



*"Pacific Auditors Working Together"*

# PRACTICAL ADVICE FOR AUDITORS OF FOREIGN AID PROJECTS IN THE PACIFIC



FIRST CO-OPERATIVE FINANCIAL AUDIT





# FOREWORD

With a worldwide focus on the UN Sustainable Development Goals (SDGs) there is an ever-increasing quantity of aid flowing into developing countries relating to SDGs. This requires governments to be even more responsible for the transparent and accountable use of funds provided by foreign aid, whether it is for SDG implementation or government projects. In the Pacific this can be even more challenging and highlights the need for a strong country financial system to manage these aid funds honestly and fairly, to ensure they are meeting the needs of the targeted government projects.

As a result, SAIs are being relied upon to conduct more and more of these audits of foreign aid projects, to ensure implementing government agencies have effective systems in place to ensure accountable and transparent use of funds provided by foreign aid. SAIs play a critical role in ensuring this by providing audit recommendations to enhance the efficiency, effectiveness and economy of programs funded by foreign aid. This will ultimately make a difference to the lives of the citizens.

This Co-operative Financial Audit highlighted that there is still room to improve SAI capacity. As a consequence PASAI is developing programs and activities that will meet the capacity needs of our member SAIs to achieve high quality audits of public sector funds, including funds provided by foreign aid.

As some key lessons gained from this regional program target auditors, it is necessary for SAIs to understand the importance of applying a risk-based approach to financial and compliance audits according to ISSAIs, when auditing foreign aid projects. A key lesson for development partners is to use the opportunity when providing foreign aid to developing countries, to build resilient, responsive and robust public financial management systems that will enhance accountability and transparency for all foreign aid provided.

This regional report is an output of the collective efforts of six SAIs and I commend this report as an example of “Pacific Auditors Working Together” to achieve the strategic priorities of the PASAI Strategic Plan and to assist governments in their preparedness to implement SDGs.



**Ihlen Joseph**

PASAI Governing Board Chairman

## Acknowledgements

INTOSAI Development Initiative (IDI) for supporting this program and the six Heads of SAI from Cook Islands, Fiji, Kiribati, Tonga, Tuvalu and Samoa. In particular, we acknowledge the ongoing support from PASAI's performance audit advisor Ms Claire Kelly and to the Cook Island Audit Office for releasing their former Senior Audit Manager Ms Aolele Su'a Aloese to participate in the reporting workshop as the subject matter expert. Last but not least, to all the audit teams that participated - thank you for your enthusiasm and eagerness to make a change to improve the way you conduct financial audits.



## 1st Cooperative Financial Audit Foreign Aided Projects

27 March - 02 April 2014

*Nuku'alofa, Kingdom of Tonga*



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# GLOSSARY OF TERMS

<b>DEVELOPMENT AID</b>	Refer to Foreign Aid term below
<b>DEVELOPMENT PARTNERS</b>	For the purposes of this report this term is used to refer to the donor agency or multilateral donor agency that is providing foreign aid (example: Department of Foreign Aid and Trade (Australia Aid), Ministry of Foreign Aid and Trade (NZ Aid), World Bank Group, Asia Development Bank). <sup>1</sup>
<b>EXECUTING AGENCY</b>	This is the responsible government agency that signs the funding agreement with the development partner and is responsible for high level monitoring and certified disbursements. Usually this is the Ministry of Finance.
<b>FOREIGN AID</b>	International transfer of capital, goods, or services from a country or international organisation for the benefit of the recipient country or its population. In the international development community the term foreign aid or external assistance or development assistance or development aid is often used synonymously, however for the purpose of this report the term foreign aid will be used and refers to the OECD definition referred to as official development assistance (ODA), which is assistance given to promote development and to combat poverty. This term can be used interchangeably with development aid. However, for the purposes of this report, the term foreign aid is used because this co-operative program was endorsed by Congress as such.
<b>IMPLEMENTING AGENCY</b>	The implementing agency is the responsible ministry that will either end up using the infrastructure or service funded and/or supervises and monitors the Project Management Unit (PMU) of a particular project. This usually includes the responsibility for the accounting and reporting of the funds.
<b>ISSAIS</b>	International Standards of Supreme Audit Institutions. The ISSAIs is a framework of standards within INTOSAI. The ISSAIs can be found on the following website: <a href="http://www.issai.org">www.issai.org</a>
<b>PMU</b>	Project Management Unit is the generic term that is given to a unit established by the implementing agency to carry out particular functions to implement this project or program. These usually are the procurement, accounting processing and financial reporting functions. Sometimes these PMU's are established within the Ministry of Finance (executing agency) with contracted staff to project manage the project/program funded by foreign aid.



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<sup>1</sup> This term is also used to refer to non-government organisations and civil society who act as development partners with various government agencies/organisations.

# EXECUTIVE SUMMARY

The regional co-operative audit of funds provided by foreign aid was the first pilot for a co-operative financial audit conducted by the Pacific Association of Supreme Audit Institutions (PASAI) under its co-operative audit program. Supreme Audit Institutions (SAIs) in six Pacific Island Countries (PICs) conducted individual audits. This report summarises the findings across the six individual audits conducted and identifies some of the common weaknesses in the audit of foreign aid projects. Furthermore this pilot program resulted in multiple observations and lessons learned which will assist SAIs in the conduct of financial audits of foreign aid projects in the future.

It is expected that both SAIs and development partners in the Pacific Region may learn valuable lessons from individual SAI reports as well as from this regional report to improve and enhance the quality of the audits of funds provided by foreign aid.

## WHAT IS FOREIGN AID?

The definition of foreign aid <sup>2</sup> is the international transfer of capital, goods, or services from a country or international organisation for the benefit of the recipient country or its population. In the international development community, the term foreign aid or external assistance or development assistance or development aid is often used synonymously. However for the purpose of this report the term foreign aid will be used and refers to the OECD definition referred to as official development assistance (ODA)<sup>3</sup>, which is assistance given to promote development and to combat poverty.

The following graph Figure 1 tracks aid per capita and percentage increase in foreign aid across the Pacific over the last decade and demonstrates the rise in foreign aid dependency:

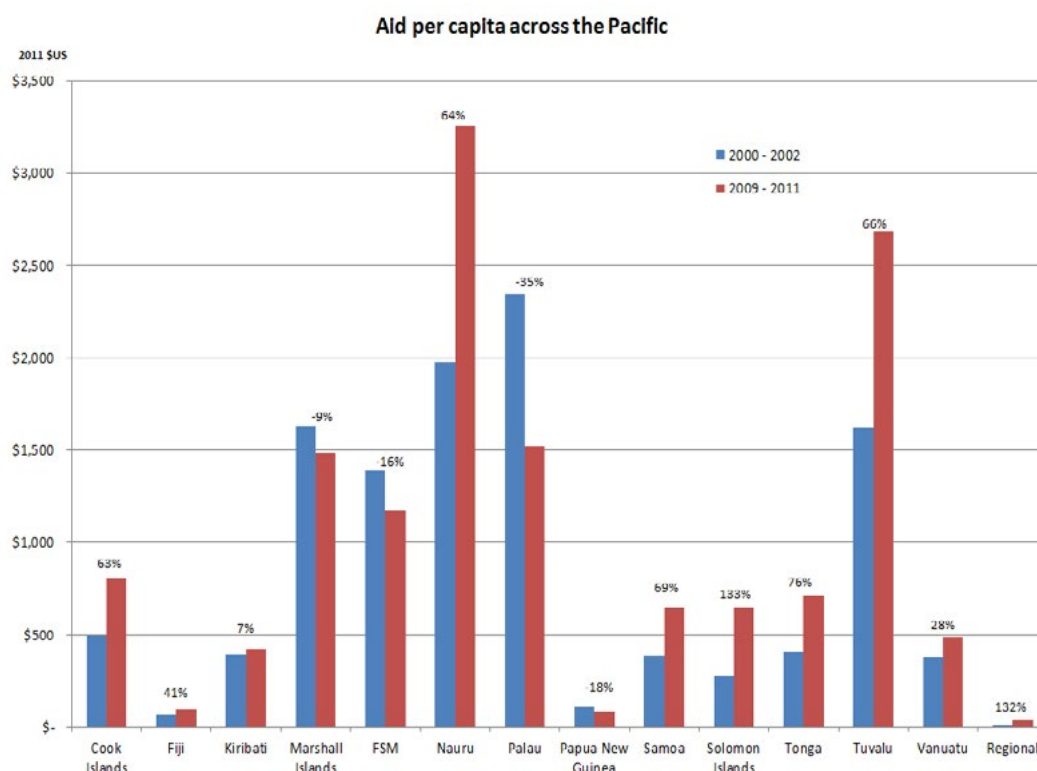


Figure 1 Source: World Bank Databank. Populations for Cook Islands, Nauru and Niue are calculated from the Pacific 2020 report. Figures shown are in \$US million ('000). Note: The percentages indicate the growth of aid per capita between the two periods. An average three-year period is taken to smooth out year to year volatility.

