis for follow up to ensure that appropriate action has been taken.

There are three main functions of an audit report. First, it is an *action document* - unless the report achieves action it will have been a waste of time for everyone involved in the audit. To achieve action the report should provide the client with a brief, objective assessment of control in the area under review and highlight any significant weaknesses identified. It should also bring out the impact of those weaknesses on the level of control and demonstrate to management that they need to do something about it:

- by explaining the risks involved, and
- by quantifying, where possible, those risks and any potential benefits.

Second, it acts as a *formal, permanent record* of: the audit work undertaken and the conclusions

drawn from it, and the level of control which exists in a particular area at a specific point in time. Finally, a good report - by communicating professionalism and competence - *demonstrates Internal Audit's objectivity and independence* and shows that auditors can help to improve efficiency and effectiveness.

3.3. TYPES OF AUDIT REPORT

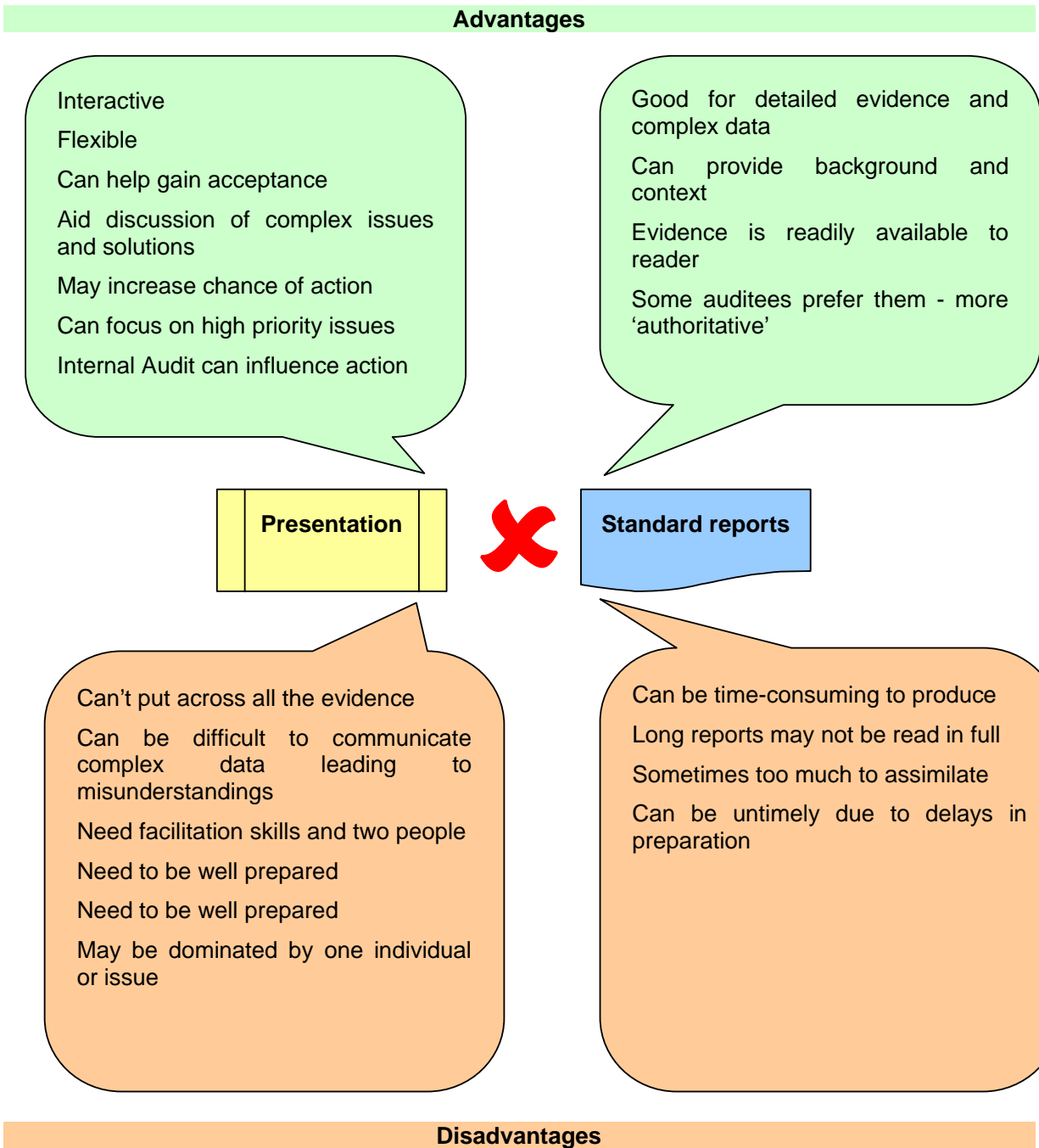
A written report should be issued after each audit to provide a formal record of the results of the audit. There are basically two types of audit report which can be considered - a Standard Report and an Audit Memoranda.

The Standard Report is the type most frequently used. It comprises three main sections - the Executive Summary, the Detailed Report and the Action Plan.

Audit Memoranda are normally shorter than Standard Reports and are used:

- for quick and special reviews carried out at the request of management to report the results of follow-up audits
- where only relatively minor points arise from the audit
- as an interim report on longer audits.

An alternative to an audit report is a *Presentation* or oral report. This involves a formal verbal presentation of the audit findings and discussion of the action to be taken by management. The advantages and disadvantages of reports and presentations are set out in the table below.



3.4. THE STRUCTURE OF AUDIT REPORTS

The precise structure of audit reports should be decided by the Chief Internal Auditor. The important thing is for every audit report in each organisation to have the same 'house style'. This makes it easier for line management to use and understand them and helps to build up an image for the internal audit unit.

Standard audit reports – typically should contain:

- Report Cover
- Contents page
- Executive Summary
- Detailed Report
- Action Plan
- Appendices/annexes

Audit Memoranda - will comprise:

- Introduction
- Conclusion
- A series of separate paragraphs, with appropriate headings for the detailed findings and recommendations.

Guidance on the detailed content of each of the sections in standard audit reports is given in the following sections.

3.4.1. Standard audit reports

The Report Cover

This should set out the report title, date of issue and report number. Some audit units adopt logos which are printed on the cover. It may also be worth considering the use of different colour covers for different types of audit review (systems, VFM etc)

Contents Page

This should include the report title, details of each of the main sections of the report and a list of all appendices.

The Executive Summary

The Executive Summary should stand alone and convey the main points to the reader without the need for them to refer to the Detailed Report. It should enable senior management to establish quickly and easily:

- the scope and main objectives of the audit
- why it was done
- the nature and scale of the system or activity reviewed
- the main conclusions of the audit, and
- the principal recommendations.

