



Kommunernes Revision

Handbook for the audit services in the municipalities in Latvia



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1 Preface

1.1 Background

This paper is made as a bilateral project between the Danish Ministry of Interior and Health and the Minister of Regional Development and Local Governments of Latvia. This is one project in a broad range of projects related to the strengthening of administrative and political capacity of local and regional authorities.

The purpose is to further develop and improve the system of municipal audit, including internal audit services in Latvia in order to ensure efficiency and transparency in the municipalities' use of resources and service delivery.

Another important aim is to prepare standards and procedures for financial audit and performance audit that fulfils EU requirements in the field of public sector financial control.

One of the objectives is to develop new methods and guidelines, and prepare a handbook for internal audit services.

1.2 Purpose of the handbook

The purpose of this handbook is to give an overview of the areas that should be covered when the handbook is fully developed, including samples of the planning and execution of financial audit and performance audit. However taking into account the great number of relevant, important topics a fully developed handbook is beyond the frame of this project.

It is also a goal to give information and knowledge among municipality politicians and officials about municipal auditing methods, tools and procedures.

Another purpose is to describe what makes public audit different from private audit and also in state auditing. A special element in municipal auditing is the importance and focus on the respect and act up to the legislation. An important part of public auditing is performance auditing. Thus performance auditing in municipalities in Latvia has in some respects another content and extent than performance auditing within the state area. This is due to the difference in political structure. The municipal politicians do not only provide the necessary means in terms of appropriations for the management of the municipal activities. In addition, the municipal politicians are directly involved in making dispositions of the appropriations as well as being responsible for the administrative management.



1.3 Audit standards

At the time this handbook was finished it was not decided how the audit should be organised in Latvia, if it should be internal audit, external audit from private firms or a new public or semi-public “Municipal Audit”.

Depending on which solution is chosen the auditor has to live up to certain general standards regarding the audit. There are several different international standards. Which standard the auditor has to live up to depends on which organisation the auditor is a member of and which area he/she is auditing (e.g. public audit or private audit).

The most known and used international standards are the following:

- w International Federation of Accountants (IFAC): Used of certified public accountants.
- w The Institute of Internal Auditors (IIA): Used of internal auditors.
- w INTOSAI Auditing Standards: Used of Supreme Audit Institutions.

In Latvia following national auditors perform audit in municipalities:

- w Internal auditors in Riga City
- w Sworn auditors: Until now only auditing of financial statements.
- w Municipal auditors / controllers: Auditors elected by the citizens/council - Not all municipalities have municipal auditors.

This handbook is based on more than 75 years of experience in municipal audit in Denmark and should be seen as an practical input to the start and development of municipal audit in Latvia. The handbook is based on our experience in municipal audit and is in accordance with the international standards mentioned above that are relevant for municipal audit as we see it.

1.4 A tool for the municipal council in audit matters.

Every municipality shall have a competent auditor, who shall be approved by a superintended body. The auditor has to be independent of the municipality, competent and well trained.

The audit include all accounting areas, which the council is responsible fore. The audit procedure and performance include both financial and performance audit.

It is the objective for this handbook to describe the relations between the council, management and the auditor, and what the council could expect from an competent auditor.

It is also meant to help the council assess where internal control can be established in addition to the municipal audit.

The handbook will also describe the division of responsibilities between the council, management and the auditor.



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Summarised the handbook can be seen as a description of the work of a Municipal Auditor, and could in that way be used in a tender, which of course only are relevant if the municipal audit is performed by external private auditors.

Finally the handbook can be of help to establish a new municipal audit institution if the decision will be go that way.

1.5 Relations between internal auditors and external auditors

Keeping in mind that it is not decided how the audit should be organised the following describes the relationship between internal auditors and external auditors:

There are both differences and similarities between the responsibilities and performance of audits by internal and external auditors. The primary difference is to whom each party is responsible. The external auditor is responsible to financial statements readers who rely on the auditor to add credibility to the statements. The internal auditor can be responsible to management or to the council. Even with this important difference there are many similarities between the two groups. Both must be competent as auditors and remain objective in performing their work and reporting their results. They both, for example, follow a similar methodology in performing their audits, including planning and performing test of controls and substantive tests. Similarly they both use the audit risk model and materiality in deciding the extent of their tests and evaluating results. Their decisions about materiality and risk may differ however, because external users may have different needs than management.

External auditors rely on internal auditors through the use of the audit risk model. (see figure in chapter 6.1.2). Auditors significantly reduce control risk and thereby reduce substantive testing if internal auditors are effective. The reduction of fee of the external auditor is typically substantial when there is a highly regarded internal audit function. External auditors typically consider internal auditors effective if they are independent of the client, competent and well trained, and have performed relevant audit tests of the internal controls and financial statements.

In municipal auditing, one also distinguishes between internal and external audit. The internal auditor in municipalities and also in state institutions, will be subordinated the municipal organisation (e.g. the municipal council or municipal management). If the municipality wants an internal audit it is important to ensure that the internal auditors are placed very high in the municipal hierarchy. Furthermore, it is important to secure a high degree of autonomy in what and how the auditor audits.

The external municipal auditor should be independent of the municipality to ensure an impartial audit of the municipality accounting and activities.

The auditing of an organisation may take place solely through internal auditing, solely through external auditing, or as a combination of both types of auditing. A great part of the audit conducted by external auditors and only a small part conducted by the internal auditor or opposite. The expenses of an external auditor can be minimised through a strong and competent internal audit unit.

Typically only the biggest municipalities have internal auditors.



Because the audit process on most points are similar between the two ways of organising the audit the requirements for education and qualifications should be the same for external and internal auditors for identical auditing tasks.

Most of the handbook can therefore be used in both solutions.

2 Definitions and terms

2.1 Audit

Audit is the accumulation and *evaluation* of evidence about information to determine and report on the degree of correspondence between the information and established *criteria*. auditing should be done by a competent, independent person.

2.2 Audit criteria's

To perform an audit, information must be present in a verifiable form and there must be some standards - criteria - by which the auditor can evaluate the information. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including financial statements of the client. The auditor also performs audits of more subjective information, such as effectiveness and efficiency.

The criteria for evaluating information also vary depending on the information being audited. For example, in the audit of the historical financial statements, the criteria usually is general accepted accounting principles.

For more subjective information, such as auditing the effectiveness of specific operations, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria before the audit starts.

2.3 Audit evidence

Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including oral testimony of the client, written communication with outsiders, observations by the auditor, and electronic data about transactions. It is important to obtain a sufficient quality and volume of evidence to satisfy the purpose of the audit.

2.4 Internal control

The whole system of financial and other controls, including the organisational structure, methods, procedures and **internal audit**, established by management within the corporate goals, to assist in conducting the business of the audited unit in a regular economic, efficient and effective manner; ensuring adherence to management policies; safeguarding as-



sets and resources; securing the accuracy and completeness of accounting records; and producing timely and reliable financial management information. (INTOSAI).

2.5 Internal audit

The functional means by which the managers of an entity receives an assurance from internal sources that the processes for which they are accountable are operating in a manner which will minimise the probability of the occurrence of fraud, error or inefficient and uneconomic practices. It has many of the characteristics of external audit but may properly carry out the directions of the level of management to which it reports. (INTOSAI)

Internal auditing is carried out by an independent appraisal function within the organisation. Internal audit services are necessarily subordinate to the leaders of the organisation within which they have been established. However, they shall - as far as possible - be functionally and organisationally independent within their legal framework.