2 Williams, V 2014, 'Foreign aid', Encyclopaedia Britannica, Research Starters, EBSCOhost, viewed 20 September 2016.

3 Flows of official financing administered with the promotion of the economic development and welfare of developing countries as the main objective, and which are concessional in character with a grant element of at least 25 per cent (using a fixed 10 per cent rate of discount). By convention, ODA flows comprise contributions of donor government agencies, at all levels, to developing countries ("bilateral ODA") and to multilateral institutions. ODA receipts comprise disbursements by bilateral donors and multilateral institutions.

SAIs of six countries (Cook Islands, Fiji, Tonga, Tuvalu, Samoa and Kiribati) participated in this cooperative audit and are included in the above Figure. There has been a significant increase in foreign aid from various development partners in the Pacific.

Foreign aid projects are programs designed to promote sustainable development for the recipient countries. However, sometimes Pacific countries have limited internal economic resources and capacity and therefore struggle to meet the accountability requirements attached to foreign aid agreements. Furthermore, different development partners use different implementation and reporting guidelines and require different financial reports to be prepared. This poses challenges for the recipients, especially those in developing countries.

Regardless of the type of project or sector involved or means of disbursing funds, it is important that the implementing government agency within each of these countries or recipients, maintain adequate and clear accounting records of all receipts and expenditure.

The government ministries or implementing agencies are usually responsible for preparing the financial report relating to the foreign aid projects and it is important that these financial reporting systems are robust and efficient to ensure accurate and reliable reporting on the progress of the project. In particular, as governments in the Pacific embrace the 17 UN SDGs, the Forum Island Countries and Small Island Developing States and Territories in the Region will be seeking funding to help strengthen the capacity of national systems to access funds required to implement the SDGs and report accordingly.

## THE ROLE OF SAIS

SAIs have a critical role to play to strengthen government public financial management systems so that they operate in a resilient and responsive manner to the influx of foreign aid received and can provide assurance that these funds are being used to further improve the quality of lives of citizens.<sup>4</sup> The independent audit and scrutiny of foreign aid projects by SAIs is considered a part of a SAI's mandate because the funds when they are received, become part of public funds. During this program the participating SAIs selected audits where foreign aid was provided as part of a funding agreement between their respective government and the development partner, or when auditing the ministry (that receive and administer the funds). During all these circumstances the SAIs objective when conducting these audits was to achieve the following:

- enhance accountability of the foreign aid projects to the recipient governments;
- decrease the opportunity for fraud and corruption, particularly if government public financial management systems are strengthened;
- identify risks for the government to sustain these projects due to substantial maintenance costs such as spare parts, training, interest charges which may not be foreign aid funded; and
- identify weaknesses that will misstate the financial reports; and
- identify weaknesses due to ad hoc arrangements that may result in financial inputs being side tracked away from essential tasks.

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4 ISSAI 12 Value and Benefits of SAIS – Making a difference to the lives of citizens



Development partners rely on SAIs to conduct audits to:

- enhance accountability in the use of the funds provided;
- provide independent assurance that the funds/resources provided have been used appropriately for the intended purpose;
- assess that the outcome of the expenditure of the funds has been achieved.

A program of regular public sector audits can assist governments to strengthen their relationship with development partners through enhancing in-country government public financial management processes.

In summary the SAI's role is crucial to:

- identifying sound and robust public financial management practices for government; and
- promoting accountability and transparency in the reporting of the use of foreign aid funds by encouraging financial data disclosure that is reliable, accurate and relevant in managing these funds from development aid.

## KEY OBJECTIVES AND OUTCOMES OF THE CO-OPERATIVE FINANCIAL AUDIT

The key objectives of this co-operative financial audit are as follows:

Objective 1 – conduct an ISSAI based financial audit	Achieved
Objective 2 – support capacity development of public sector financial auditors	Achieved
Objective 3 – obtain high quality training and expertise during the joint meetings	Achieved
Objective 4 – encourage a uniformly high standard of methodology based on ISSAIs	Achieved

The co-operative audit methodology used is summarised in Section 1 of this report with an emphasis on promoting a risk-based approach to financial auditing, according to Level 4 Financial Audit ISSAIs.

The primary purpose of financial statements or financial accounts of foreign aid projects is to provide relevant and reliable information to users, particularly development partners, about the use of their funds. A financial audit is an independent assessment, resulting in a reasonable assurance opinion, of whether an entity's reported financial condition, results, and use of resources are presented in accordance with the applicable financial reporting framework. A risk-based approach focuses on the entity's business risk i.e. the risk that the entity or in this case the project will fail to achieve its objectives established by the funding agreement.

The INTOSAI Development Initiative (IDI) supported PASAI in the conduct of this co-operative audit. Furthermore IDI/PASAI engaged a technical advisor from the SAI Cook Islands to provide technical support for participating teams during the reporting phase meeting. Overall the key objectives were met and this is supported by the results of an evaluation process obtained from participants, which is in Section 4 of this report.

Additionally from the perspective of PASAI as a regional body, this program has been valuable to obtain a stocktake of the technical competency and existing audit practice of the participating SAIs in relation to conducting financial audits of foreign aid projects. The observations and lessons learned will help PASAI achieve Strategic Priority 3 by assisting SAIs to improve their audit practice to achieve high quality audits.

## ABOUT THE AUDIT

This pilot program was the first time a co-operative financial audit was carried out. The demand for the program was based on the need identified by Heads of SAI to enhance the capacity of their staff in relation to incorporating a risk-based approach in financial auditing practice. This was also an objective of the previous Pacific Regional Audit Initiative (PRAI) and development partners were keen for this program to be delivered.

Practical audit experience and knowledge from colleagues and experts were shared, together with technical support to develop relevant and useful audit recommendations. If implemented, these audit recommendations will help enhance accountability and transparency of the use of foreign aid in the participants' countries. A risk-based approach compliant with International Standards of Supreme Audit Institutions (ISSAIs) was used during the audit and as a result the participants' capacity to conduct a high-quality financial audit was enhanced.

## RISK-BASED APPROACH TO FINANCIAL AUDITS

The topic for this co-operative financial audit (CFA) was easily understood, however the concept of identifying risks and implementing a risk-based approach to this audit was challenging. Traditionally the participating SAIs have substantively audited all documentation for development funds without identifying high level risks.

A risk-based approach focuses on the entity's business risk i.e. the risk that the entity will fail to achieve its objectives. In the context of audits carried out by SAIs, the term "business risks" is also interpreted to mean consideration of the risks of the entity failing to achieve the public policy objectives established by law, regulation or other directives. This approach requires the auditor to be familiar with the entity's strategies and processes in order to understand whether the financial statements are fairly presented. The auditor views all activities in the entity, first in terms of risks to strategies and objectives and then in terms of management's plan and processes to mitigate the risks. <sup>5</sup> **Challenges for Audit teams**

The financial audit methodology was taught to participants and for many, a risk-based approach was a new concept as traditionally they were used to a systems-based approach to auditing. Participants were challenged to adopt this concept of risk-based auditing provided in templates during the audit.

During the planning meeting it was quite evident that the auditors lacked the understanding of the funding agreements, which in most cases were quite lengthy and complex. There was a time constraint during the planning meeting to spend time with each team to go through these funding agreements. To a certain extent, these factors combined to limit the scope of the audits.

## AUDIT FINDINGS

The conduct of a financial audit does not include any scope for the auditor to comment on the efficiency or progress of the project itself or the effectiveness of the foreign aid received by government. This scope falls under the audit requirements of a performance audit. On this basis, the audit reports provided an audit opinion on compliance with the funding agreement.

The audit findings that resulted from the audits are summarised as follows:

1. non –compliance with the funding agreement in relation to procurement processes and reporting requirements
2. weak controls over the disbursement of payments

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5 IDI online RBAFA course materials (do you have a website address for these materials?)