This is the most important part of the report. It is the main opportunity to encourage the reader to look at the Detailed Report and either take action, or ensure that appropriate action is taken. It should not normally be more than three typed pages in length and should include the following sections.

Introduction and background - covering

- general information of the revised area, including indications of the importance of the topic / system and why it is audited
- the scope and principal objectives of the audit
- any important areas excluded from the review, and why
- when and why it has been audited.

Main Conclusions - which should paraphrase the most important conclusions reached in the Detailed Report. These are often set out on a section by section basis, but sometimes it can be more effective to identify any common ‘themes’ which run through the report. Any overall opinion must reflect accurately the findings and comments in the Detailed Report. Keep to the major issues arising and try to avoid raising any minor conclusions in this section.

Principal recommendations - this should list only the key (high priority) recommendations that feature in the Action Plan and each of them should relate to one or more of the main conclusions.

The key thing to remember is that the Executive Summary should stimulate interest which will lead to action.

3.4.2. The Detailed Report

Format

The main body of the report should be divided into suitable sections, each clearly headed. The order of the sections will be determined during the report planning process. It may reflect the relative significance of the audit findings, a chronological sequence or simply follow the order in which events occur in the system.

Normally recommendations should be placed at the end of each section. However, if a section is particularly long, and/or deals with a variety of issues, recommendations can be inserted at appropriate points in the section. Recommendations should be placed in a separate paragraph(s) preceded by the subheading “**Recommendations**” in bold type.

Content

Each section should contain details of the relevant findings. It is important to highlight the underlying causes of weaknesses and their impact on performance or the level of control. Failure to do so is one of the biggest single weaknesses of audit reports. Ask yourself:

- “why is this happening or not happening?”
- “what is the effect on performance, control, efficiency etc.?”
- “why do management need to know this?”

Recommendations should be included which deal with those underlying weaknesses.

Descriptive material should be restricted to what is needed to establish the nature and extent of any weaknesses identified. It is not necessary to provide full and detailed descriptions of every part of the system under review.

It is often useful to include graphs, tables and charts to quantify and illustrate facts and data. Beware of overusing graphs etc, as this can obscure the message and sometimes irritate the reader.

The report must be factual. Subjective comments are not acceptable. Where it is necessary to make value judgements or assumptions, their basis should be clearly stated.

Avoid the use of long paragraphs wherever possible.

Don't be afraid to say when something is being done well, or to refer to good points you have found. Be careful you don't overdo this.

Recommendations

In developing your recommendations there are some simple things that you should try to remember. They should:

- be based on reliable information
- deal with the underlying cause of the problem, and not just the symptoms
- describe precisely what needs to be done
- suggest who should be responsible for taking action
- be clear, concise and simple
- be unambiguous
- be achievable
- refer to a discrete action point - i.e. each recommendation deals with a single point.

Where an auditee has already taken action, or agreed to do so, this should be stated in the report.

3.4.3. Paragraph numbering – some simple rules

Reports should adopt a simple one-part numbering system (1; 2; 3 etc) beginning with the Executive Summary and continuing to the end of the report.

Recommendations should be numbered (R1, R2, R3 etc) so that they can be readily identified.

Headings and sub-headings should not be numbered.

3.4.4. Finalising the report

Before finalising your report there are a number of key checks you need to make. At the very least you should ask yourself the following questions:

- 1) *The Executive Summary*
 - a. Does it motivate the reader to want to read the detailed report?
 - b. Do the main conclusions reflect accurately the major issues and conclusions contained in the detailed report?
 - c. Does each key recommendation relate to one or more of the main conclusions?
- 2) *The detailed report*
 - a. Are the conclusions appropriate and meaningful?
 - b. Are weaknesses and benefits quantified where appropriate?
 - c. Is the need for corrective action sold? Have you explained the effects of the issues you have identified? Use the “so what?” test.
 - d. Do your recommendations deal effectively with the underlying causes of the problem?
- 3) *General*
 - a. Is the tone of the report appropriate?
 - b. Where appropriate and possible have you tried to be positive?
 - c. Is the report easy to read and understand?
 - d. Have you deleted all unnecessary words and phrases?

You could also use the following check-lists to help ensure you produce high quality draft and final reports.

3.4.5. Audit report quality assurance check-list

Report content

| | | Draft | Final | N/A |
|---|--|-------|-------|-----|
| 1 | The audit report includes: | | | |
| | - transmittal letter | | | |
| | - title page | | | |
| | - table of contents | | | |
| 2 | The audit report contains an executive summary (2/3 pages maximum) | | | |
| 3 | The detailed report includes: | | | |
| | The purpose of the audit, including the reason (whether is planned with the annual plan or is exceptional) | | | |
| | The scope of the audit, time period covered, functions or processes reviewed, and audit techniques used | | | |

| | | Draft | Final | N/A |
|---|---|-------|-------|-----|
| | Background information describing - the system, process or the activity | | | |
| | - the audit finding | | | |
| | - the audit conclusion | | | |
| | - the audit recommendations | | | |
| | - the action plan | | | |
| | - all the correct appendices | | | |
| 4 | A draft report is clearly labelled 'draft' | | | |

Report quality, tone, and appearance

| | | Draft | Final | N/A |
|----|--|-------|-------|-----|
| 1 | The report is clear and concise, free of unnecessary detail | | | |
| 2 | The conclusions expressed in executive summary and the body of the report are consistent | | | |
| 3 | Report is divided into sections and each is clearly labelled | | | |
| 4 | Descriptions of operating procedures, if required, are kept short and concise | | | |
| 5 | The structure of the report is logical and easy to follow | | | |
| 6 | Jargon, technical language, clichés, and colloquialisms are avoided | | | |
| 7 | Acronyms and abbreviations are defined before being used | | | |
| 8 | Active voice predominates | | | |
| 9 | The report is direct and to the point | | | |
| 10 | Headings are informative and descriptive | | | |
| 11 | Opening sentences are strong and attention-getting | | | |
| 12 | Main points are presented first | | | |
| 13 | The report has a balanced tone | | | |
| 14 | Findings are worded constructively | | | |
| 15 | Recommendations are directed toward achieving desired results without prescribing step by step actions | | | |

| | | | | |
|----|---|--|--|--|
| 16 | Report has a professional appearance | | | |
| 17 | Spelling, grammar and punctuation are correct | | | |

3.5. ACTION PLANS

Action plans are vital to recording and monitoring the action taken by management on Internal Audit's recommendations. They make follow-up audits easier and more effective. An Action Plan should be prepared for every standard audit report. It details what management have agreed to.

A template for an Action Plan is shown below. It lists every recommendation contained in the audit report and shows for each of them:

- the comments of management
- who is responsible for action, and
- the date by which action will be taken.