Internal auditing often has the following objectives:

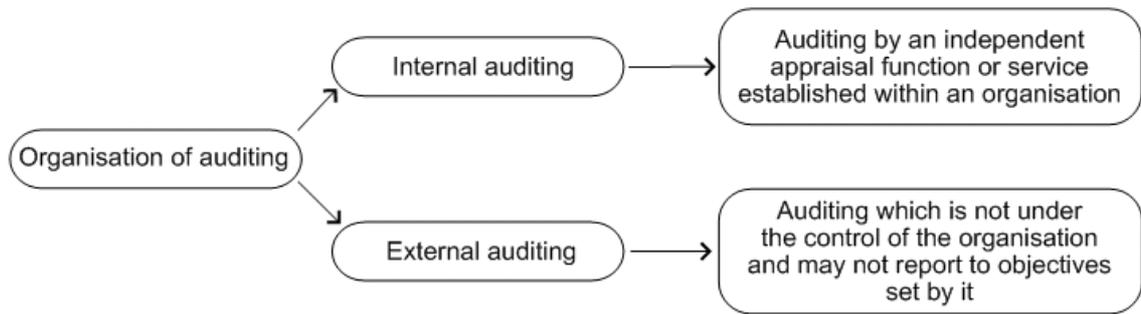
- w To monitor and reassure management of the adequacy of its controls
- w To advice management on the balance between risk and control
- w To assist management to:
 - w Use resources effectively
 - w Safeguards assets
- w Assess the reliability and accuracy of management information
- w Comply with agreed procedures, regulations and laws
- w To provide independent advice and proposing solutions to control problems
- w To advice management on the impact of new systems and activities

2.6 External auditing

External auditing of an organisation is when the auditors are not under the control of the organisation and may not report to objectives, set by the organisation. If the internal auditing is judged to be effective, efforts shall be made to carry out an overall audit as to achieve an appropriate division of tasks between the internal and external auditing. The auditing of an organisation may take place solely through internal auditing, solely through external auditing, or as a combination of both types of auditing. The following figure gives an overview of the organisation of audit.



The Organisation of audit



It should be noted that the concept of “internal auditing” is used to describe the whole system of financial and other controls, including the organisational structure, methods and procedures, which can be established by management within its corporate goals, to assist in conducting the business of the audited entity in a regular economic, efficient and effective manner. “Internal audit” may be – but does not necessarily has to be – carried out by a *fully* independent internal auditing service.



3 Responsibility of the municipality

It is a significant requirement for good public auditing practice that responsibility between the municipality and the auditor is well defined. As a general rule the municipality is responsible for preparing the accounts, but it is the auditor's responsibility to make an assessment of how the management of the municipality has managed the task.

The municipality is responsible for making goals, strategies and plans of action available and for ensuring the carrying out of performance. The municipality must ensure that sound financial considerations have been taken into account. The municipality is responsible for establishing an appropriate administrative systems, and an appropriate internal control system. In other words, an administration should be organised to include the necessary financial management, accounting systems and internal controls, in order of presenting accurate and reliable accounts, documenting that the funds have been used in accordance with the requirements, and that the results that were sought have been achieved. The municipality must also report by way of accounts, reports and so forth.

The auditor serves the accountability relationship between the council and management. The auditor has an important role in providing assurance about the reports and representations made by management to the council.



4 Co-operation and communication between the audited municipality / entity and the auditor

4.1 Communication between the municipality and the auditor

The municipality and auditor agree on time limits for preparing financial statements, specifications etc. and whether the necessary information, including appropriate documentation is present or will be procured.

Performance of audit in the municipality is an activity based on knowledge and experience and has or will obtain and maintain a knowledge regarding the political and administrative organisations of the municipality, which play an important role when planning the auditor's work and the municipality's use of utilities.

Dialogue is important and the auditor must always be well informed concerning what is happening in the municipality as a "company" and as a local society. In this way, the necessary fertile soil is created for a constructive dialogue concerning the possible actions of the municipality.

Beside the common audit tasks a good audit:

- w Looks ahead and supports the efforts of the council and management concerning developing and making the municipality's activities more efficient
- w In co-operation with the management and employees of the municipality seeks to meet and possibly correct errors and lacks before the closing of the accounts
- w Gives access to draw on the knowledge base of the audit company concerning the administrative and political condition of the municipality
- w Has auditors with educations specifically aiming at making audits in the public sector
- w Puts together teams which are specifically made to solve a specific task which correspond to the needs and expectations of the municipality

The auditor makes sure that at least one contact person is available – it makes it easier to organise the work.

The auditor's fingertip knowledge means that often he/she will be able to immediately answer the questions of the municipality. The consultancy includes ad-hoc consultancy, which can be given on the spot during the audit or by telephone consultation. The consul-



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tancy will especially include sparring with the management, accounting conditions and budgeting, interpretation of present legislation, information about principal decisions etc.

Through an ongoing dialogue, the auditor should give support and consultation on the basis of his/her experiences from other municipalities and his/her knowledge to other municipality rules in all areas of importance to the administration of the municipality. This contributes to a positive and constructive co-operation environment – a co-operation environment in which an auditor is not just a professional auditor but also a good sparring partner and councillor.

The auditor is, in a constructive way, to draw the attention of the administration to possible errors and inconsistencies that he/she discovers during the auditing and at the same time be able to give instructions on how possible problems can be solved. This secures an optimal and forward oriented utility value of the results of the audit effort.

4.1.1 Material plans

Well in advance before the end of the year, the auditor, to the extent possible, hands over the materials plans that can ease the work of the municipality regarding the closing of the accounts. The plans include a systematic outline of which materials the individual administration should make to secure that the annual accounts of the municipality are correctly presented.

4.1.2 Meetings between the municipality and the auditor

The auditor reports in accordance with the wishes of the municipality so it can be used as a tool in the political and administrative steering process.

Example of an ongoing dialogue about the outcome of the audit:

Ongoing oral dialogue

- w Meetings with political and administrative management
- w Management letters after each audit
- w Audit report
- w Audit report on financial statement(s)

At the beginning of each audit (visit) the management and the involved entities are supplied with information about the purpose, extent and expected duration of the audit to be performed. At the end of an audit (visit) the responsible parties in the audited entities are supplied with information about the outcome and results of the audit.

Meeting with the management

Beside the ongoing dialogue with the management and other responsible parties from the municipality the auditor gives an oral information about the outcome and results of the audit to the political and administrative management after each audit.



4.1.3 Management letters

The purpose of the management letters is to give the management an ongoing and broad information about the audit performed which can be used in the management of the municipality.

4.1.4 Audit reports

The auditor reports to the council about the audit performed in audit reports, which is in line with the demands from the legislation and the councils need for information. Audit reports are given in connection to interim audit and in connection to the final annual audit. The auditor reports immediately if the audit expose irregularities, breach of the law and other important issues. Audit reports are presented in a meeting with the management before they are forwarded to the council.

Audit reports are issued for financial statements and specifications.

4.1.5 Political information

Beside the meetings with the management the auditor can offer to meet with the council and give his explanation e.g. to the annual audit report. During such meetings the auditor can inform about his impressions of the economic and administrative relations of the municipality in light of the expected development and inform about the outcome and results of the performed audit.

4.2 Audit agreement between the municipality and the auditor

An audit agreement between the municipality and the auditor must exist. The audit agreement contains the terms of the engagement between the municipality and the auditor. The audit agreement will be a documentation of the engagement, where the auditor documents his understanding of the engagement, and will contain

- w engagements objectives
- w the responsibility of the municipality
- w the responsibility of the auditor
- w the engagements limitations

4.3 Avoid duplication of respective work

In order to avoid duplication of respective work, the external audit has to co-ordinate the activities of the external audit service and exchange information with other executors of internal and external audit of the public legal entity.



5 Description of the auditors tasks

5.1 Auditors tasks

It is important to emphasise that audit is carried out in order to strengthen the trust of the surrounding world in the given information.

In order to be able to provide this trust the auditor has to live up to a number of demands.

The auditor has to:

- w be independent

The main way is for the auditor to be aware of the issue and document his assessment

- w be competent

This is accomplished by continuously

- w being careful

- w being responsible

- w being objective

- w having integrity

This is accomplished in many ways.

Independent:

The main way is for the auditor to be aware of the above and documenting his assessment.

The auditor must gain a very good knowledge of:

- w the legislation concerning municipalities

- w the nature of the activities of the municipality and their accounting principles

- w goals and strategies of the municipality and the risks connected to these

- w the internal control environment

- w the achievements of the municipality and the measurement hereof

This knowledge is indispensable in deciding where to place the efforts of the audit.

In comparison with auditing in the private sector the auditors tasks are different when auditing municipalities. Some of these differences are illustrated below:

	Municipality	Private sector
Goal	Services (performance and effects)	Money (Returns on investment)
Means	Taxes, fees, state subsidies/grants etc.	The business (Services, products)



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One of the most important reasons for auditing is to provide the account with credibility.

It is the auditor's responsibility to plan and carry out the audit, and to review and assess whether the municipality has complied with the aforementioned obligations in chapter 3 to ensure a reliable and financially sound account. The task of the auditor is hereafter to plan, carry out the audit, and to report accordingly.

It is also the auditor's task to provide assurance about financial reports and presentations made by management to the council, board or other key stakeholders (state, EU, citizens, banks etc.) or possibly, in the absence of such reports, of assessing the quality of management practices and systems, or reporting themselves on the effectiveness of the organisation.