3. poor record management systems
4. lack of asset management processes in place (no fixed assets register)
5. budget reports were not sufficiently comprehensive and were sometimes not prepared according to funding agreements (or project operational manuals)
6. untimely budget reporting which limits their usefulness
7. lack of evidence of governance arrangements such as no signing of minutes of steering committees and no sign off by review panelists to engage contractors

The management responses received from the auditees were positive and in support of the audit recommendations raised by the SAIs.

Overall the foreign aid for these projects was generally managed effectively and as a result the findings were not pervasive and the audit opinions issued were therefore unmodified. However, these audit findings are repeated year after year and usually the auditors do not follow up on the implementation of recommendations until the next annual audit. If these audit issues are not addressed by the implementing agency when the auditors raise them, this increases the opportunity in the future of risk of theft, fraud and misappropriation of funds or assets.

Details of the audit scope, including what constitutes a risk-based approach to financial auditing and audit findings can be found in Section 1 and Section 2 of this report.

## LESSONS FOR SAIS – PRACTICAL ADVICE FOR PUBLIC SECTOR AUDITORS

PASAI has learned that the risk-based approach to financial auditing is not being used consistently due to lack of understanding and the challenge that the SAIs face in ISSAI implementation. Two of the six SAIs that participated (33%) demonstrated the application of the risk-based approach to financial auditing. However, overall there is a need for improvement. Indeed the evaluation highlighted that participants of this co-operative audit built their capacity and knowledge about a risk-based approach. Nevertheless, to improve SAI audit practice by adopting a risk-based financial auditing methodology requires more than just sharing of ideas and knowledge through co-operative audits. In particular the following seven (7) key lessons were learned as a result of the peer review:

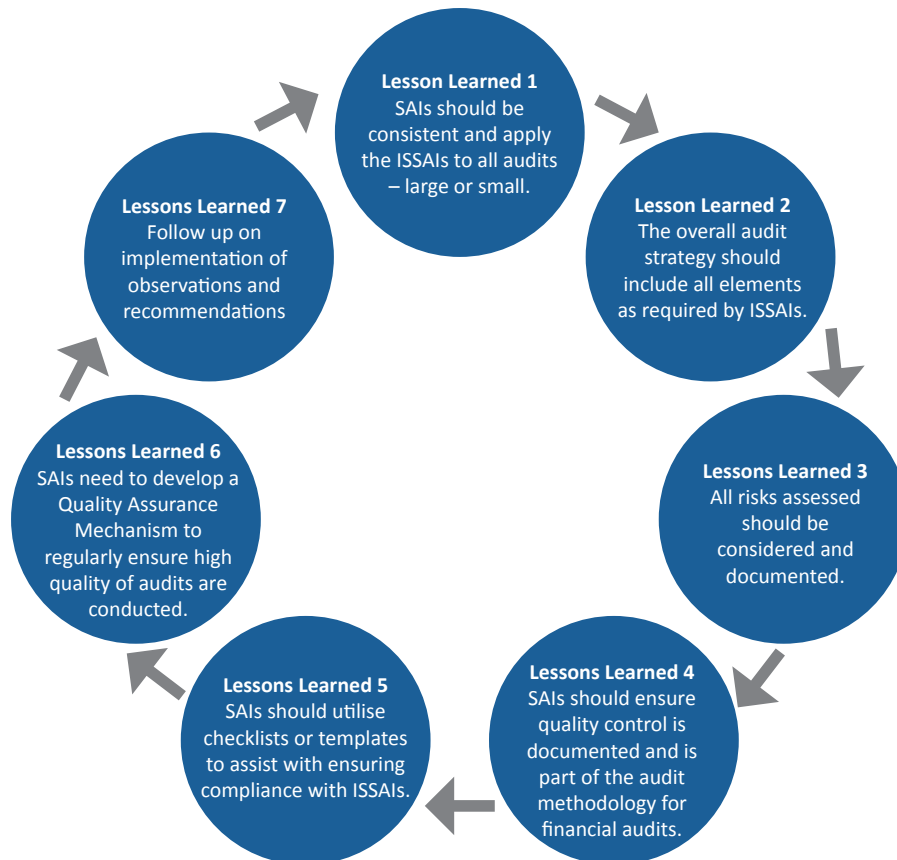


Figure 2: Summary of key lessons for SAIs

The reasons for identifying these seven lessons are provided in Section 3 of this regional report.

Making use of these lessons requires SAIs to assess and improve their own audit practice. This improvement requires that the tone at the top of the SAI is supportive of suggestions for change. It also requires an evaluation of existing audit methodology in order to review and update the current audit practice.

The audit recommendations raised during these audits were reported to the implementing agencies to encourage them to improve their project management and monitoring duties, to ensure foreign aid was being used for the benefit of the government and ultimately the citizens. However when the auditors are not following up with the implementing agency to ensure these audit recommendations are being actioned, the risk is that these matters will not be actioned and potentially there is a risk of fraud, misappropriation of assets or theft.

Auditors are given limited time to carry out these audits. They are usually given a very tight time and lower priority, due to other significant mandated audits. In a risk-based approach, audit resources are directed towards those areas of the financial statements that may contain misstatements (either by error or omission) as a consequence of the risks faced by the business. Therefore, if auditors apply the risk-based approach to all financial audits, this will provide some assurance that significant risks are being identified and addressed, including in audits of foreign aid.

Additional guidance for auditors has been provided in Section 5 of this report.

## LESSONS FOR DEVELOPMENT PARTNERS

During this co-operative program the participants shared their experience and knowledge of these types of audits and the challenges they face when dealing with government implementing agencies and the expectations placed on them by development partners.

PASAI acknowledges that the contractual relationship is between development partners and government. Yet this feedback is provided to development partners to support their work with governments to build resilient, responsive and robust public financial management systems that will enhance accountability and transparency for all foreign aid received:

- development partners are encouraged to facilitate discussions with SAIs and auditees to provide an understanding of the requirements under these funding agreements.
- funding agreements did not specify the financial reporting requirements needed by implementing agencies to manage the projects or programs;
- funding agreements were complex and sometimes difficult to understand and comprehend by implementing agencies;
- development partners impose priorities and timeframes that can impact on country ownership and capacity for projects. This may contribute to milestones for projects being impractical and not being met. This was evident in non-compliance matters including delayed payments, program evaluation reports and project completion reports delayed. These audit issues are raised every year.

## OVERALL CONCLUSION

This co-operative program highlighted from the outset during the planning workshop, the immediate need for training and support to SAIs in relation to an ISSAI compliant risk-based approach to financial audits. There were some key audit findings identified however what this program highlighted was more related to SAIs and the need to improve this capacity in risk-based auditing. In particular:

- there is a lack of understanding of the risk-based approach to financial audits. In particular the audit methodology needs to be developed and updated to reflect the risk-based approach and the SAIs need to strengthen their expertise to adopt this approach;
- participants suggested that making a change requires support from management and sometimes this is difficult to obtain;
- implementing agencies in-country have very little time to prepare the accounts and to get these audited. The timing is usually restricted and there is pressure to get the grant agreement audits done in a small timeframe. Usually there is pressure to get the audits done so that the executing agency can receive their tranches;
- foreign aid funding agreements are generally complex documents and both the executing and implementing agencies may lack an understanding of the requirements to fully meet the conditions of the agreements.

## PASAI - LOOKING FORWARD

PASAI has learned that a risk-based approach is generally lacking within the audit practices of its member SAIs. This co-operative audit program has provided support to our member SAIs to learn about the risk-based approach to financial audits. However providing training and workshops are not sufficient. SAIs need to take responsibility to revise their audit practice and methodology to adopt a risk-based approach according to ISSAIs. This can only occur where there is support from the Head of SAIs.

This program has highlighted areas of focus for capacity building in relation to achieving high quality audits and the next co-operative financial audit (to be designed in 2017) a financial audit of a State Owned Enterprise or the Whole of Government accounts (WOG) / financial statements of Government (FSGs) should provide an opportunity to build on this.

As a regional working group of INTOSAI, this program has helped PASAI identify some areas of focus to:

- encourage SAIs to advocate the need to improve the financial reporting and financial processes within government to align with international standards, so that implementing and executing agencies can effectively and efficiently manage projects funded by foreign aid;
- encourage SAIs to be proactive, advocate for and educate development partners and auditees about the different types of audits and what is involved in carrying out an audit;
- encourage development partners to enhance their engagement with the current financial reporting frameworks that exist in each country and align their project reporting requirements accordingly;
- continue to provide capacity support to SAIs to produce high quality audits in a timely manner to assist governments develop effective, accountable and transparent institutions at all levels.