ACTION PLAN

Audit Report No. _____

| 1 | 2 | 3 | 4 | 5 | 6 |
|--------|----------------|----------|-------------------|--------------------|---------------------|
| Rec No | Recommendation | Priority | Action Agreed Y/N | Person Responsible | Implementation Date |
| R1 | | | | | |
| R2 | | | | | |
| R3 | | | | | |
| R4 | | | | | |
| R5 | | | | | |
| R6 | | | | | |
| R7 | | | | | |
| R8 | | | | | |
| R9 | | | | | |
| R10 | | | | | |
| | | | | | |

Prepared by : _____

Approved by : _____

3.5.1. Completing the action plan

Internal Auditors with the previous audit report to the heads of the audited units delivered Action plan¹ with completed column 2.

The Head of the audited units within 10 days of receipt of the previous audit report should provide the same response (comments on the contents of the report and signed an action plan to implement the recommendations with particular defined period of execution and responsible persons).

The Head of Internal Audit Unit, the final Action Plan to implement the recommendations as part of the final report submitted to the Head of the institution and to the heads of the audited units.

The Action plan contains:

Recommendation number (RecNo) - This is the number given to each recommendation in the Detailed Report (R1, R2, etc). The Action Plan should include every recommendation made in the audit report and the recommendations should be listed in the order in which they appear in the Detailed Report.

Recommendation - Each recommendation is included here, worded exactly as it appears in the Detailed Report.

Priority - This indicates the level of importance of the recommendation - high/medium/low.

Action agreed - It should be pointed concerted activity.

Person responsible - This should record the name and title of the person who is to take responsibility for implementing the recommendation. Depending upon the nature of the recommendation, this could be either the person who will actually be making the changes, or the manager who is responsible for the unit, department or sector to which the recommendation relates.

Implementation date - The date by which management intend to make the recommended changes.

3.5.2. Significance of the completed Action Plan

The Action Plan should be sent out with the draft audit report and the Chief Internal Auditor should ensure that it is completed and returned –together with any other management comments within ten working days. The completed Action Plan should be reviewed to ensure that:

- recommendations have been accepted
- any alternative proposals by management are acceptable
- An appropriate person has been made responsible for implementing each recommendation
- suitable dates for implementation are proposed.

1 Form of Action plan

The completed Action Plan should be inserted as Appendix 1 in the final report and a copy of it placed on the Permanent Audit File. Based on the action plan the Chief Internal Auditor should schedule a follow-up audit – if necessary before the next planned audit.

3.6. AUDIT FOR FOLLOW-UP OF RECOMMENDATIONS

The audit for follow-up of the recommendations is one of the most important stages of any audit, that should not be neglected or incorrectly implemented. If internal audit fails to make sure that its recommendations are implemented, then all of the investment in doing the audit may be wasted.

The timing of the follow-up should be determined in relation to the significance and impact of the recommendations and the criticality of the system which has been audited. It should also take account of the implementation dates given in the Action Plan. It is important that time for follow-up audits is provided in the short term (annual) plan and that any specific follow-up audits are scheduled upon completion of each audit.

There are three main ways of following-up an audit, these are:

3.6.1. By letter asking the auditee to confirm action has been taken

In many cases, and certainly for those audits containing minor audit findings, this will be the most appropriate approach. Checks should then be made at the next scheduled audit to ensure appropriate action had actually been taken and that the controls had been implemented properly.

3.6.2. Scheduling a specific follow-up audit

This may involve either:

- an interim review of the systems and controls which have been introduced, discussions with management to determine how they are operating and a limited programme of testing to ensure they are working as intended, or
- a full systems audit to establish that the correct action has been taken and controls are working effectively or, where no action has been taken by management, to determine the impact of the lack of control.

In deciding whether to do an interim review or a full systems audit some things to consider are:

- the risk, importance and materiality of the system
- known changes in organisational objectives or priorities since the audit was done
- the stability of the system (systems which are subject to frequent change are less likely to be suitable for interim reviews)
- the extent of the changes recommended in the audit report

- any indication that significant changes or new systems developments may have taken place.

3.6.3. Follow-up as part of the next audit

It should be standard practice on any scheduled audit to carry out a follow up to establish the extent of implementation of the recommendations made at the last audit. This should be done at the start of the audit so that audit testing can be adjusted appropriately. The audit report should highlight clearly any further action which needs to be taken in relation to the last audit.

4. SAMPLING

4.1. INTRODUCTION

Internal audit consists of obtaining evidence to form a view and provide recommendations for improvement regarding the soundness and application of accounting, financial and operational controls of an organisation. The evidence has to be sufficient, relevant and reliable. This chapter is concerned primarily with the sufficiency of evidence and the use of audit sampling.

Sufficient evidence is the quantity of evidence necessary to provide the auditor with reasonable assurance that the systems of internal control being audited do not contain material weaknesses. The auditing profession accepts that absolute certainty cannot be assured. For most audits the required level of assurance is obtained from a number of audit procedures including the evaluation of controls and the selection and examination of a sample of items.

Audit tests may be carried out using various techniques and the auditor may apply such tests to an entire set of data (100% testing). This can be very time-consuming and costly to do. Alternatively the auditor may choose to draw conclusions about the entire set of data (population) by testing a representative sample of items selected from it; this latter procedure is "audit sampling".

Main objectives of the audit procedures that include samples are:

- To substantiate the accuracy and regularity of transactions, permanent records, accounting records or financial statements, (substantive tests);
- To confirm that the system described to the auditor and recorded in the auditor's system documentation actually works as it has been described (walk-through tests);
- To ascertain the extent of errors or losses in a population of transactions where previous testing has disclosed a high error rate, (weakness tests).

If it is systems based audit, the objective of audit procedures is to confirm that internal controls operate as intended by management and if the answer is yes, assessing whether the auditor can rely on the system to limit errors and losses (tests of control).

Each of these decisions will have an impact on both the size of the sample and the method of selection and consequently on the amount of work planned by the auditor. In general the following apply:

- Higher sample sizes when adopting a substantive approach (when you can not rely on the internal controls in the system);
- Lower sample sizes when relying on the system to prevent or detect errors;

- Lower sample sizes where the auditor assesses that the risk of error or loss is low.

Further decision points occur when the auditor is considering the results of the sample. Generally the results of procedures are the discovery of no error or some errors. Different errors have different consequences and the auditor's subsequent action depends on the type of error discovered.

Before selecting a sample the auditor must decide the amount of evidence that will be sufficient. This requires a judgement about the materiality level - materiality is the significance of undesirable events occurring, and in the context of systems it is concerned with the significance of a failure to achieve management's objectives.