Dialogue is an important precondition for sparring and the auditor must always be well informed about what is going on in the municipality as a "company" and as a local society. In this way, the necessary fertile soil is created for a constructive dialogue concerning the possible actions of the municipality.

Errors versus fraud

Either type of misstatement can be material or immaterial. An error is an unintentional misstatement of the financial statements, whereas fraud is intentional. It is required that the audit is designed to provide reasonable assurance of detecting both material errors and fraud in the financial statements. To accomplish this the audit must be planned and performed with an attitude of professional scepticism in all aspect of the engagement. Professional scepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should not assume that management is dishonest, but the possibility of dishonesty must be considered.

Training of the auditors

Regular training of the auditors enables them to acquire the necessary skills required for the audit work. It is the duty of the head of the audit unit to ensure regular upgrading of professional qualifications of the staff in accordance with the designed training plans.

5.2 Auditors ethics

There are many views on how an auditor should conduct himself.

As mentioned in chapter 1.3 there is different international standard regarding audit. Every stand has it own roles about auditors ethics.

There are some common topics on the area:

- w Integrity

By showing integrity the auditor gains trust and thereby provides the basis for reliance on their judgement.

- w Objectivity



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The auditor must always have an unbiased approach to the audit and be free of conflicts of interests. This also means that the auditor may not have close personal relations with the person being audited.

w Confidentiality

The auditor must respect the value and ownership of the information he receives and may not disclose information without appropriate authority. This also means that the materials received must be stored appropriately.

w Competency

The auditor has a responsibility to have the necessary skills to perform the audit. This includes continuously maintaining/upgrading his knowledge, skills and other professional qualities and capacities.



6 The audit process

6.1 Audit planning

Audit planning is developing an overall strategy for the conduct and scope of the audit. The nature, extent, and timing of planning varies with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business and tasks.

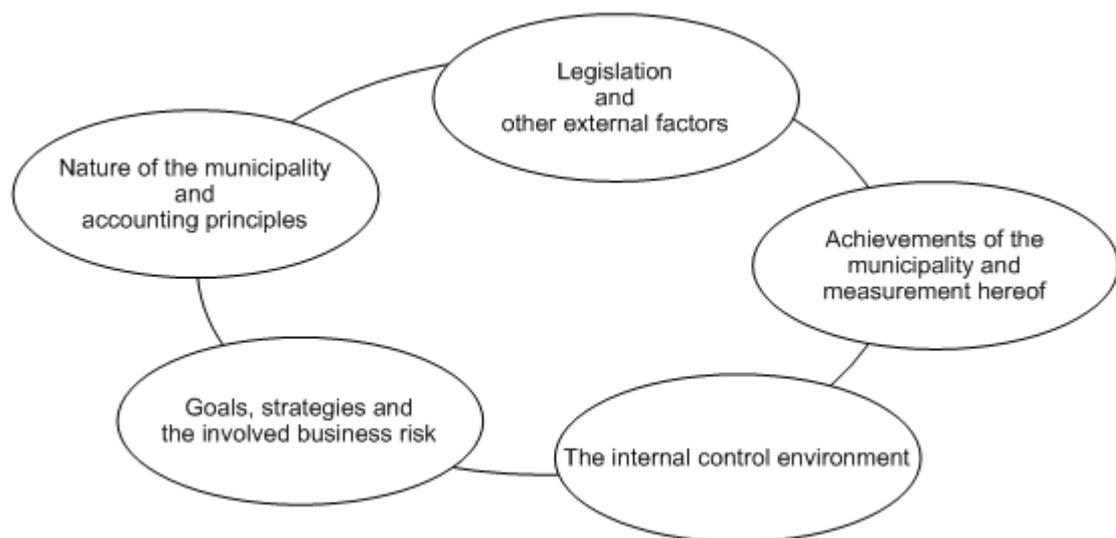
The auditor performs an active, ahead and dynamic audit, where the major part of the audit is performed in the municipality.

6.1.1 Collection of information of the municipality/enterprise

Each year an audit plan is developed in accordance with this handbook, securing that the audit is performed in accordance with legislation and based on materiality and risk assessment. The audit plan is debated with the management of the municipality with the objective to perform the audit as useful as possible - of course without losing the auditors independence and integrity - and have the proposals of the management e.g. to performance audit before the audit planning is finalised.

The audit planning is based on the budget of the municipality and the general political objectives and goals.

At the materiality and risk assessment the auditor shall monitor the level of internal control and the management performed in the municipality. The audit planning always takes its starting point in the legislation and other relevant rules and EU-regulations.



Overall assessment of the municipality

Gaining an understanding of the municipality's tasks and situation is a very important step in the audit planning. This chapter will explain the steps the auditor has to go through in the overall assessment of the municipality.



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Making this assessment the auditor in addition is performing preliminary analytical procedures.

There are several good reasons for the auditor to start the planning on this level. It is to enable the auditor to get competent know-how about the municipality, and to keep audit costs reasonable.

In this phase the auditor is starting the assessment of materiality and risk.

Important chapters of the overall assessment of the municipality is the auditors knowledge about the municipality e.g.:

- w Formal information about the municipality.
- w Staff competence, capability and efficiency
- w Turnover of staff
- w The municipalities economy
- w Financial management and principles for budgeting
- w Demografi and perennial budgets
- w Level of the municipalities activities and development

6.1.2 Materiality and risk

The audit is not responsible for finding all misstatements, but only the material misstatements.

A misstatement in the financial statement can be considered material if knowledge would affect a decision of a reasonable user of the statement.

The problem is to determine when an misstatement is material. This can be done on more levels. One error can in itself be material just as many small errors can sum up to be material even if they each are insignificant. The level of when an error is material is determined by many factors. E.g. the larger the balance the higher the level of materiality. A misstatement of 100.000 can be highly material for a small municipality but can be immaterial for a large municipality.

The auditors responsibility is to determine whether financial statements are materially misstated. If the auditor determines that there is a material misstatement, he or she must bring it to the attention of the municipality so that a correction can be made. If the municipality refuses to correct the statements, a qualified or an adverse opinion must be issued, depending on how material the misstatement is. Therefore, auditors must have a thorough knowledge of the application of materiality.

There is a close relationship between materiality and risk.

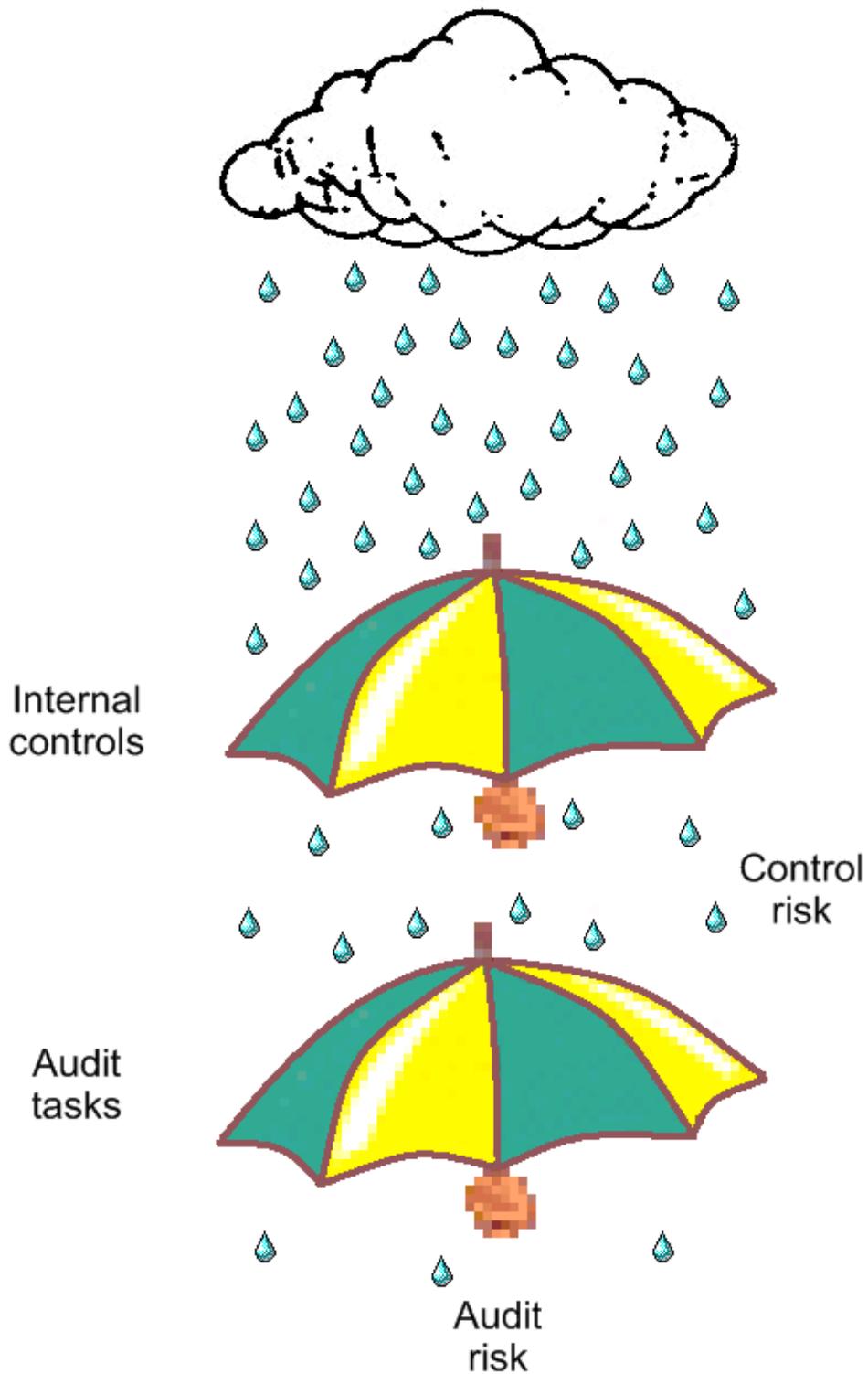
The auditor recognises that risk exists and deals with those risks in an appropriate manner.