Finally, this pilot program has emphasised for PASAI that a compliance audit methodology appears to be the more appropriate approach in the audit of foreign aid projects in the region. The ISSAIs for compliance audits are still quite a new concept and PASAI will also work with IDI to improve the understanding of this compliance audit methodology. PASAI will also assist SAIs through its capacity programs to improve their audit practice accordingly to ensure their auditing practice is effective and efficient and of high quality. Though PASAI can provide guidance, in the end the Head of SAI is in the best position to make this professional judgment and consider the most appropriate audit methodology according to his/her audit mandate.

These forward looking objectives align with Strategic Priority 3 - *High quality audits completed by Pacific SAIs on a timely basis* of the PASAI Strategic Plan 2014-24.

## REGIONAL REPORT STRUCTURE

This regional report showcases achievements against the key objectives for this program and reports on the challenges faced to raise the capacity of public sector auditors in the Pacific region, particularly when faced with auditing foreign aid projects. The structure of this regional report is slightly different to previous regional reports and is as follows:

### **Section 1: Description of the co-operative audit approach**

- Participating SAIs and financial audits selected
- Audit objectives and audit scope
- Co-operative audit methodology
- Risk-based approach to financial audits

### **Section 2: Summary of audit findings**

- SAI results: detailed summary of audit findings

### **Section 3: Lessons Learned from peer review**

- Details of the lessons learned for SAIs and development partners.

### **Section 4: Interim Evaluation Results**

### **Section 5: Further Guidance to audit foreign aid projects**



# REGIONAL REPORT

## SECTION 1: THE CO-OPERATIVE AUDIT APPROACH & PARTICIPATING SAIs

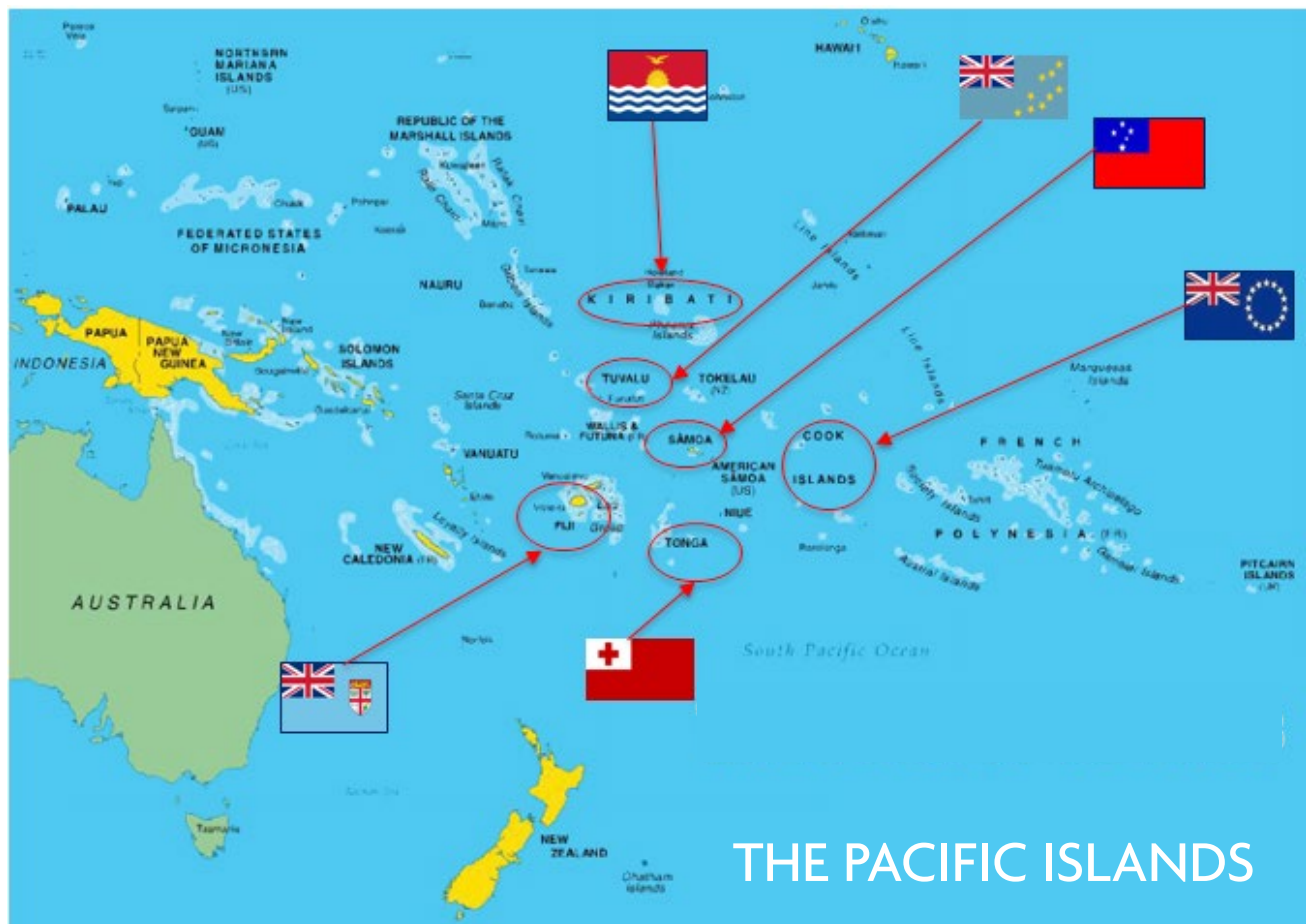
### 1.1 INTRODUCTION

PASAI's Co-operative Audit program was launched at the 12th PASAI Congress in Palau in 2009 as part of the broader Pacific Regional Audit Initiative (PRAI). Since 2009, PASAI has completed five co-operative performance audits following a program approach, which has been quite effective in achieving its objectives. However, this is the first co-operative audit conducted for a financial audit. It has proven to be challenging because many of the participating audit teams were not applying a risk-based approach to the audit and some audit teams were doing this type of auditing for the first time.

### 1.2 PARTICIPATING SAIS AND FINANCIAL AUDITS SELECTED

Six SAIs participated (Cook Islands, Fiji, Kiribati, Samoa, Tonga and Tuvalu) as depicted in Figure 1 below, with 12 participants attending the planning meeting and 10 participants attending the final reporting meeting.

Figure 3: Map of Six participating SAIs



Each team was asked to consider a relevant foreign aid financial audit and to bring with them to the planning meeting a draft set of financial accounts or statements that related to the foreign aid funded project. Table 1. below summarises the audits that were chosen for this co-operative audit which consisted of audits across four sectors supported by four development partners:

*Table 1: Summary of financial audits*

SAI	Audit Entity	Period Audited	Development partner
<b>Cook Islands</b>	Education Sector	30 June 2013	MFAT (NZ Aid)
<b>Fiji</b>	Roads Infrastructure	18 months period ended 30 June 2014	Asian Development Bank (ADB)
<b>Kiribati</b>	Roads Infrastructure	Period ended 31 December 2013	World Bank/ADB
<b>Samoa</b>	Law and Justice Sector	Periods ended 30 June 2013 and 30 June 2014	DFAT (Australia Aid)
<b>Tonga</b>	Aviation Sector	Year ended 30 June 2014	World Bank
<b>Tuvalu</b>	Aviation Sector	Year ended 31 December 2013	World Bank

### 1.3 AUDIT OBJECTIVES AND AUDIT SCOPE

The audit objectives of the co-operative financial audit were to:

- 1) conduct an audit of revenues and expenditures in accordance with funding agreements;
- 2) assess compliance with funding agreements; and
- 3) review the internal controls relating to the use of foreign aid within a particular project or programme.

The above audit objectives are broken down into these specific sub-objectives:

- express an opinion on whether the project’s financial statements present fairly, in all material respects, whether resources received from the development partner agency and expenditure incurred for the periods under audit are in conformity with International Financial Reporting Standards (IFRS) or other relevant financial reporting frameworks compatible with the development partner’s requirements;
- determine if the expenditure reported as incurred under the project agreement are in fact allowable and reasonable;
- evaluate and obtain sufficient understanding of the internal control structure, assess control risk, and identify reportable conditions, including material internal control weaknesses and prepare a management letter reporting weaknesses and findings;
- perform tests to determine whether the implementing and executing agency complied, in all material respects, with the project agreement terms and applicable laws and regulations.