4.2. STAGES OF SAMPLING

Audit sampling involves the following stages:

- Deciding on the sampling approach.
- Determining the sample size.
- Testing the selected items.
- Evaluating the results of the tests.

4.3. PLANNING OF SAMPLES

Judgement sampling based on audit judgement

Clearly throughout the audit process the auditor is using judgement, and this is particularly true when it comes to selecting items for sampling. Judgement is often applied during the initial evaluation of the system (assessing the nature, appropriateness and extent of controls in place) when a decision could be made to include an item or a group of items in the testing.

Judgement also comes into the identification of those key controls which need to be tested. It is also important when it comes to deciding on the size and method of selection of items for testing. Decisions to test may reflect concern over the way in which a control appears to be operated or a suspicion by the auditor that management is not giving serious attention to particular controls.

These processes are often called 'judgement sampling'. Statistical sampling, on the other hand, tends to remove bias in selecting items for sampling allowing reliable estimates to be made. However, even with statistical sampling auditors need to use judgement to decide on how reliable estimates need to be of the whole population.

Simple Random Sampling

In simple random sampling, each unit of the target population has the same chance of being selected. It assumes that you know the population and that each item has a known chance of selection. Selection of the items to be tested is done using random number tables – which are particularly suitable where each item has a predetermined number, eg purchase orders, payroll listings, goods received notes etc. When using random number tables the starting point in the table should be selected at random by placing a pencil on some place on the table. The tables are printed in groups of numbers and it is up to the auditor to decide how to read off the numbers – the main thing is to make sure this is done in a consistent way. The biggest advantage to a simple random sample is that you get a pretty good, unbiased sample fairly easily. The biggest downside is that you may not get all elements of the population that are of interest.

Interval selection

Where the population is unnumbered random number tables cannot be used. In such cases it will be necessary to select a sample using interval selection. It is important to know the structure of the population to make sure that your sample is being taken from all items and that each item stands a known chance of being selected. It is also important how the first item is to be selected. Once the first item is identified the auditor then works through the population selecting items at a given interval (ex. every 10th or 20th etc item). If the selection came up with an item which is not relevant to the test, that item should be ignored. For example, if you are selecting every 20th sales invoice in a population containing both sales invoices and credit notes, and an item you select is a credit note, then you should ignore the credit note. Next item selected should be separated from the credit note by the standard interval you are using, in this case 20. Thus if the credit note is the 60th item in the population, you ignore it and select the 80th item in the population. The precise interval you use is determined by the size of the population and the size of the sample required. See below for guidance on sample sizes.

Stratified Random Sampling

This is a way of reducing the sample size in a population which displays considerable variety. A stratified random sample is one in which the population is classified into "strata" or subgroups and then a random sample is pulled from each subgroup. For example, if we were looking at contract tendering procedures in an organization, the contracts could be divided into (a) contracts over MKD 22.5million, (b) contracts between MKD 2.25million and MKD 22.5million and (c) contracts under MKD 2.25million. Similarly, if we are auditing stocks (ex. medical supplies in a hospital) we could divide them into (a) small quantity, high value items, (b) medium quantity, middle value items and (c) large quantity, low value items.

A sample is then taken from each stratum using random number or interval selection techniques. It is necessary to interpret the results separately for each stratum and then draw conclusions for the whole population.

Cluster Sampling

Cluster sampling can be used for more difficult or complex populations. It is particularly useful when it is difficult to sample from the entire population. In this case the selection is made from one or more parts of the population. For instance if you want to test the system for reviewing and approving school budgets by the municipalities, because of the way in which the files and information are held it may be most practical to restrict the sample to schools in a particular area or district. The important thing is to ensure that all areas and

districts have an equal chance of being selected. Cluster sampling generally uses naturally occurring clusters such as business units, categories of school (primary, secondary etc) or asset categories (property, equipment, vehicles etc). Random sampling can then be used to select items within each cluster, or to review all items within a particular cluster if appropriate. Cluster sampling gives reduced reliability because it is difficult to ensure that every item has an equal chance of selection.

Computer sampling

In computerised systems it is often possible to carry out 100% checks of the population (ex. of payroll records) against specific criteria. Alternatively the computer can be used to select the sample for more detailed review. This can be done using software such as IDEA. Excel can also be used to select samples based on data input to worksheets prepared by the auditor.

Attribute sampling

This deals with the rate of occurrence or frequency of items in a population which have a particular attribute – ex. the number of patients having to wait more than six months for cancer treatment; the number of children who start kindergarten at the age of four. The results are expressed as a simple percentage of the total sample size.

Variables sampling (Sample according to monetary unit)

Variables sampling (monetary unit sampling) is designed to determine the value of something that occurs within a population, based on testing sample selected according to ascertained monetary unit (expressed in denars).

The variable sample is used for testing units that can have any value in specific continual interval. Therefore, it is used for comprehensive tests. For example, average annual value of stocks, liabilities, demands, etc.

4.3.1. Determining the sample size

The basic information which affects the sufficiency of audit evidence required by the auditor is the:

- size of the population of transactions or properties governed by a system;
- distribution of types of transactions or properties governed by a system;
- attributes of individual transactions or properties within the population;
- acceptable error rate in the records, transactions or properties subject to audit;
- risk that the audit conclusions, based on samples may not be applicable to the whole population.

These factors are discussed in more detail below.

Population size

Basically, the larger the population, the larger the sample size required. However, using probability theory applied to a representative sample, there is a cut-off point where, with a

prescribed confidence level, additional testing will not significantly improve the reliability of the result.

Hence the required sample size is affected only to a limited extent by the size of the population from which the sample is chosen. Once the population sizes reaches a certain level, the required sample size to achieve a given level of confidence increases only marginally. As inherent risk falls, so the maximum sample size also falls.

Inherent risk understands risk of the system/process, that is present substantive of the functioning of the internal controls.

Population variability

The distribution of different types of transaction in the population may have an impact on sample size. There are two common distributions:

- a different proportion of high and low value transactions;
- a different volume at certain peak periods.

Guidance on sample sizes for different types of tests are given below.

4.3.2. Size of the sample for walk through tests

If using a SBA approach, auditors should begin by performing a walk through test on between 1-3 items, depending on the complexity of the system.

A walk through test is a process adopted as part of a systems audit. Typical transactions are followed through the system and its controls to enable the auditor to understand how procedures are conducted in practice. The objective of walk through tests is to confirm that the auditor's understanding of the system, which has been documented on file, is correct.

4.3.3. Tests of controls

Guidance on sample sizes for tests of controls depends on the classification of the system, the inherent risk assessment, and the preliminary control risk assessment. Appropriate sample sizes for tests of controls over individual transactions are given in the table below.