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To assess the likelihood of material misstatement in the financial statement the auditor uses an audit risk model to further identify the potential for misstatements and where they are most likely to occur.

The figure below illustrates the different types of risk an auditor encounters.



**Understanding the figure:**

The cloud represents the accounting system. In every system errors will occur. Errors are represented by the raindrops. Each drop represents an error. The internal controls function as an umbrella, preventing or detecting the errors. Good internal controls leads to fewer errors (lower control risk).

The auditor assesses the control risk and plans the audit tasks in accordance with this. If the control risk is high the auditor will perform more audit tasks attempting to eliminate the control risk. When the audit has been performed there is still the risk that the auditor has not detected all material errors. This risk is the audit risk.

Definitions:

Inherent risk: A measure of the auditor's assessment of the likelihood that there are material misstatements in a segment before considering the effectiveness of internal control.

Control risk: A measure of the auditor's assessment of the likelihood that misstatements exceeding a tolerable amount in a segment will not be prevented or detected by the internal controls.

Audit risk: A measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unqualified opinion has been issued.

Having a high materiality means that the auditor cannot choose not to perform audit tasks on that area. It is only a question of how much is to be done.

6.2 Audit strategy

After collection of information of the enterprise of the municipality and the assessment of materiality and risk an strategic audit plan shall be developed.

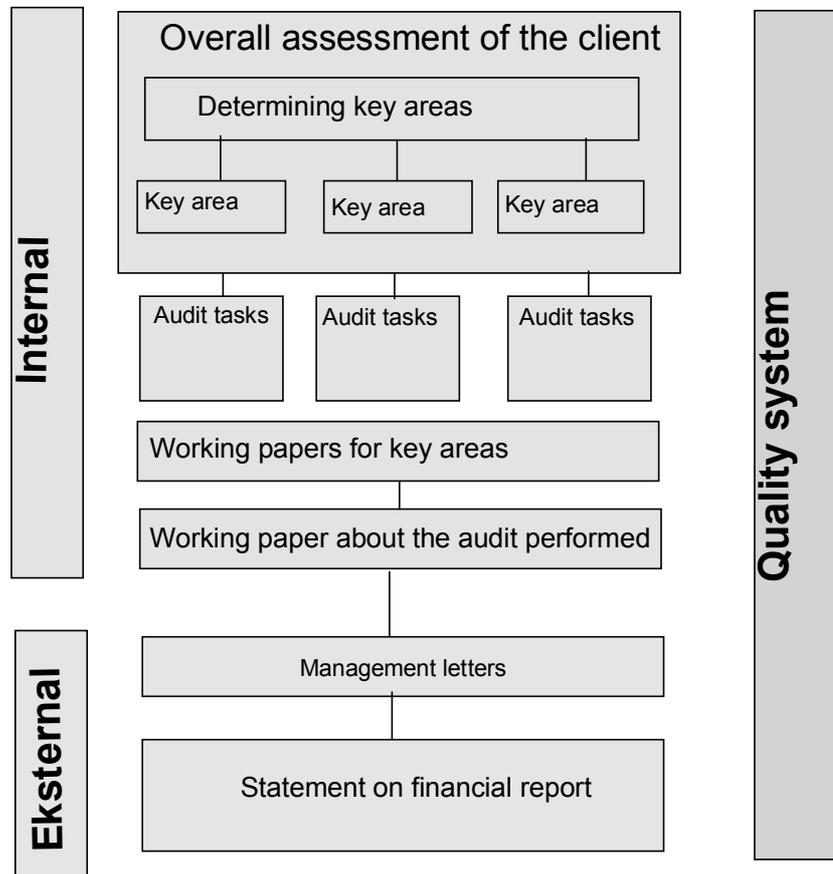
The overall audit plan and the audit program should be revised as necessary during the course of the audit. E.g. by establishment of new functions and systems in the municipality as well as other factors affecting the existing systems in the municipality.



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The audit process can be illustrated so:

The audit process



After the overall assessment of the municipality the auditor has to determine key areas. Key areas in Latvian municipalities e.g. could be:

- w Revenues, subsidiaries, grants
- w Salaries
- w Social welfare
- w Schools and education
- w Sports and culture
- w Technical area,
- w Balance
- w Enterprise A
- w Enterprise B



Audit tasks/Audit Program

The auditor should develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan.

The audit program serves as a set of instructions to assistants involved in the audit and as a means to control and record the proper execution of the work. The audit program may also contain the audit objectives for each area and a time budget in which hours are budgeted for the various audit areas and procedures.

In preparing the audit program the auditor would consider the specific assessments of inherent and control risks and the required level of assurance to be provided by substantive procedures. The auditor would also consider the timing of tests of controls and substantive procedures, the co-ordination of any assistance expected from the entity/municipality and the availability of assistants.

Distinction between financial and performance auditing

The major distinction between financial and performance auditing is in the purpose of the tests. Financial Auditing emphasises whether historical information was correctly recorded. Performance auditing emphasises effectiveness, efficiency and management. The financial auditing is oriented to the past, whereas a performance audit concerns operating performance for the future.

6.2.1 Financial Audits

Definition

Financial audit include financial statement and financial related audits.

Financial statement audits provide reasonable assurance about whether the financial statements of the audited entity present fairly the financial position, results of operations, and cash flows in conformity with generally accepted principles (could be a uniformed accounting system for municipalities). Financial statements audits also include audits of financial statements prepared in conformity with e.g. demands from state level.

Financial related audits include determining whether financial information is presented in accordance with established or stated criteria the entity has adhered to, specific financial compliance requirements. It also includes determining whether the municipality's internal control structure over financial reporting and/ or safeguarding assets is suitably designed and implemented to achieve the control objectives.

Performance of financial auditing

When carrying out financial audit the auditor verifies the accuracy of the accounts (in other words, that the accounts have no significant errors and deficiencies) and verifies whether the actions taken are in accordance with appropriations and laws.

The goal of a Financial Audit is to obtain reasonable assurance of the quality of the individual organisation's accounts and of the internal control system. The auditor must plan



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the audit in order to ensure a balance between quality and an economic way of carrying out the audit. The design of the auditor's strategy will depend on assessment of the risk of significant errors and deficiencies in the accounts. If the auditor has previously established that the system's internal controls are working satisfactorily, and if the auditor is convinced that no material changes have been implemented in the system compared to earlier years, the auditor does not have to test the system every year. All material systems and internal controls should be reviewed and tested within a reasonable fixed number of years. The goals, scope, and expected results of the audit are established in the audit plan.

Systems audit is applied as aggregated audit principle, though combined in varying degrees with substantive audit in accordance with the auditor's assessment of materiality and risk. Good public auditing practice also includes conditions for the documentation of audit proof and of quality management.