The audit scope is defined as the audit procedures that, in the auditor’s judgment and based on the ISSAIs, are deemed appropriate in the circumstances to achieve the objectives of the audit and issue an appropriate audit opinion.

## 1.4 CO-OPERATIVE AUDIT METHODOLOGY

Figure 4 below provides a summary of the methodology that was followed for this co-operative audit. This methodology is the same as the previous five co-operative programs.



PASAI 6TH CO-OPERATIVE REGIONAL REPORT PUBLISHED IN 2016

*Figure 4: Methodology for the Co-operative Audit*

## 1.5 RISK-BASED APPROACH TO FINANCIAL AUDITS

The primary purpose of financial statements or financial accounts of foreign aid projects is to provide relevant and reliable information to users, particularly development partners, about the use of their funds.

Financial audit is an independent assessment, resulting in a reasonable assurance opinion of whether an entity's reported financial condition, results and use of resources are presented in accordance with the applicable financial reporting framework.

The applicable financial reporting framework is defined in ISSAI 1200.13<sup>6</sup> as following:

*“Applicable financial reporting framework is the financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements or that is required by law or regulation.”*

The following key processes required of a risk-based approach to financial auditing relating to a project funded by development or foreign aid are:

- ⊕ PRELIMINARY ENGAGEMENT ACTIVITIES
- ⊕ OVERALL AUDIT STRATEGY
- ⊕ AUDIT PLANNING PHASE
- ⊕ EXECUTION PHASE
- ⊕ REPORTING PHASE

The following section begins with the **ISSAI requirement** under each phase of the financial audit process then followed by “Key purpose” and “Basic Concepts”.



<sup>6</sup> **ISSAI 1200** Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing [The International Standards of Supreme Audit Institutions, ISSAI, are issued by the International Organization of Supreme Audit Institutions, INTOSAI. For more information visit [www.issai.org](http://www.issai.org).]

## ⊕ PRELIMINARY ENGAGEMENT ACTIVITIES

*ISSAI 1300 Planning an Audit of Financial Statements* requires that the auditor plans to perform an audit to achieve an efficient and effective audit process. The initial planning required the auditor to carry out the following preliminary activities before agreeing to be associated with an entity or perform an audit engagement.

### **Key Purpose**

Preliminary engagement activities that are relevant to developing the overall audit strategy are consideration of relevant ethical requirements, independence, terms of engagement and acceptance and continuance. In particular for foreign aid projects, usually the SAI is approached by the implementing government agency to conduct these audits.

### **Basic Concepts**

The auditor should agree or if the terms of the engagement are clearly mandated, establish a common understanding of the terms of the audit engagement with management or those charged with governance.

## ⊕ OVERALL AUDIT STRATEGY

*ISSAI 1300 Planning an Audit of Financial Statements* requires that the auditor should include documentation and detail key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

### **Key purpose**

To identify preliminary decisions on the focus of the audit including the objective, scope, nature, timing and materiality of the audit.

### **Basic Concepts**

The overall audit strategy is distinct from the audit plan in that it sets the framework for the scope, timing and direction of the audit. This guides the development of the detailed audit plan.

## ⊕ AUDIT PLANNING PHASE

*ISSAI 1300* requires auditors to plan an audit to reduce audit risk to a sufficiently low level. The audit plan includes more detailed information about the nature, timing and extent of audit procedures to be performed by the audit team members in order to obtain sufficient audit evidence to reduce audit risk to an appropriate level.

### **Key purpose**

The auditor carries out risk assessment procedures early in the audit process in response to those risks identified during the understanding of the entity and its environment. Risk Assessment Procedures is a key requirement of *ISSAI 1315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. Also *ISSAI 1330 The Auditor's Responses to Assessed Risks* should also be considered as part of the audit-planning phase.

### **Basic Concepts**

It is important that the auditor gains an understanding of the entity and its environment and the nature of its transactions to identify potential risks of material misstatements. This includes understanding the Entity's Internal Control, Control Environment, Information systems and the entity's risk assessment process.

## ⊕ EXECUTION PHASE

Risk of material misstatement forms the theoretical starting point for the designing of further audit procedures, including tests of controls, analytical procedures and tests of details. This theoretical starting point means that audit planning should direct audit procedures to those areas where the risk of material misstatement is the greatest.

In making risk assessments, the auditor should identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. It is useful to obtain an understanding of controls and relate them to assertions in the context of the processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

### **Key purpose**

At the execution stage, the auditors should ensure fulfilment of the audit objectives and conduct audit procedures to meet these objectives and address the risks identified during audit planning phase.

### **Basic Concepts**

Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements, and are used by the auditor to consider the different types of potential misstatements that may occur. Management assertions are an accepted method for classifying misstatements.

## ⊕ REPORTING PHASE

During this phase, the auditor should accumulate misstatements identified during the audit, and communicate with management and those charged with governance as appropriate on a timely basis, all misstatements accumulated during the course of the audit. It is important to consider all misstatements in order to have a record of the impact of the audit, bring all misstatements to the attention of the appropriate level of management, and assist the auditor in evaluating the risk of further misstatements as a part of the consideration of unadjusted misstatements. After having completed the audit work, the auditor should form an opinion, based on an evaluation of the conclusions drawn from the audit evidence obtained, on whether the financial statements as a whole are prepared in accordance with the applicable financial reporting framework. The opinion should be expressed clearly through a written report that also describes the basis for that opinion.

### **Key purpose**

The auditor should be able to assess the results of the audit conducted and form an independent audit opinion and issue a written report to the audited entity.

### **Basic Concepts**

If the auditor concludes that the financial statements are free from material misstatement, he or she issues an unmodified auditor's opinion. However, if the auditor concludes that a material misstatement is present, the auditor's opinion must be modified. When the auditor modifies the audit opinion, the auditor uses the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph.



RBAFA workshop for Tonga SAI from 11-10 September 2014



## SECTION 2: SUMMARY OF AUDIT FINDINGS

The audits selected by participating SAIs varied and the requirements were different for each development partner. Table 2. below provides an overview and details of the findings and summary of audit opinions issued. From these results, the projects were generally managed effectively and as a result the findings were not pervasive, therefore the audit opinion issued was unmodified. However these audit findings are repeated year after year and usually the auditors do not follow up on the implementation of recommendations until the next annual audit. If these audit issues are not addressed by the implementing or executing agency (or those charged with governance of these programs/projects) when they are raised by the auditors, this increases the opportunity in the future of risk of theft, fraud and misappropriation of funds or assets.

**Table 2: Detailed summary of audit findings and audit opinions of six SAIs**

SAI	Audit Entity ("entity")	Devel- opment Partner	Accounting Standards	Audit findings		Audit Opin- ion/ Financial Statements
				Non compliance	Payments	
<b>Cook Islands</b>	Education Sector	MFAT (NZ Aid)	IPSAS	<p><b>Property plant and Equipment (PPE)</b></p> <p>The entity did not undertake a year-end stock take of property plant and equipment.</p> <p>The entity needs to refrain from grouping assets within the PPE register without assigning individual identification numbers.</p>		<b>Unmodified /</b>  Financial statements (general purpose)
<b>Fiji</b>	Roads Infrastructure	ADB	Generally Accepted Accounting Principles (GAAP) & ADB Loan Agreement No 2514-FIJ	<p><b>Accessibility to information</b></p> <p>Audit was not able to obtain and review any progress reports from the Project Management or contractors.</p>	<p><b>Late payments</b></p> <p>Expenditures recorded in the project financial statements at year end are late</p>	<b>Unmodified/</b>  <b>Special purpose financial statements</b>
<b>Kiribati</b>	Roads Infrastructure	World Bank/ ADB	Modified cash basis	<p><b>Absence of Annual Budget</b></p> <p>The entity failed to prepare an annual budget according to the Project Operational Manual</p> <p><b>Timesheets</b></p> <p>The consultants did not maintain a timesheet but it was completed on their behalf by the finance manager</p>	<p><b>Payment system control improvement</b></p> <p>No indication that the internal review and checks have been carried out by authorised personnel</p> <p><b>Unauthorised payments</b></p> <p>There is no indication that payments have been authorised according to the payment policy system</p>	<b>Unmodified/</b>  Financial statements according to donor and GoK (Project Operation Manual)