Tests of Controls - sample sizes

Tests of controls over individual transactions

| Inherent Risk | Preliminary Control Risk | System assessed as: (number of units in the sample) | | |
|---------------|--------------------------|---|-----------------|-------|
| | | Fundamental | Non-fundamental | Minor |
| High | Moderate | 50 | 40 | 30 |
| | Low | 40 | 30 | 30 |
| Moderate | Moderate | 40 | 30 | 30 |
| | Low | 30 | 30 | 30 |
| Low | Moderate | 30 | 30 | 30 |
| | Low | 30 | 30 | 30 |

Note: Tests of control should not normally cover more than 25% of the transactions in the population

The sample size in the table refers to big populations. If subject to testing are small populations, the sample size should be decreased respectively.

If preliminary control risk is high, a systems based audit approach should not be used.

Examples for sample size for consolidation tests:

- Where testing relates to controls that are carried out monthly, e.g. bank reconciliations, auditors should review evidence for 2 months and obtain evidence that the process occurred in the other 10 months of the financial year.
- Where testing relates to controls that are carried out weekly, e.g. checks over weekly batch processing, auditors should review evidence for 5 weeks and obtain evidence that the process occurred in the other 47 weeks of the fiscal year.

4.3.4. Extended tests of controls

Where the initial sample of controls yields a low error rate (1 or 2 errors), the auditor may be unsure whether this error rate reflects the whole population or is the result of sampling error. To provide a sound basis for the audit conclusion, it is recommended that the auditor extends the test of controls to seek further evidence. The extent of further audit testing will be subject to the auditor's professional judgement, but should not be larger than the original sample size. If any significant errors are found in the extended testing, the auditor may stop the tests there and conclude the system is not operating effectively.

4.3.5. Substantive testing

Substantive testing should not normally be used by internal audit. However, where controls are not in place or have been assessed as high risk, it may be impossible to gain assurance through controls testing. In that case, it is necessary to implement substantive tests on sample from the population.

4.3.6. Weakness tests

Where tests of control or substantive tests identify a high error rate in a particular type of transaction or group of transactions, the auditor should carry out weakness tests on this sub-population. Tests should be focused on the type of error found and conducted in sufficient quantity to draw a conclusion in order to:

- Report about:
 - failure to manage
 - failure to follow management instructions

- Direct the auditor to:
 - investigate the cause of high error rates
 - conduct an investigation resulting in discovery of an irregularity
 - recommend action to address the weakness

The objective of such tests is to focus on known system weaknesses or sub-populations with a suspected high error rate. Two examples are shown below with suggested responses.

Control (check) not implemented:

- Identify the person responsible for the particular control (or check);
- For a statistical conclusion, examine 100 transactions at random
- Otherwise, select transactions known to be at risk (similar to key item selection) and examine closely.

Transactions related to a particular supplier:

- Identify the supplier;
- For a statistical conclusion, examine 100 transactions at random and evaluate the findings;
- Otherwise, select transactions known to be at risk and examine closely.

Guidance on Sample Selection for Substantive Tests

4.3.7. Key items

Often when performing substantive testing, there will be items in the sample which can not be considered as having the same attributes, and therefore the same expected error rates as other items in the population. These are known as key items.

The best example of a key item is one with a **value** significantly higher than other items in the population. Such an item is important for two reasons. Firstly, due to its value, any deliberate or accidental errors relating to it are likely to be of interest to management. Secondly, due to its value, it may be subject to a different control procedure than other items (e.g. approval by a senior officer for transactions over 100 thousands denars), and hence be less susceptible to error than items under this value.

4.3.8. Sampling options

There are two approaches to sampling for substantive testing. If the auditor has no suggestions for key item selection then stratified sampling should be used as the preferred approach. Otherwise, the auditor should incorporate three stages; a high value selection, key item selection and representative sampling.

The difference between the methods is summarized below.

4.3.9. Preferred option - Stratified sampling

This is a technique of dividing a population into relatively homogeneous subgroups called strata. These strata then may be sampled separately; the sample results may be evaluated separately or combined, to provide an estimate of the characteristics of the total population. Whenever items of extremely high values or low values, or other unusual characteristics, are segregated into separate sub-populations, so that each sub-population becomes more homogeneous.

For example, payment vouchers may be classified in strata or layers of, say, 1,001-10,000 MKD, 10,001-100,000 MKD and over 100,000 MKD. It may then be decided that all vouchers of over MKD 100,000 each should be checked without exception, while a series of progressively declining sample sizes may be picked from the remaining strata in descending order. Such sample sizes should preferably be determined on the basis of the auditor's professional judgement.

The additional example given below may help the use of stratified sampling. Assume there is a payment account that has a total value of MKD 3,000,000. Using stratified sampling it is split up into the following strata.

| | Strata (MKD) | Number of transactions | Value (MKD) |
|-----|------------------|------------------------|-------------------------|
| (1) | Below 10,000 | 543 transactions | 100,000 |
| (2) | 10,001 - 25,000 | 325 transactions | 190,000 |
| (3) | 25,001 - 40,000 | 200 transactions | 490,000 |
| (4) | 40,001 - 55,000 | 65 transactions | 390,000 |
| (5) | 55,001 - 70,000 | 30 transactions | 470,000 |
| (6) | 70,000 - 85,000 | 20 transactions | 400,000 |
| (7) | 85,001 - 100,000 | 10 transactions | 285,000 |
| (8) | Over 100,000 | 6 transactions | <u>675,000</u> |
| | Total: | 1200 items | <u>3,000,000</u> |

The auditor decided that items (transactions) over MKD 70,000 are to be checked fully and the 36 items valued at 1,360,000 MKD (ordinary number 6, 7 and 8) need to be excluded from the calculation leaving a residual population of 1,640,000 MKD (ordinary number 1 to 5). From the remaining strata a sample size of 113 was calculated according to the following formula:

$$\text{Sample Size} = \frac{\text{Size of Population} * \text{Security Factor}}{\text{Material Amount}}$$

The size of the population in our case is 1,640,000 denars. The factor of safety was previously determined by the following table and is 2.31 (with confidence level of 90% and 0 expected 100% errors), and the amount of materiality is determined at the beginning of the review as a percentage (usually 0.5%) of the total amount of the balance sheet and in our example is 33.525 denars.