6.2.2 Performance auditing

An important part of public auditing is performance auditing or value for money auditing. Thus performance auditing in municipalities has in some respects another content and extent than performance auditing within the state area. This is due to the difference in political structure. The municipal politicians do not only provide the necessary means in terms of appropriations for the management of the municipal activities. In addition, the municipal politicians are directly involved in making dispositions of the appropriations as well as being responsible for the administrative management.

Thus there is a much closer interaction between the municipal politicians and the administration than between the parliament and the ministries. This implies that performance auditing in municipalities must be performed as a continuous process of current interest, and that the auditor enters a dialogue with the municipal politicians concerning the processes of management and decision making.

Performance auditing is important as a democratic control system of the municipal administration because of the nature of public services, for developing the administration, and ensuring the quality of the services. The purpose of the performance auditing is to evaluate the service delivery and to give information about economy, efficiency, effectiveness and the management system.

The nature of public services

A major part of public services are produced by municipalities. The nature of public services is different from commercial services. The users do not pay all the costs directly and prices are not marked prices. People cannot always choose freely which services they use.

Public services are financed by state and municipalities. The politicians set up the result objectives for the activities of the municipality. It is important for the decision-makers to keep up with the supply and the quality of services.

The evaluation of public services ought to be made with high quality methods and the bases for comparisons have to be reliable. Performance auditing can give the politicians new information when they are setting the objectives for municipal performance.

Performance auditing is an effective tool when the management wants an objective and independent sparring partner who is able to evaluate the performance in accordance with



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the political objectives. The municipality often carries out surveys about the administration. The performance audit can be a supplement to the municipalities own surveys.

Developing administration

If the needs of citizens are changing, then the services should meet the needs and requests from citizens. Public services should adapt to changes in the environment, e.g. during economic depression more social services and health care are demanded when people have trouble with finances and are unemployed. Performance Auditing can help authorities to implement changes, and with advanced performance auditing methods it is possible to get viewpoints about services.

Ensuring the quality of the services

Municipalities should be able to ensure the quality of the services, no matter if it is done by the municipality or the private sector. If municipalities have privatised their services, they should be able to ensure the quality of the services produced by the private sector. Performance auditing methods help to be a good orderer.

Some municipal services should be competitive with the private sector. Performance auditing provides methods for comparing similar kind of services. In addition performance auditing can review the authority's own arrangements for securing information about economy, efficiency, effectiveness and the management system and in the use of resources. It is a method for developing the quality of management.

Allocation of scarce resources

Public services have shortages of resources because tax level cannot always rise to fulfil increasing demands or needs. The municipalities have to allocate resources. It is necessary to give priority to the needs of the people. For this work performance audit-methods provide important information.

**Objectives**

Performance auditing is performed to evaluate whether the administration/management of the municipality have taken place in an economic and appropriate way.

One could give the following four questions:

Economy <i>Auditor analyses, if the same can be performed with fewer money</i>	Efficiency <i>Auditor estimate, if there could be done more for the same money</i>
Effectiveness <i>Auditor estimate, if the objectives are reached</i>	Management and leadership <i>Auditor estimate, if the leadership is organised in an appropriate way</i>

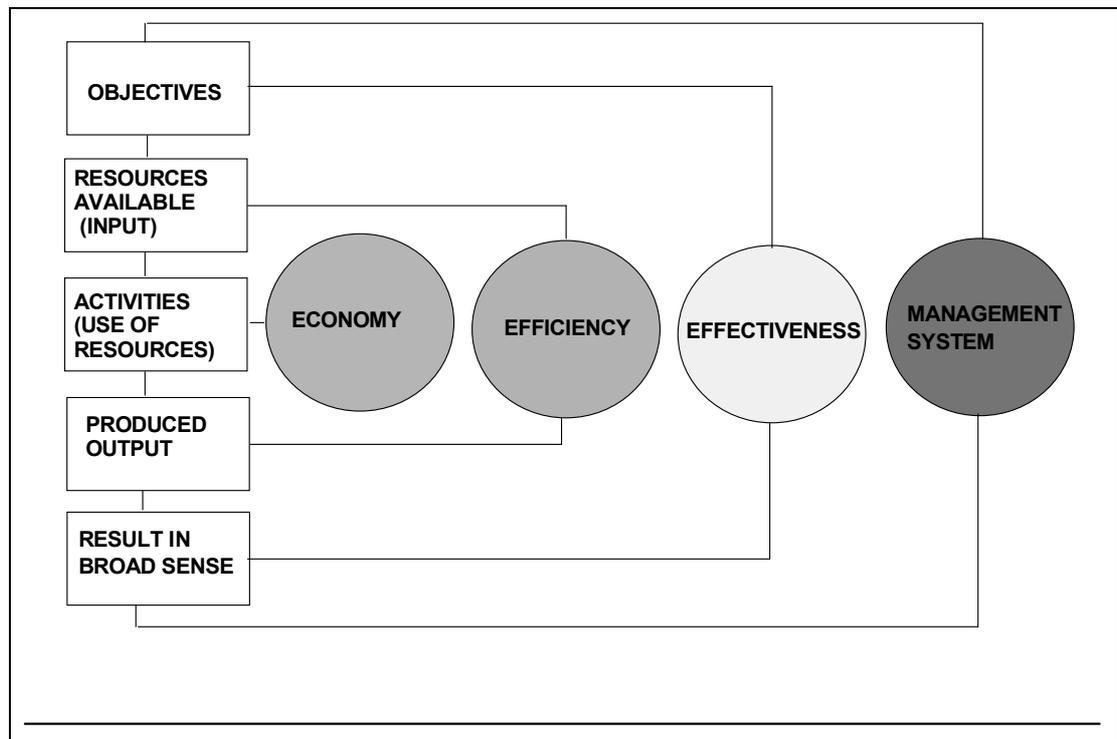
This handbook splits performance auditing into four aspects. The reason why this handbook has added another aspect is the development in auditing practice in municipalities.

- w Economy may be defined as the terms under which the authority acquires human and material resources. an economical operation aquires these resources in the appropriate quality and quantity at the lowest cost.
- w Efficiency may be defined as the relationship between goods or services produced and resources used to produce them. An efficient operation produces the maximum output for any given set of resource inputs, or it has minimum inputs for any given quantity and quality provided.
- w Effectiveness may be defined as how well a program or activity achieves its established goals or other intended effects.
- w Management system may be defined as the control system securing the accountability for economy, efficiency and effectiveness.



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The four aspects are summarised in the following diagram:



The concept of performance auditing is aimed at whether the operations of the local authorities are carried out in an appropriate way and are satisfactory from an economic point of view. It also focuses on monitoring and reviewing within the authorities to find out if the systems are adequate for running the operations effectively.

A fact to be considered when checking whether the operations are carried out in an appropriate way is the question of service objectives. Are they actually run in accordance with policies, relevant laws and decrees in an economic and appropriate way? An important question concerning the economy is if the outcome of operations is fair to the use of resources.

One of the most important objectives of the performance auditing is to initiate ideas and recommendations for improvements.

Approach

The auditor has to form a general view of the task on the right level to determine the range of the project. Subsequently further detailed investigations can be added, but only to the point where the auditor is in possession of sufficient information to enable him to draw a satisfactory conclusion. Performance Auditing is not to be viewed as a separate area of activity, but represents part of the overall audit approach. Also, during the course of regular audit work, staff must remain alert at all times to possible indications of areas which could potentially point to poor performance auditing.



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In order to reduce audit costs and reach a high level of acceptance by the client, performance auditing projects should be planned and carried out in close association with the management staff of the municipality.

The investigated items will not only be those with economic and statistic aspects, but also management, organisation, job satisfaction and other humanitarian aspects which may influence utilisation of the resources.

Common techniques used for performance auditing are:

- w Inventory of procedures.
- w Interviews.
- w Business economics analyses of costs and possible profits.
- w Comparison between similar organisations, with base figures etc.
- w Statistic analysis of collected material.

Performance auditing can very well be combined with financial auditing. In most cases the municipality will benefit if the performance auditing is carried out simultaneously with the financial auditing.

Sampling

During the financial audit the use of samples is normal. Performance auditing also use samples. The auditor will among other things search for unusual or reasonable items.

General and progressive view

During performance auditing the auditors view is general and progressive when evaluating the activities etc.

Naturally the auditor attaches the greatest importance to economic aspects in the administration, because that is the main task of the financial audit. The auditor has to ensure that the performance auditing is up-to-date and forward-looking. When the performance auditing is carried out as mentioned above the performance auditing is preventive and consultative.