SAI	Audit Entity ("entity")	Development Partner	Accounting Standards	Audit findings		Audit Opin- ion/ Financial Statements
				Non compliance	Payments	
Samoa	Law and Justice Sector	DFAT (Australia Aid)	GAAP as per the Direct Funding Agreement	<p><b>Program Evaluation report and Project Completion report delayed</b></p> <p>The Direct Funding Agreement requires the program evaluation report to be submitted one month prior to the end of the Funding agreement. However this was submitted on 15 December 2014 the month the funding ended.</p> <p><b>Minutes of Steering Committee not signed</b></p> <p>The minutes were not approved or signed by the Chairperson.</p>		Unmodified/ Special purpose Financial Statements
Tonga	Aviation Sector	World Bank	GAAP approved by Government of Tonga	<p><b>Procurement manual not provided</b></p> <p>The procurement manual and policy was not provided to audit.</p> <p><b>Contract Management Database</b></p> <p>This should be in place to monitor all contracts</p> <p><b>Review panellists do not sign</b> the Statement of Confidentiality, Ethical Conduct, Corruption and Fraud Declaration Form Not in the world bank guidelines but good practice</p> <p><b>Frequency of National Committee Meetings</b></p> <p>According to the Project Operational manual this committee should meet no less than quarterly</p> <p><b>Minutes of Meetings should be signed</b></p>	<p><b>Progress reports from a contractor had not been submitted</b></p> <p>The contractor should submit monthly progress reports to the project management however this was not done.</p>	Unmodified/ Financial Statements  General Purpose
Tuvalu	Aviation Sector	World Bank	IPSAS Cash Basis		<p><b>Costs incorrectly shared</b></p> <p>Payments made relating to cost share activities are incorrect. These costs should be reviewed closely before allocation.</p>	Unmodified/ Financial Statements General purpose

## SECTION 3: LESSONS LEARNED FROM PEER REVIEW

Overall the audits conducted were completed satisfactorily however, the peer review highlighted many issues for the attention of PASAI in relation to the audit methodology being used by member SAIs to conduct financial audits. In particular, these results have helped PASAI identify the need to improve audit quality, and are part of the efforts under PASAI's Strategic Priority 3. This peer review highlighted that PASAI needs to carry out further assessment and provide technical support for each SAI on a case-by-case basis to assist with high quality audits. This ongoing work with SAIs and the knowledge gained about capacity needs, will form the basis for the design and delivery of a second co-operative financial audit program. SAIs will be invited to participate.

### 3.1 LESSONS LEARNED FOR SAIS

The six SAIs that participated conducted a peer review over their audit files to assess how the risk-based approach in auditing was applied during this co-operative audit. Each SAI brought audit files and copies of audit reports and management reports for this peer review. During this peer review it became obvious that there was still room for improvement especially concerning the application of a risk-based approach to financial audits. The following is a summary of the peer review and lessons learned:

#### ⊕ PRELIMINARY ENGAGEMENT ACTIVITIES

##### **SAI Audit Results**

The code of ethics declaration and the competency matrix of the audit team were not addressed by all the participating SAIs.

There was no evidence that an agreed term of engagement was completed.

##### **Lessons Learned 1**

- SAIs should ensure that they complete the same level of preliminary engagement activities to all audits conducted. All of the participating SAIs treated these foreign aid project audits as small audits and didn't apply the ISSAI 1300 as they would have done for a department.

#### ⊕ OVERALL AUDIT STRATEGY

##### **SAI Audit Results**

There was a lack of justification or rationale for the materiality levels identified.

##### **Lessons Learned 2**

- SAIs should, no matter how big or small the audit engagement is, ensure a rationale is supported for all key aspects of the overall audit strategy.
- More than half of the participating SAIs included budgeted hours in their overall audit strategy or plan, but did not report on actual hours at the completion of the audit.

#### ⊕ AUDIT PLANNING PHASE

##### **SAI Audit Results**

There was no separate document that highlighted the risks assessed. Many of the SAIs could improve their understanding of the industry or the project when assessing and identifying risks of material misstatement due to fraud or error.



### Lessons Learned 3

- SAIs should develop an understanding of the ISSAIs relating to a risk-based approach to financial audits.
- SAIs should ensure they document these assessed risks, and their impact on the material misstatement of the financial statements or accounts.
- SAIs did not document any information about the Information System used by implementing agencies.
- The type of audits selected for this co-operative audit should have been a State Owned Enterprise or a Ministry to apply the risk-based approach to financial audits.

## ⊕ EXECUTION PHASE

### SAI Audit Results

All participating SAIs did not adequately document the link between the risks identified and the audit procedures conducted. Also internal control conclusions and substantive tests performed were not clearly documented for all SAIs.

Overall quality control for the audit process was not present in all SAI audit files.

### Lessons Learned 4

- SAIs should ensure quality control is documented and is part of the audit methodology for financial audits.
- SAIs should enhance and improve their audit methodology by including templates to guide financial auditors to ensure they follow the risk-based approach to financial audits (RBAFA). In particular, SAIs should consider the use of the templates from the IDI online course for RBAFA that were provided to participants during the planning meeting.

## ⊕ REPORTING PHASE

### SAI Audit Results

The participating SAIs did not have evidence that they carried out a disclosure check including a review of subsequent events. There was also no evidence that fraud or ongoing concern matters were checked. Quality control was also noted as an important area for improvement.

Additionally many of the audit reports did not follow the ISSAI format requirement.

### Lessons Learned 5

- SAIs should utilise checklists or templates to validate that the completion steps of an audit are carried out and are evidenced in the working papers. This will give assurance that SAIs comply with ISSAIs, therefore ensuring that high quality audits are completed and the correct opinion given.

### Lessons Learned 6

- SAIs should ensure a Quality Assurance mechanism is in place so that there is a degree of assurance that the quality of the audits completed are in accordance with the relevant ISSAIs.

## Lessons Learned 7

- SAIs should have an appropriate system for ensuring audited entities take appropriate action on observations and recommendations made by the SAI, and possibly by others charged with governance of the entity. This should include the opportunity for the audited entity to respond to the recommendations, as well as the SAI undertaking follow-up, reporting on findings of follow-up activities in an appropriate manner, and where necessary reporting publicly on such findings.

Overall the conduct of the audits were to an adequate standard, however these lessons learned highlight areas of improvement to achieve high quality audits.

### 3.2 LESSONS LEARNED FOR DEVELOPMENT PARTNERS

As a result of this program, through observations and discussions with the participating SAIs they also provided some feedback for development partners that provide development aid. This feedback is provided so that development partners work with governments to build resilient, responsive and robust public financial management systems that will enhance accountability and transparency for all foreign aid funds received.

- **More dialogue held with SAIs**

For many of these projects funded by foreign aid, development partners require the project management unit or responsible body within the implementing agency to provide statements of expenditure and receipts which can be audited by a SAI and an audit opinion issued. It would be beneficial if discussions and dialogue were held with the SAIs so that SAIs fully understand the requirements for the audit. This would enable the SAI to determine the type of audit or mixture of audit types that would be the most appropriate to be carried out.

- **Incomplete financial reporting requirements**

The funding or grant agreement is usually generic concerning which financial reporting framework should be followed. Usually this results in financial accounts being produced according to a financial reporting basis that does not follow international accounting standards.

The impact is that the SAIs find it difficult to conduct an audit of this type when there is not a standard financial reporting framework being used to prepare the accounts.

- **Lack of engagement of in-country public financial reporting frameworks**

Development partners do not engage consistently with the in-country public financial reporting frameworks, which are integral to the public financial management systems. Development partners could contribute to strengthening in-country financial systems by encouraging the use of international standards (IPSAS, ISAs, ISSAIs, GAGAS) in their requirements of the funding or grant agreements.

## SECTION 4: INTERIM EVALUATION RESULTS

PASAI uses co-operative audit approaches as a capacity-building strategy to facilitate knowledge sharing, to pool expert resources with a view to deepening auditors' understanding of an audit topic, and to enhance the quality of financial audits to comply with ISSAIs and international good practice.