Factors of safety

| | Level of trust | 95% | 93% | 92% | 90% | 89% | 86% | 83% | 78% | 72% | 67% |
|--------------------------------|----------------|------|------|------|-------------|------|------|------|------|------|------|
| Number of expected 100% errors | | | | | | | | | | | |
| 0 | | 3,00 | 2,66 | 2,53 | 2,31 | 2,21 | 1,97 | 1,77 | 1,51 | 1,25 | 1,13 |
| 1 | | 3,75 | 3,33 | 3,17 | 2,89 | 2,77 | 2,46 | 2,21 | 1,87 | 1,51 | 1,34 |
| 2 | | 4,30 | 3,83 | 3,65 | 3,53 | 3,18 | 2,83 | 2,53 | 2,13 | -- | -- |
| 3 | | 5,16 | 4,24 | 4,04 | 3,69 | 3,52 | 3,13 | -- | -- | -- | -- |
| 4 | | 5,16 | 4,60 | 4,38 | 4,00 | -- | -- | -- | -- | -- | -- |
| 5 | | 5,52 | -- | -- | -- | -- | -- | -- | -- | -- | -- |

The sample to be selected from each strata was calculated in the following manner.

| | Calculation | Number of units in the sample |
|---------------|-----------------------------------|-------------------------------|
| Stratum No. 1 | $\frac{100.000 * 113}{1.640.000}$ | 7 units |
| Stratum No. 2 | $\frac{190.000 * 113}{1.640.000}$ | 13 units |
| Stratum No. 3 | $\frac{490.000 * 113}{1.640.000}$ | 34 units |
| Stratum No. 4 | $\frac{390.000 * 113}{1.640.000}$ | 28 units |
| Stratum No. 5 | $\frac{470.000 * 113}{1.640.000}$ | 31 units |
| | Total: | 113 units |

4.3.10. Alternative option – Key item selection

This option has been proposed because it has the advantage of using the auditor's judgement to select key and particularly risky items from the population before selecting the representative sample. It should only be used when auditors are familiar with the application of this approach to the individual account balances that they are auditing.

High value selection

All transactions which are individually above a fixed amount should be examined. The maximum amount for this value will be the amount of materiality but the approach to fixing this level may be subject to the auditor's professional opinion. As a guide, it is common to investigate all items exceeding 3% of the total value of the population. The total value of the high value transactions examined should be calculated and recorded on the audit file along with the percentage this bears to the whole population.

Auditors should bear in mind that the results of this 100% check of part of the population cannot be used to draw conclusions about any other strata of the whole population. However, the auditor obtains assurance about the presentation of a significant value of the population.

Key item selection

Transactions from each different type of account balance which are known to be risk prone can be identified. Guidance on the risk prone items for selected account balances is shown in the Table below. It is important to note that this is not an exhaustive list and auditors should put forward their suggestions for key items when they are conducting the audit.

In drawing conclusions about the population of key items auditors should take care to draw conclusions only about the key item population and the specific objective being tested. The results should not be applied to any other part of the audit sample.

4.3.11. Guidance on key item selection for different account balances

The object of the key item selection is to choose those items which are risk prone. This may be due to the nature of the transaction, the people incurring it or the system through which it is processed.

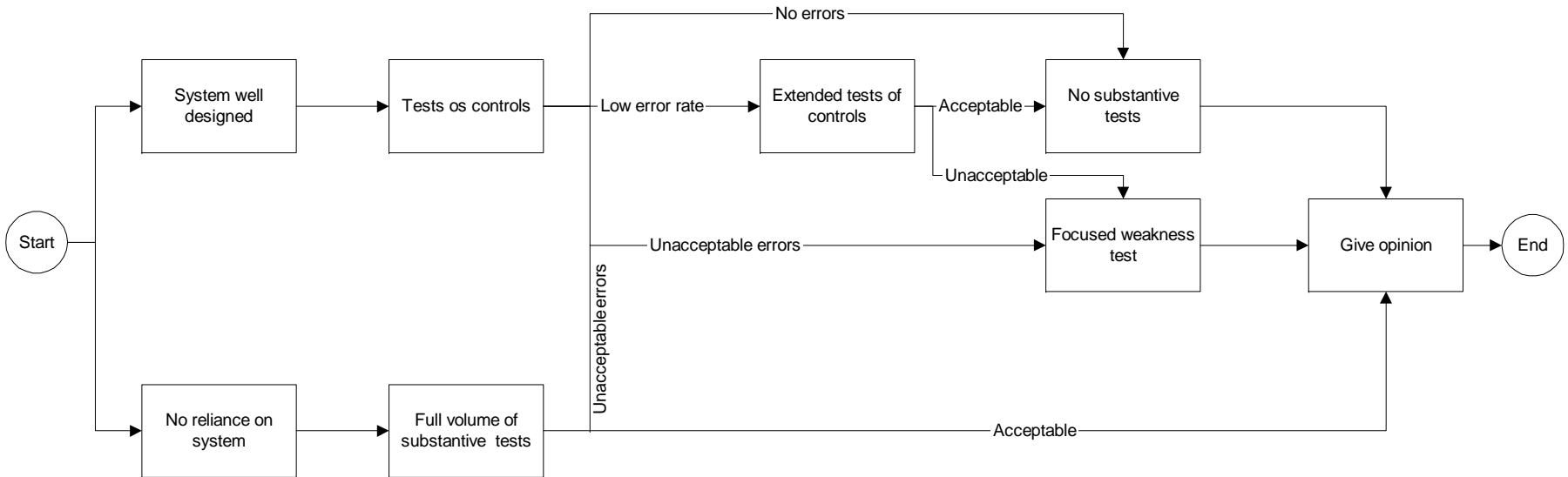
| Account balance | Suggested key item selection | Objective of test |
|--------------------------|--|---|
| Payroll | <ul style="list-style-type: none"> • Starters, leavers, people transferred or retired who may be kept on the payroll as ghosts • Pay levels of salaries section, accountants and computer section staff • Pay rates and amounts of temporarily employed staff particularly on projects • Attendance and time recording | <ul style="list-style-type: none"> • Substantiation of salary payments using a witnessed pay out • Substantiation of salary rates from prime documents of authority • Both of the above • Confirm that staff are attending for the full paid hours |
| Expenditure and payments | <ul style="list-style-type: none"> • Hand written invoices and small piece meal purchases • Non-recurring creditors • Purchases from abroad • Purchases without quotations • Continuing purchases or contracts with only one supplier | <ul style="list-style-type: none"> • Substantiation of payments to small suppliers • Substantiation of the reason for use of unofficial suppliers • Substantiation of the item(s) purchased and confirmation of the justification for the purchase • Confirmation that tendering and contracting arrangements for those suppliers were in accordance with financial regulations |