Political decisions

The auditor evaluates the administration to get a view about the quality and suitability of the works. From his work he calls relevant information to the attention of the decision makers. To ensure full benefit the auditor gets into a dialogue with the politicians to make sure that they are aware of the suitability of their decisions and the consequences for the local governments finances.

As long as they are legal, the suitability of the decisions should not be criticised by the professional auditor. This is up to the auditor elected by the people and the political minorities in the council. The auditor can evaluate the grounds of the decision and call attention to unintended consequences of the decisions.

Reporting and presentation of results

Presentation of audit results should be in the form of a report and an oral presentation. The result of the project depends on how well the presentation is prepared and carried out. The reports are sent to the municipal council and are open to the public.



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The final stages of performance auditing involves reaching conclusions based on the investigations, making recommendations and drafting the report. Unless the results are presented in a clear, comprehensible manner, the project will not achieve the intended results.

Conclusions must be based on reliable, up-to-date information. The report itself should be concise, clear and easy to read. In order to make the information interesting and easy to read, the text should, if possible, be mixed with graphics.

A summary of the report including main findings should be used. Special attention should be given to the framing of recommendations so the decision makers can choose the right solutions.

Follow up

A follow-up of the Performance Audit is important to:

Ascertain whether management has effected the changes in arrangements the politicians have decided.

Determine whether the action taken has had the desired results.

For the success of performance auditing, systems for the follow up are very important. For projects where large value opportunities have been identified, this should normally be on a regular basis and by the latest reported at the time for auditing the financial statements.

Failure in carrying out a sufficient follow up of performance audits can mean that the impetus for change will be lost. The results of follow up are essential to help the auditor evaluate the authority's overall management arrangements.

The aim of performance auditing in other words is:

- w to assess whether sound financial considerations have been taken into account
- w to assess the validity and reliability of indicators on efficiency and effectiveness in the reports of the administration/institutions or entities
- w to assess whether the organisation does enough to identify areas of improvement
- w to assess whether sound public financial management has been applied.

When making performance audit examinations the following may be examined:

- w the extent to which the entity has actually been economic, efficient and effective
- w whether the entities systems ensure that sound financial considerations have been taken into account when administering the budgets and funds.

Performance auditing will include an examination of whether the entity has established an appropriate steering system which contributes to making the entity economic, efficient and effective. This kind of examination will often be a financial management examination.



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In relation to the steering systems, goals, strategies and actual performance targets have to be established, supplying information on whether the goals of the organisation are achieved using the planned amount of resources, and the reliability of information systems including among other a time registration system. Furthermore a reporting system must also be established conveying to the public, the appropriation authority and the subsidy donor, what has been achieved and with what efficiency and effectiveness.

It is important that this kind of information is well balanced so that it focuses primarily on economy, efficiency and effectiveness, as well as on quality and service.

Performance audit may be carried out as an integrated part of financial audit, or concurrently with the financial audit of the annual financial statements, or may be organised as a separate examination of a public expenditure programme.

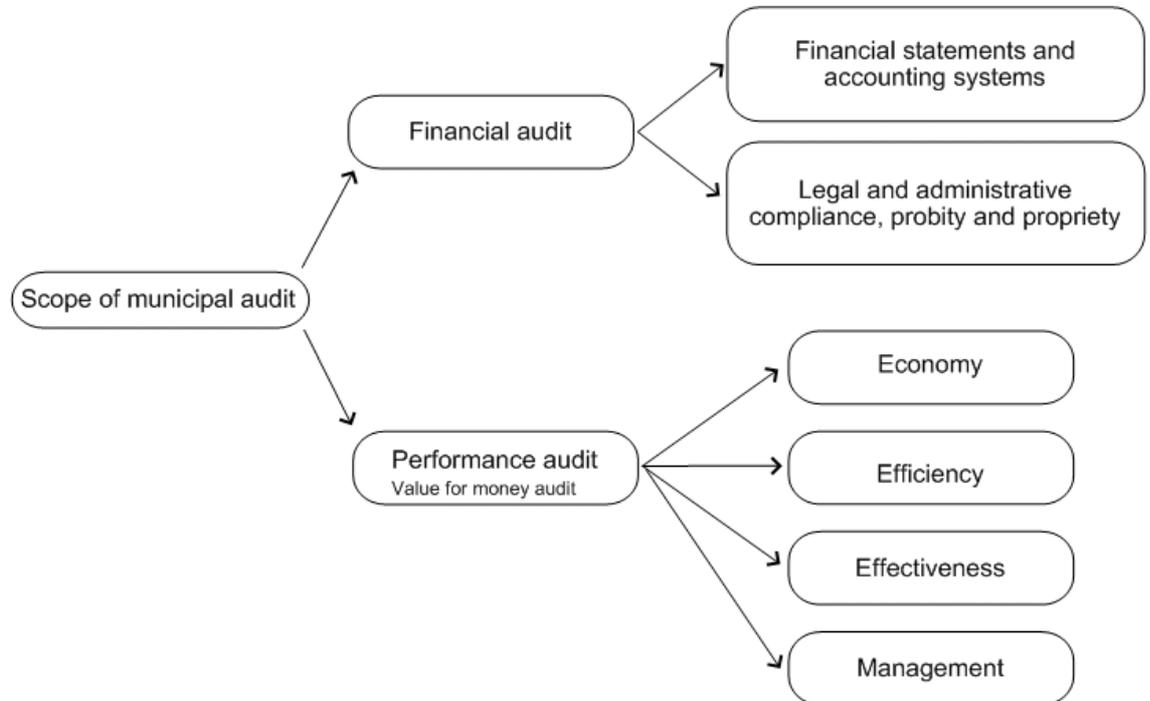
When making examinations of public expenditure programmes, an analysis will be made of an audit area without any necessary connection with the annual accounts. A preliminary study is made, resulting in a presentation which includes analysis of financial, judicial and management related matters. The auditor shall, in accordance with the principles of good public auditing practice, make a written report. The report must set out its purpose, methodology, basis of assessment, and results of the examination. The conclusions and any recommendations must be supported by evidence and documented. In the principles of good public auditing practice a lot of emphasis is placed on the viewpoints of the audited entity - any comments from the audited entity are faithfully incorporated in the report and the reporting should clearly present questions and problems which the decision makers should act on.

It is important to notice that it is not the aim of performance audit to evaluate political decisions, but to evaluate the material which have formed the basis of the political decision. Therefore it is the municipal council who decides how they will react on the recommendations from the auditor.



The following figure gives an overview of the scope of audit.