Evaluating the program is useful to determine whether it is working or achieving its objectives and also provides a way to track progress and fine-tune planning for future co-operative financial audits. Monitoring and evaluation is also helpful for participants so any necessary adjustments to the program can be made to ensure they stay on track to achieve results. A qualitative methodology was used to evaluate whether the four objectives were achieved. Multiple methods of inquiry were used to gather information during both joint planning and reporting meetings — questionnaires, observations, discussions, peer review and the results are summarised below:

**Table 3: Results of overall key objectives achieved**

KEY OBJECTIVES	RESULTS
1. Conduct an ISSAI based financial audit	<p>✓ Achieved</p> <p>Participants all acknowledged they had increased their understanding and capacity to conduct an ISSAI risk-based approach to financial audits, however they still need more training and practice.</p>
2. Support capacity development of public sector financial auditors	<p>✓ Achieved</p> <p>During planning and reporting meetings this was achieved.</p> <p>The following additional training provided to the participating SAIs were not part of this CFA, however they were beneficial for these SAIs in understanding the risk-based approach to financial auditing:</p> <ul style="list-style-type: none"> <li>• Tonga Audit Office 8–12 September 2014 – RBAFA Workshop for 27 staff</li> <li>• World Bank pilot workshop for Tonga, Tuvalu and Kiribati – 6 auditors 18-22 May 2015</li> </ul>
3. Obtain high quality training and expertise during the joint meetings	<p>✓ Achieved</p> <p>PASAI Director of Technical Support</p> <p>IDI Programme Manager</p> <p>SAI Cook Island Technical Advisor</p>
4. Encourage a uniformly high standard of methodology based on ISSAIs	<p>✓ Achieved</p> <p>Level 1,2,3 and 4 ISSAIs that relate to financial audits were taught during joint meetings <sup>1</sup></p>

## 4.1 PLANNING AND REPORTING MEETING

During the planning meeting the teams were introduced to the theory and application of International Standards of Supreme Audit Institutions (ISSAIs) relating to financial audits. Each team was asked to prepare a presentation about their auditee and their planning activities completed. To consolidate their understanding and application of the theory and ISSAI requirements, the rest of the group were given a list of questions to consider while listening to the presentations. These questions focused the listener and prompted them to ask questions. As each presentation was made, it was clear that the rest of the group were thinking and identifying what was required by the ISSAIs, which provided a very good consolidation of learnings.

The group was introduced to checklists to ensure that audit planning complies with the required ISSAIs. The audit teams were also given time to consider their planning tools/plans used against these checklists to ensure they covered what is required from the ISSAIs.

The experts then spent time with each of the audit teams and found that in many instances the teams prepared the usual templates and letters and were able to identify what their current audit practice did not cover. In other situations the teams identified, with the support of the experts, that some templates being used in SAIs were not necessary. This exercise helped them see where they could streamline these audit processes.

Another interesting point is that it was quite evident that the audit teams all struggled at first to consider the business risks of the entity being audited as required under ISSAI 1315. On a number of occasions audit teams would quickly go through the usual planning templates, and then when selecting the most effective and efficient audit approach they ended up either substantially selecting samples to test without appropriate consideration of the risks identified to the audit approach. The checklists used during the CFA planning meeting highlighted the need for the audit teams to ensure this consideration was in place to assist decision-making.

Audit teams were supported in consolidating their understanding of ISSAIs by completing the checklists and improving their own audit planning documentation.

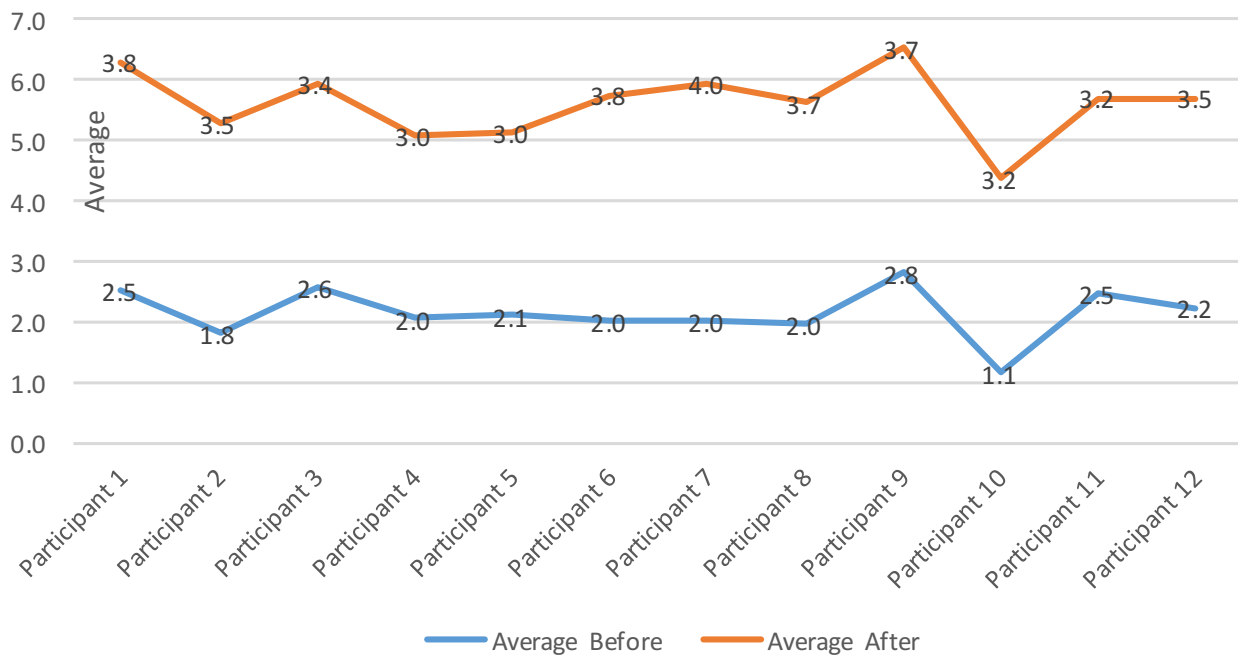
On Day 1, each participant was asked to evaluate their level of knowledge and understanding of the following areas (see Table 4 below) and then on Day 6 the participants were asked to evaluate their knowledge as a result of participating in this program. The results were positive and as shown in Figure 3 below, it is clear that the capacity and knowledge of the participants increased in relation to planning financial audits.

Audit Area	Relevant ISSAIs
Overview	ISSAI 1200, ISSAI 1315, ISSAI 1220
Preliminary Engagement activities	ISSAI 1300, 1315, 1320, 1210, 1220
Understanding of the Entity & its Environment	ISSAI 1315, ISSAI 1230
Assessing risk	ISSAI 1315

**Table 4: Audit areas included in the Evaluation Form**



## EVALUATION SUMMARY - JOINT PLANNING MEETING



**Figure 5: Planning Meeting - Evaluation of Individual capacity development**

### 4.2 PARTICIPANT'S FEEDBACK:

- *“Program content was very informative and well delivered. Main benefit achieved from this program was enhancing our current planning processes and ensuring risk assessment was linked to the audit plan, previously this link was not being met.” – Samoa participant*
- *“Program was well organised. There was good sharing of knowledge among the participants.” – Tonga participant*
- *“I’m happy to report I’ve got two very enthusiastic supervisors who have just returned from Tonga and are pumping with adrenalin to exert what they have recently learnt on the course to the rest of the troops. So the workshop was a success!!”- Audit Manager, Cook Islands*
- *“The planning went well for approval. We have also provided our management of a gap analysis for the current methodology with the methodology under ISSAI. We are working towards aligning our current methodology with the requirements of ISSAI”- Fiji participant*

During the reporting meeting an evaluation highlighted that participants’ understanding of an audit report had improved.



## SECTION 5: FURTHER GUIDANCE TO AUDIT FOREIGN AID PROJECTS

The following is guidance provided for auditors when considering the planning, execution and reporting of a financial audit of projects funded by foreign aid. This guidance will be included in the 3rd edition of the PASAI financial audit manual to be released by 30 June 2017.

### ⊕ PRELIMINARY ENGAGEMENT ACTIVITIES

Performing preliminary engagement activities prior to starting the audit assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

SAIs should initiate meetings with the project management unit to gain an understanding of their requirements as well as the matters that have been identified in project implementation during the audit period.

Also, before starting with planning the audit, the auditor needs to understand the concept of financial reporting framework (FRF) as one of the pre-conditions of auditing the financial statements. Therefore the auditor needs to clarify the following issues concerning FRF:

- Is there an applicable FRF for public sector entities?
- Is the FRF acceptable?
- Is the FRF a special purpose framework or a general purpose framework?
- Is the FRF a fair presentation framework or a compliance framework and how to report accordingly?
- What are the options for SAIs if the FRF is deemed to be non-acceptable?