| Account balance | Suggested key item selection | Objective of test |
|--------------------------------|---|--|
| Project payments | <ul style="list-style-type: none"> • Administrative expenses • Salaries paid to permanent employees | <ul style="list-style-type: none"> • Confirm that these are reasonable • Confirm that the employees are contributing to the project • |
| Major contractual payments | <ul style="list-style-type: none"> • Tendering arrangements for major works • Payments to contractors • Major items maintenance and contractual payments | <ul style="list-style-type: none"> • Confirm that regulations have been followed in the award of contracts • Confirm that all payments over specified amount have been checked and approved by the authorized person • Confirm that the work has actually been done |
| Stocks and stores transactions | <ul style="list-style-type: none"> • Slow moving balances • Items with general domestic use • Stock shrinkage | <ul style="list-style-type: none"> • Substantiation of stores value and write off to the operating statement • Substantiation of regular use of purchases • Confirm the reason for the losses |
| Transport | <ul style="list-style-type: none"> • Vehicles and plant with low utilisation • Private use | <ul style="list-style-type: none"> • Maintenance of uneconomic plant and vehicles • Irregular use |
| Revenues | <ul style="list-style-type: none"> • Taxes levied more than one month after the due date • Taxes unpaid and in dispute | <ul style="list-style-type: none"> • Confirm reasonableness of the reason for late billing • Establish origin of dispute and confirm that it is reasonable |

| | | |
|--|---|--|
| | <ul style="list-style-type: none"> • Old uncollected and/or unpaid balances • Services to staff on credit | <ul style="list-style-type: none"> • Over valuation of assets and under valuation of bad debts reserve • Irregular use of discount facilities and poor cash flow |
| Properties including equipment and general inventory | <ul style="list-style-type: none"> • Attractive items • Disposals of properties of any sort | <ul style="list-style-type: none"> • Substantiation that items exist • Confirm that they were no longer useful to the entity • Confirm that disposal arrangements were in accordance with financial regulations |

4.3.12. Critical decisions in the chain of audit testing

The key decisions on the type of audit tests to be applied in a particular situation are illustrated in the attached diagram **Testing decision tree**



4.4. TYPES OF ERROR

4.4.1. Substantive error

A physical difference between the transaction or property being examined and what the auditor expects to find. For example, a monetary error on a transaction or a property, this cannot be located.

Such an error might result in the auditor deciding to extend the programme of tests and if fraud is suspected, this might lead to a special investigation.

4.4.2. Walk through error

A failure of a document or process to follow the system described to the auditor. Changes to the audit documentation should only be made after the auditor has confirmed the correctness of the revised system.

Such an error might mean that the person describing the system failed to remember the details of the system operation. In this case, if the error is confirmed, the audit documentation should be amended. If, on the other hand, the error indicates that the person did not understand the system which they are responsible for implementing, then this may have implications on the way controls are performed and hence may affect the auditor's evaluation of the effectiveness of the system.

4.4.3. Tests of control error

A failure to operate a control in a manner intended by management, a failure to record evidence of the operation of the control or failure to comply with individual rules, regulations or policies which establish or exercise control.

In evaluating these results the auditor should bear in mind that a failure to carry out these operations may not affect the completeness, measurement or regularity of a transaction. Indeed, it is a fair assertion that the majority of transactions are correctly recorded when they occur which is normally before control procedures come into operation.

4.5. VALUATION OF SAMPLING RESULTS

Whenever audit work is carried out by sampling methods rather than testing of entire populations, it is necessary to consider how these results should be interpreted. The results of tests on relatively small samples will be used:

- as the basis for reporting conclusions on whole systems and batches of transactions to management
- as the basis for internal audit conclusions on the overall effectiveness of accounting, financial and operating systems
- to guide further preventative and investigative action to be taken by management

It is therefore of critical importance that the conclusions and recommendations drawn from samples reflect the underlying characteristics of the whole population. In practice, the sampling methods used should provide 95% confidence that the conclusions drawn by the auditor from sample testing are reflective of the underlying characteristics of the population.

The method of interpreting sample results depends fundamentally on two things:

- the type of audit test being conducted
- the type of sampling and method of selection

4.5.1. Types of audit tests

Walk through tests

The first and easiest case relates to walk through tests. Discovery of errors on a walk through test usually mean that the auditor has not properly understood the way the system works – either in theory or in practice. Usually it means that the system does not actually work the way it was designed or documented. The auditor therefore needs to update his / her understanding and documentation of the operation of the system.

Occasionally, an error on a walk through test can mean that a planned control or process was omitted for this particular transaction. The auditor should therefore note this as an error and include this item in the future sample. (S)he should also conduct another walk through test on a different item, to confirm the correct operation of the system.

Tests of Controls / Extended Tests of Controls

Tests of controls are designed to assess the practical effectiveness of the internal control framework in place. They provide evidence over the effectiveness of controls in reducing material

risks to the organisation, such as the potential for physical loss of resources. Controls are a preventative measure. The absence or poor operation of a control does not imply that a loss has occurred; but it does mean that an error, accidental or otherwise, may not be detected. This increases the risk of an error occurring, and makes the organisation more vulnerable to fraud and corruption. Internal audit focuses on controls rather than transaction testing where possible, because controls are a proactive measure which can prevent loss, while transaction testing identifies losses after they have occurred.

In evaluating the results of tests of controls therefore, it is important to emphasise that weaknesses lead to increased risk, but that tests of controls will not normally identify actual loss. Where controls are weak, the auditor will normally supplement tests of controls with substantive tests, which can provide evidence on the size of losses incurred by an organisation as a result of a poor control framework.

Where extended tests of controls are used, these should be treated in the same way as tests of controls, though possibly applied to a sub-group of the original population.

Substantive / weakness tests

Substantive tests over individual transactions can provide evidence on the correctness of the processing of groups of transactions. It can be used as an indirect way of identifying whether controls operated satisfactorily in practice, though it can not differentiate between transactions that were checked as valid and transactions that were valid but not checked. However, the discovery of errors provides evidence that a system of controls was not operating effectively. Thus substantive testing can confirm when a system is not working properly, but is unlikely to provide substantial evidence that a system of control is functioning effectively.

Conclusions relating to substantive testing should therefore emphasise that it does not provide positive evidence on a system of internal controls. However, unlike controls testing, it can be used to provide estimates of losses incurred in a whole population, based on the rates of losses observed in a sample.

Where weakness tests are used, these should be treated in the same way as substantive tests, but applied to the specific sub-group of the original population that exhibits these weaknesses, e.g. all payments processed by a particular individual.

4.5.2. Type of sampling and method of selection

Results from different sampling methods require different interpretation.

Statistical attribute sampling

This involves random selection of items across a whole population, such that each item has the same probability of being selected, regardless of its value. Errors found in tests selected by this

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method should be assessed as error rates, e.g. 3/30 or 10% error rate. Assuming there has been no bias in the method of sample selection, it is appropriate to conclude that this error is the best estimate of the error rate in the whole population. So for tests of controls, the auditor could conclude that controls are not applied to 10% of transactions. For substantive tests, for example on the validity of payments, the auditor could conclude that 10% of the payments were not valid. The best estimate would then be that 10% by value of the payments were invalid.