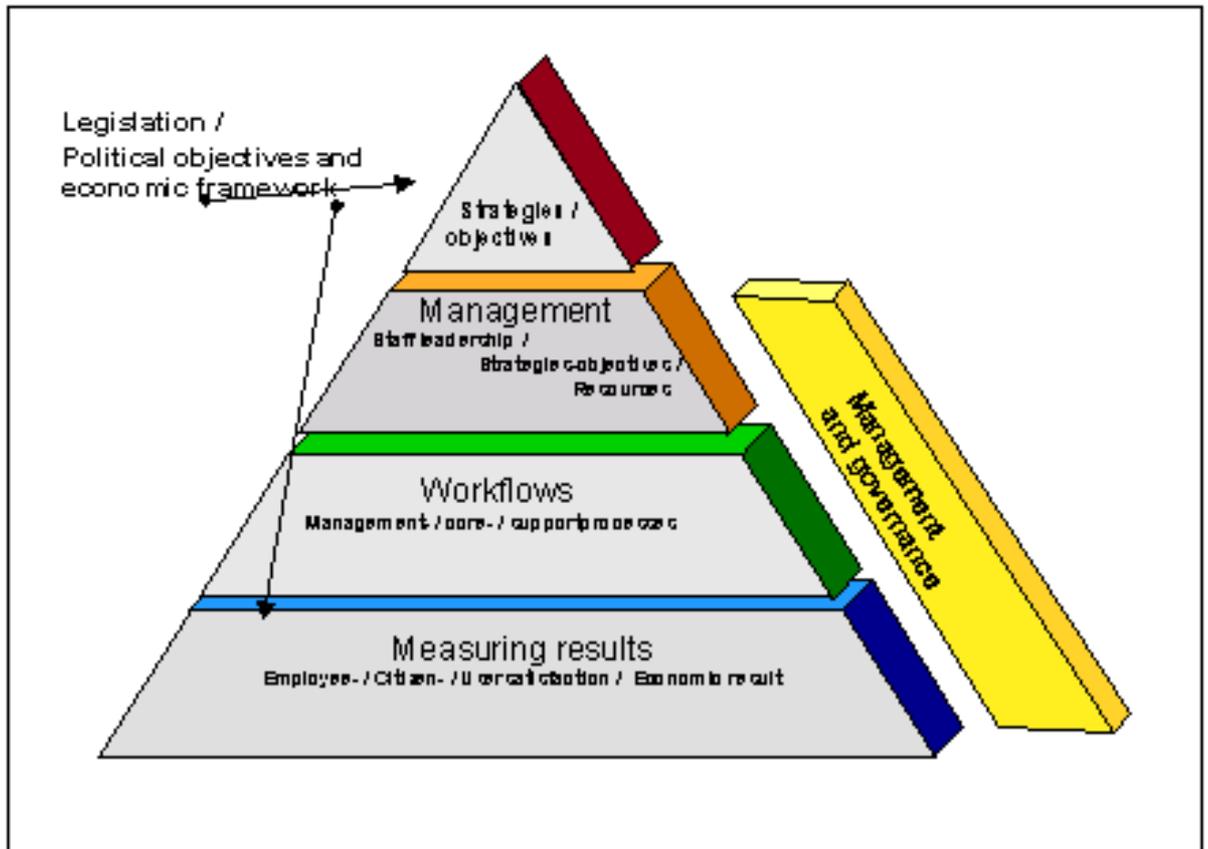
The scope of audit



6.2.3 Example of an audit on one of the key areas

Example of an analytical audit

In the audit process the auditor has to give attention to and understand the municipalities operations, strategies and performance system, and integrate the principles from the financial audit with the principles from the performance audit. By auditing the specific entity, institution or key area the auditor can systematically use the subsequent model as a starting point, where the auditor on the basis of the legislation and the politicians objectives and goals and frameworks is focusing on, how the management in the municipality has created coherence and contest between the political objectives and framework for service, quantity, resources and the achieved results.



Assess the municipalities activities based on a systematic examining of,

- w **Legislation / political objectives, goals and framework** - based on existing legislation and the political objectives, goals, framework and steering tools, which are laid down in the area.
- w **Strategies / objectives and goals** - It shall be assessed how political and administrative strategies and objectives and goals for e.g. results, quality in service, framework, quality and effekt is laid down and spread out in the organisation - *Effektivens*
- w **Management** - It shall be assessed , how management on the specific areas of responsibility, is organised / performed to secure, that the municipalities resources are used effektivt, improved and conserved - *Management - economy*
- w **Working processes** - It shall be assessed, how the municipality's working processes are laid down and performed, and how they are evaluated and improved (system audit), and has the management established an adequate level of control and -environment - *Financial Audit / efficiency*
- w **Measuring result** - It shall be assessed, which elements is a part of the measuring of the municipalities result-, quality- and objectives and goals, and which actually results is achieved - *Effektivens - efficiency - Financial Audit*



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- w **Management** - It shall be assessed, which management information / management tools are used to secure the quality and effectiveness in the performance of the tasks.

By this systematical audit and examination, focusing on the general proces - from beginning to end - the auditor has the possibility to identify the possibilities for improvement and reforms, which can be identified in correlation between the specific areas in the municipality.

Finally a basis is created for a dialogue about

- w simplification/reduction of aktivitees, giving poor or no increase in view of value for money (excessive control activities - duplication of work - coping and so on)
- w improving the value creating activities by making smaller adjustments in the process (removal of bottlenecks, reduction of complexity, improvement of coordination)



6.3 Audit performance

6.3.1 Audit Program

The list of audit procedures for an audit area or an entire audit is called an audit program. The audit program always includes a list of the audit procedures. It usually also includes sample sizes, items to select, and the timing of the tests. Normally, there is an audit program, including several audit procedures, for each component of the audit. Therefore there will be an audit program for accounts receivable, for salaries and so on.

Most auditors use computers to facilitate the preparation of audit programs. The simplest computer application involves typing the audit program on a word processor and saving it from one year to the next to facilitate changes and updating. A more sophisticated application involves the use of specialised program designed to help the auditor think through the planning considerations of the audit and select appropriate procedures using auditor program generator software.

6.3.2 Relationship between interim audits and annual audits

A part of the audit procedure that normally would be performed for annual audits can be omitted for interim audits, assuming that such omissions are reasonable.

E.g. the legislation demands that the municipal auditor has to evaluate the effectiveness of the internal control in the municipality, and has to make cash checks.

The level of assurance in interim audits are not as high as the level of insurance on annual audits.

Interim audit

Interim audit should be performed as an integral part of the annual audit process. It should be well planned to utilise the result of procedures performed during the interim audit in the annual audit.

The auditor should perform interim audit efficiently and systematically. For this purpose the auditor must create interim audit plans in conjunction with his consideration of the audit plan for the annual audit.

When planning interim audit the auditor should take the following issues into consideration:

- w The materiality level at the planning stage
- w Evaluation of the effectiveness of internal controls
- w Procedures that would normally be performed in interim audits
- w Audit procedures on interim financial statements



6.3.3 Sampling

The audit findings, conclusions and recommendations must be based on evidence. Since auditors seldom have the opportunity of considering all information about the audited municipality or entity, it is crucial that the data collection and sampling techniques are carefully chosen.

Before the audit can be performed the auditor needs to decide for each audit procedure the sample size and sample items to select from the population.

Factors affecting the decision to sample

Audit evidence can be obtained using various techniques which fall into the broad categories of inspection, observation, inquiry and confirmation, computation and analysis.

The auditor can apply such techniques to an entire set of data (100% testing) or may choose to draw conclusions about the entire set of data (the population) by testing a representative sample of items selected from it. This latter procedure is audit sampling.

The auditor must make a judgement as to whether sampling is an appropriate way of obtaining some of the audit evidence required. Amongst the factors that must be considered are:

- the number and relative sizes of the items in the population
- the materiality of, and inherent risk of error in, the items concerned
- the relevance and reliability of evidence produced by alternative tests and procedures, and the relative costs and time involved in each.

Sampling will frequently be appropriate when undertaking both tests of control and substantive testing. However, as the objectives of these types of testing are different, different sampling approaches may need to be used.

Basic concepts and definitions

As the auditor is seeking to draw conclusions about a whole population by testing a sample of items selected from it, it is essential that the sample is representative of the population from which it is drawn.

There is a risk that the conclusions the auditor reaches after testing a sample are different to those that would have been reached had the whole population been tested: this is known as sampling risk. The auditor must use judgement in planning, carrying out and evaluating the results of sampling work in order to reduce sampling risk to an acceptable level.

A sample may be statistical or non-statistical. Both require the use of professional judgement in the planning, testing and evaluation stages. In addition, statistical sampling demands the use of random selection methods, and uses probability theory. This allows the auditor to:

- determine the sample size
- evaluate the results quantitatively; and
- estimate the sampling risk, and thus draw conclusions regarding the whole population.



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This handbook does not seek to provide detailed guidance in the area of probability theory: if necessary the auditor should obtain expert advice in order to reach sound judgments in this area.

Even when the auditor decides to take a non-statistical sample, consideration should be given to using random selection methods. This would normally increase the likelihood of the sample being representative of the population. The auditor must always carefully consider whether a non-statistical sample provides a reasonable basis for drawing conclusions about the population from which it was drawn.



6.3.4 The impact of information technology on the audit process

Even when a municipality's use of IT leads to enhanced internal control, the use of IT-based accounting systems introduces new risks typically not associated with traditional manual systems. Well managed municipalities recognise these new risks and respond by implementing effective general and application controls in the IT system to reduce the impact of those risks on financial reporting. The auditor must be knowledgeable about these risks and obtain an understanding of the municipality's general controls and applications controls to effectively plan an audit. Obtaining knowledge about general controls provide a basis for the auditor to rely on application controls. Some of the auditor's test of controls can be performed by the computer, often as a way to achieve more effective and efficient audits.

6.4 Documentation of auditors work

6.4.1 Working papers

To perform the audit in line with international standards it is demanded, that the auditor documents his work correctly. This documentation is done in the working papers.

The purpose with the working papers is:

- w to document an appropriate justifiable planning of the audit task. In this way the audit covers all relations of importance,
- w to make it possible for another senior auditor who has not participated in the performance to make quality control of the audit work
- w to document the performed audit including how the conclusions are achieved

If an audit is not documented it cannot be considered performed.

Standard for working papers (Example).