The auditor should consider whether a financial or compliance audit is necessary for the engagement. This will determine the audit approach, however it will still be applying risk-based principals.

### ⊕ OVERALL AUDIT STRATEGY

The objective of this phase will be to produce an approved strategic and comprehensive audit plan to cover the year under audit. The following tasks should be performed:

- carry out a detailed review of the project operations and activities and the environment in which the project is operating. The auditors should acquire knowledge of the project/program by reviewing all the applicable documents such as:
  - the agreements between development partner and recipient;
  - the sub-agreements between the recipient and other implementing entities, as applicable;
  - contracts and sub-contracts with third parties, if any;
  - the budgets, implementation letters and written procedures approved by the development partner;

- conduct specific assessments of individual audit areas as required by the development partner agency audit requirements;
- conduct a preliminary understanding of the projects internal controls including computer controls (when applicable) for the purpose of assessing associated audit risks;
- conduct preliminary analytical procedures to identify where potential errors or problems may exist and take significant variations into consideration in determining the extent of substantive testing;
- prepare an audit plan and identify detailed audit procedures. In particular, the auditors should:
  - establish audit criteria and the tests necessary to meet them;
  - identify the important aspects of the environment in which the project is being undertaken;
  - develop an understanding of the accountability relationship between the development partner and the recipient;
  - consider the form, content and users of audit opinions, conclusions or reports;
  - identify key management systems and controls and their strengths and weaknesses;
  - determine the materiality of matters to be considered;
  - review internal audit of the project and its work program;
  - determine the most efficient and effective audit approach;
  - provide for appropriate documentation of the audit plans of the project;
  - prepare a budget and a schedule for audit;
  - familiarise the audited entity about the scope, the objectives and the assessment criteria of the audit and discuss them as necessary.

It is necessary that the SAI should agree with the responsible government agency (normally ministry of finance) that they are completely informed on development partner agreements in order to have an adequate picture of their potential workload.



## ⊕ AUDIT PLANNING PHASE

Generally, certification audit programs will cover project expenditure (e.g., bill paying) but some separate checks may be necessary for overseas aid receipts control.

Having regard to the above, there is also a case for periodic value for money (VFM) examinations of aid-funded operations. This could take a form of a broad study supported by a close examination of one or two individual projects. The main features of a VFM study will be to examine the adequacy of control over development projects with the following questions in mind:

- Are projects conceived in relation to national needs along with state funded projects? Ideally, a program of projects important to national development will be drawn up. Then, some of these will be selected for overseas funding. It should not be the case that the development partner suggests the project (i.e.: there should be an integrated budgetary system regardless of input services);
- Are forecasts prepared of support costs (including loan repayment charges) future cost implications and foreign exchange needs?
- Are the objectives and benefits clearly defined and subject to technical analysis, evaluation and consideration of alternatives?
- Is there a central planning document that includes financial authorities, powers of project officers, project timetables and reporting requirements of development partner countries?
- Is there a rigorous system for control over land procurement, award and execution of contracts, both physically and financially, and over stores procurement?
- Are there arrangements for timely claiming for funds?
- Are there procedures for reviewing progress against target dates, for evaluating project outputs against original feasibility study, for employing performance indicators to measure unit costs, etc. and for assessing the effectiveness of the provision (including a review after, say twelve months)?
- Is there provision for prompt preparation of the project accounts?

Having assessed the adequacy of control procedures, in light of enquiries along the lines suggested above, the auditor can then test compliance by reference to the standard of performance in practice.

## ⊕ EXECUTION PHASE

The financial audit will consist of the following procedures:

- Perform compliance tests: to ensure compliance with the agreements signed between the signing country and the development partner;
- Perform substantive tests: and other audit procedures on transactions recorded by the project accounting system;
- Perform detailed analytical procedures: on the financial data to identify situations requiring modifications of the audit plan or accounts that may contain misstatements and are likely to be adjusted;
- Provide supervision: during the fieldwork to ensure that audit objectives are achieved and the audit is completed with minimum disturbance to the project operations;



- Prepare a management letter: including audit findings and recommendations and receive management response on those.

A financial/compliance performance audit of the funds provided by the development partner should be performed in accordance with International Standards of Auditing or INTOSAI standards (ISSAIs) or GAGAS or other approved development partner guidelines where applicable, and accordingly include such tests of the accounting records as deemed necessary under the circumstances.

Some of the procedures, which are emphasised by development partners, include that:

- Auditors should review procurement procedures to determine whether sound commercial practices including competition were used, reasonable prices were obtained, and adequate controls were in place over the qualities and quantities received;
- Auditors should ensure all funding received by the recipient's from the development partner was properly recorded in the recipient's accounting records and that those records were periodically reconciled with information provided by the development partner;
- Compliance review should determine if cost-sharing contributions were provided and accounted for in accordance with the terms of agreement. The auditor's report on compliance should set forth, as findings, all material instances of non-compliance;
- Auditors should review the cost-sharing schedule and determine whether cost-sharing contributions were provided and accounted for by the recipient in accordance with the terms of agreement;
- Auditors should review the status of actions taken on findings and recommendations reported in prior audits of development partner-funded programs

The **materiality levels** should be determined from the users' point of view. The auditor needs to consider who the users of the financial statements are, the probable uses that they will make of them, and the precision that they will require in the financial statements to make their decisions.

Depending on the type of projects, whether revenue or non-revenue earning projects, the foreign aid agencies (e.g. World Bank or Asian Development Bank) require financial statements pertaining to project accounts and overall accounts of the executing agencies. The primary user of the financial statements of the project accounts is the foreign-funding agency. This agency uses the financial information to monitor the use of the loan proceeds and to satisfy the agency with the financial viability of the project entity. The primary user of the financial statements of overall accounts of the executing agency may include the ministers, Members of Parliament, the Public Accounts Committee and other parliamentary committees. International trade organizations, investors, foreign-funding agencies, media and general public may be the secondary users of these financial statements.

Different users may have different purposes for the financial information, and may therefore have different materiality amounts. In many cases, the auditor selects the lowest amounts. However, if the auditor finds that the primary users have a much higher materiality amount than the other users have, he or she must weigh the cost of performing the additional work that would be required if the materiality amount of the secondary users were used. This amount would be against the risk of issuing a clean opinion on a set of financial statements that some users could consider being materially misstated.

## ⊕ REPORTING PHASE

In carrying out an audit of development partner-funded projects, SAIs should follow reporting guidelines on audit reports, timing and format, with copies sent to the implementing agency. The objective of the final phase will be to finalise the audit report per the development partner agency reporting requirements.

This will entail the following steps:

- carry out a final review of the fieldwork to ensure that:
  1. all the work has been completed and documented properly;
  2. all audit recommendations are supported by examples and management response has been obtained;
  3. all agreed audit areas have been covered;
- prepare a draft report in compliance with development partner agency auditing requirements;
- conduct final work paper reviews and finalise audit reports.

The auditor's reports should state in proper perspective, material irregularities, illegal acts or other non-compliance. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances of irregularity or illegal acts identified should be related to the number of cases examined and be quantified, if appropriate, in monetary terms.

The reports should also contain, after each recommendation, pertinent views of responsible recipient officials concerning the auditor's findings and action taken by the recipient to implement the recommendations. If possible, the auditors should obtain written comments.

When the auditors disagree with management comments opposing the findings, conclusion or recommendations, they should explain their reasons following the comments. Conversely, the auditors should modify their report if they find the comments valid.



Auditors should always ensure that they refer to the funding agreements for any other particular requirements specific to the audit and consider (where relevant) the government financial instructions and public financial systems that are applicable.

SAIs should also refer to the lessons learned from the SAIs (refer to Section 3 of this report) during this program to ensure they have quality control mechanisms in place to ensure a high quality audit is conducted. Guidance on these requirements can be found in the relevant ISSAIs, ISAs or GAGAS (for the US insular states and territories).

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(Footnotes)

1 These are the four levels of auditing standards in the ISSAI framework:

- Level 1: Founding Principles
- Level 2: Prerequisites for the Functioning of SAIs
- Level 3: Fundamental Auditing Principles
- Level 4: Auditing Guidelines



For further information, contact the PASAI Secretariat: Email: [secretariat@pasai.org](mailto:secretariat@pasai.org)  
Telephone: +64 9 304 1275 Fax: +64 9 307 9324  
Website: [www.pasai.org](http://www.pasai.org)