When evaluating errors, the auditor should pay careful attention to the cause of the errors found. If, for example, most errors relate to transactions processed in a particular month or by a particular employee, then it would be appropriate to regard this as a separate population with its own error rate. Interpretation and evaluation of errors in these cases are given below under stratified attribute sampling.

Stratified attribute sampling

This involves stratifying the population to be tested according to key attributes which are expected to influence the results of the tests. For example, payments over a certain value may be subject to additional control checks and are therefore less likely to contain errors. Testing a sample of payments which includes payments under and over this value may not be appropriate. Error rates found from testing items under this value could not be applied to transactions over this value. Similarly, payments processed in very busy periods, or by new and inexperienced staff, may not be representative of the population as a whole.

Once a population has been stratified into sub-populations, which have then been tested separately, it is important to evaluate the results separately. The error rates for each test should be applied to that specific sub-population, and the overall error rate will therefore be a weighted average of the individual error rates. The process for calculating the overall error rate is illustrated below.

| Sub-population (shillings) | Number of errors / sample size | Population value | Sample error rate | Forecast error | Population error rate |
|-----------------------------------|---------------------------------------|-------------------------|--------------------------|-----------------------|------------------------------|
| 0 - 10,000 | 20/100 | 3,500,000 | 20% | 700,000 | 20% |
| 10,001 - 100,000 | 5/50 | 6,700,000 | 10% | 670,000 | 10% |
| 100,001 - 1,000,000 | 0/3 | 4,800,000 | 0% | 0 | 0% |
| Total population | 25/153 | 15,000,000 | | 1,370,000 | 9.1% |

Note here that the error rate from the sample is $25/153 = 16.3\%$ but the actual error rate for the whole population would be estimated as 9.1% ($1,370,000/15,000,000$).

Alternative sampling approach – selection of high value and key items

Where a non-statistical approach is used to select a sample, but picking out items over a certain value, and key items (e.g. new employees on a payroll test), it is not valid to consider errors on

these key items as representative of the sample as a whole. This is because we have already identified these particular transactions or properties as having different characteristics to the rest of the population.

Key items selected should be regarded as a separate sub-population subject to 100% testing. Therefore the actual value of errors found is the error in the whole sub-population. Testing of key items should always be accompanied by statistical / random testing of the remainder of the population. Error rates found in the remaining population should then be extrapolated in the usual manner. The overall error rate for the population as a whole should be calculated as in the above example, treating key items as a separate sub-population.

4.5.3. Reporting results of sample tests

The purpose of reporting the results of audit tests is to provide information to management on the operation of financial, accounting and operational systems. To aid management, internal audit should make that information as clear and understandable as possible.

It is recommended that reports clearly identify to management:

- the importance of the control or transaction tested
- the nature and purpose of the test conducted
- the results of the test, in a standard form such as percentage compliance
- a firm conclusion, on whether the control was in place or the transactions valid
- the implication of findings for the effective operation of the organisation
- recommendations to management on action to address weaknesses found

An example of the results of an audit test into the authorisation of payments is illustrated below:

1. Internal audit reviewed the process for authorising payments in the Ministry of Health.
2. Effective authorisation of payments is required under financial regulations, and is important to ensure that only valid and necessary payments are made, relating to goods and services received by the Ministry.
3. Internal audit reviewed a sample of 120 payments to ensure that the invoice had been matched to a purchase request form, signed by an authorised officer; that the invoice amount had been properly calculated; and that the correct payment had been made.
4. In 6 cases (5%), the invoices could not be traced to an appropriate authorised order. After discussion with officers in the Ministry of Health, it was concluded that the payments should not have been made.
5. The total loss to the Ministry was 45,000 MKD. Estimates of the potential loss from unauthorised payments for the whole Ministry are around 560,000 MKD.
6. Internal audit therefore conclude that there is an ineffective system for ensuring that the validity of payments.
7. This lack of effective control represents a significant weakness to the operation of systems of internal control, and poses a fundamental risk to the organisation.
8. It is recommended that:
 - management review its system for matching invoices to approved orders
 - managers are reminded of the need to monitor spending against their budgets closely and regularly
 - spot checks are carried out on the authorisation of invoices, to ensure all processing clerks are carrying out their duties effectively.

4.5.4. Forming opinions based on sample results

In order to direct management resources towards the most significant issues, internal audit should categorise any weaknesses found as fundamental, serious or minor. This categorisation should be at the front of auditors' minds when designing and conducting audit tests.

In order to provide an opinion to management on the results of individual tests and on the overall control framework in the organisation, auditors should therefore bear in mind the following factors:

Nature of systems and materiality

Errors on fundamental systems pose a greater risk to the organisation than errors in non-fundamental and minor systems. This should be reflected in internal audit reports. Similarly, when errors are discovered, the projected value of these errors should be compared to the materiality value. Projected errors exceeding materiality represent fundamental weaknesses which need to be investigated and addressed immediately. Projected errors below materiality are serious, but may not compromise the ability of the organisation to achieve its objectives.

Type and Rate of Error

Some controls, and therefore some audit tests, are more important than others. For example, a control which safeguards a physical asset or resource may be considered more fundamental than a control which checks the level of authorisation or timeliness of processing of a transaction. Also, an error rate of 5% in the application of a control check may be regarded as acceptable to

management (as the majority of transactions to which the control is applied are likely to be satisfactory anyway), whilst an error rate of 50% may be regarded as so high that unauthorised transactions may be processed, and the laxity of controls may actually increase incidents of fraud and corruption.

Compensating controls

In many cases, a weak control in one area may not be a significant problem to the organisation if there is a strong control operating elsewhere in the system that would identify any errors missed by the first weak control. Compensating controls may also include the overall budgetary framework and governance arrangements. For example, a weak control of authorisation of payments may be compensated for by a strong budgetary control framework in which all budget holders regularly review details of profiled expenditure against their budgets.

Combination of System Weaknesses

Similarly, a minor weakness in one area may be compounded by weaknesses in other areas and a poor overall control framework. Where this is the case, a series of minor but related errors may together pose a significant risk to the organisation. Internal auditors should therefore evaluate the results of individual tests in the context of other audit findings, to provide a picture on the control system of the organisation as a whole.

Adverse Reports to the Manager in charge

Where an individual control weakness or the overall control environment is considered so fundamental that it adversely affects the ability of the organisation to meet its objectives, internal audit should consider issuing an adverse report to the accounting officer. Such action should not be done lightly, but after discussions with the manager in charge and HIA. If internal audit regard every weakness as fundamental, the manager in charge will be less likely to carry out actions suggested by internal audit. However, if this tool is used sparingly it can prompt management to take decisive, corrective action when it is really needed.