In the following chapters there is a presentation of a standard of the content of working papers.

Model for internal working papers - to ensure quality and uniformity

- The objective, result and conclusion
- Audit results on key areas/visits
- Follow up on audit plans

The advantage of uniformed rules for making working papers

Advantage for the senior auditor

It is easier to survey working papers, which are prepared after uniformed principles. Better and more survivable working papers will in that way form a better basis for writing the management letters and the audit reports.

**Advantage for the auditor**

A uniformed concept is also an advantage for the auditors, who have formed the working papers. The auditors know, how the working papers have to be formed, and when the senior auditor has certified the working paper, the performed audit is approved and the responsibility for an sufficient audit is in that way transferred to the senior auditor.

Advantage for the quality control

Good working papers is a condition for the quality control. Rules for uniformed working papers makes the quality control easier and cheaper.

See chapter 6.5 about Quality Control.

The content of a working paper

The following chapters gives some guidelines for the main content of a working paper.

Objectives and goals

The working paper describes the objectives and goals with the audit tests.

Decision's of evidence

The auditors decision on evidence is a very important part of the audit. The auditor's decision of evidence can be broken down into four sub decisions:

- w Which audit procedures to use
- w What sample size to select for a given procedure
- w Which items to select from the population
- w When to perform the procedures

This judgement is important because of the prohibitive cost of examining and evaluating all available evidence.

Result / conclusion

Under this point of the working paper the result / conclusion of the audit tests are described, and it is estimated if the result is of such an importance that it has to be mentioned in the audit report or management letter.

Review by senior auditors

When the audit work is finished the auditor signs the working paper, which is due to review and approval by senior auditors.

Follow up on audit plans and programmes

Planned and not performed audit tests shall be listed here to secure that the audit tests will be performed later in the audit process.

Ownership of working-papers and audit files

Audit documentation prepared during the engagement, including schedules prepared by the municipality or entity for the auditor, is the property of the auditor.

The only time anyone else, including the client, has a right to examine the files is when they are subpoenaed by a court as legal evidence.



Summary

Audit documentation is an essential part of every audit for an effective planning of the audit, providing the record of the evidence accumulated and the results of the tests, deciding the proper type of audit report, and reviewing the work of assistants. The audit firm establish their own policies and approaches to audit documentation to make sure that these objectives are met.

6.4.2 File of working papers

The working papers are filed in permanent files and current files.

Permanent files

It is not possible to make a complete list of the contents of the permanent files. However it is important, that the permanent files contains documents, having importance for the audit from year to year.

The permanent files typically include the following:

- w The audit agreement
- w Cash and funds administration and accounting regulations
- w Information related to the understanding of internal control and assessment of control risk
- w Extracts or copies of bylaws and contracts which are of significance to the auditor for as many year as it is in effect
- w Administrative organisation and staff policy
- w Budgets and Financial statements from preceding years
- w The results of analytical procedures from the audit of previous years
- w Accounting system (IT-systems) and decentralised accounting
- w Audit reports
- w Management letters

Current files

The current files include all audit documentation applicable to the year currently being audited. The current file typically include the following:

- w Audit programmes for every audit
- w Audit memos
- w Copies of minutes from council and committees
- w Working papers



6.5 Quality control

The purpose of quality control is to ensure and maintain that the auditor meets his professional responsibilities to clients and others. These methods include the organisational structure of the audit firm/entity and the procedures the audit firm/entity establishes. For example, the firm or audit entity might have an organisational structure that ensures the technical review of every engagement by an auditor who has the expertise in the municipalities task and legislation. At the same time the audit firm/entity must ensure that generally accepted auditing standards are followed on every audit.

It is recommended that the audit firm/entity establishes quality control policies and procedures.

6.5.1 Example on a guideline

In the following you will find an example on a guideline for a quality control policy:

Preamble

“The purpose of this guideline is to maintain and increase the quality control system of the audit firm to ensure the high standard of work by the auditor.

These guideline express general principles which have to be more specific in the quality control system in the specific audit firm.

The words “personnel” and “staff” in these guidelines include every person doing audit and/ or consultancy work within the audit firm/entity.

Quality control is split into two: internal and external control.

Internal control is carried out by the audit firm/ entity and is split into three:

- w A general chapter where policies and procedures regarding the quality control are determined.
- w An individual chapter regarding the quality of the individual audit.
- w A review chapter (after the auditors report).

The external control has to be carried out by an external body. It is not possible to point out which body will be relevant, because the organisation of the municipal audit in Latvia is not decided when this handbook was finished.

Internal quality control

The purpose of internal quality control is to establish:

- Policies and procedures for the audit firm/ entity in general.
- Procedures regarding the individual audit.
- Procedures regarding internal reviews of the quality control.

**Generally**

The audit firm/ entity should implement control policies and procedures, and should incorporate the following objectives:

- w Professional requirements:* The auditor adhere to the principles of Independence, Integrity, Objectivity and Confidentiality.
- w Skills and competence:* The audit firm/ entity is staffed by people who have the skills and competence required to enable them to fulfil their responsibilities.
- w Information systems:* The audit firm/ entity have systems that spread information to increase know-how.
- w Assignments:* The audit firm/ entity is to assign audit work to personnel who have the level of on the job training proficiency required under the circumstances.
- w Delegation:* The audit firm/ entity makes sure there is sufficient direction, supervision and inspection of work at all levels to provide reasonable assurance that the work performed meets appropriate standard of quality.
- w Consultation:* It is necessary that whenever the audit firm/entity use consultants within or outside the firm the consultants should have the appropriate expertise.
- w Monitoring:* The audit firm/ entity monitors the continued adequacy and operational effectiveness of quality control policies and procedures.

Individually

The auditor in charge examines and is responsible for the quality of the work of his staff e.g. planning, performing, documentation and reporting.

The auditor in charge is responsible for the implementation of quality control procedures which are in accordance with the policies and procedures of the firm and appropriate to the individual audit.

The audit firm/ entity base their plans on knowledge of the specific client situation with regard to:

- Legislation.
- Generally accepted public auditing standards.
- Company policies.
- Internal control procedures and risk analysis

The auditor in charge considers the professional competence of personnel performing work delegated to them, when deciding the extent of appropriate direction, supervision and inspection.

The audit firm/entity have set standards for their audit documentation and document matters which are important in providing evidence that the audit was carried out in accordance with principles of objectivity, integrity, independence, and confidentiality.

Working papers should record the auditors planning, the nature, timing and extent of the auditing procedures performed and the conclusions drawn from the evidence obtained.



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Working papers should be sufficiently complete and detailed for an experienced auditor to obtain an overall understanding of the audit.

The audit firm/entity has to set standards for reporting the results to the clients.

- The procedures are based on legal and company requirements.
- Reporting is intended to give an reliable information about the audit in a form useful to the governing bodies, to the organisation audited and to other concerned parties. Reporting may be done in a specified form for different objects and for different levels of the client's organisation.
- Many circumstances in various situations determine the timing, contents and distribution of reports.
- There must be valid evidence to support presented matters.
- No report should be delivered to the client before relevant findings have been discussed with him/her.

Review

The audit firm/ entity work out guidelines for planning, performance, documentation and reporting of the internal reviews.

The internal review is done in accordance with guidelines for reviews. This include both the quality control in general and control of the individual audit.

The review is done to determine that work has been planned and carried out efficiently and in conformity with professional and company standards.

External quality control

The purpose of the external quality control is that a third party checks the quality control system of the audit firm/ entity and checks that the quality control is sufficiently documented.

6.6 Reporting

6.6.1 Standards for reporting

Audit reports are essential because they communicate the auditors findings. The different stakeholders around the municipality rely on the auditors reporting to provide assurance on the municipalities financial statements and economic performance in general.

The audit firm/entity has to set standards for reporting the results to the municipalities.

- The procedures are based on legal and company requirements.
- Reporting is intended to give an reliable information about the audit in a form useful to the council, to the organisation audited and to other concerned parties. Reporting may be done in a specified form for different objects and for different levels of the client's organisation.
- Many circumstances in various situations determine the timing, contents and distribution of reports.



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- There must be valid evidence to support presented matters.
- No report should be delivered to the client before relevant findings have been discussed with him/her.

The auditor reports to the council about the audit performed in audit reports, which are in line with the demands from the legislation and the councils need for information. Audit reports are given in connection to interim audit and in connection to the final annual audit.

The auditor reports immediately if the audit expose irregularities, breach of the law and other important issues. Audit reports are presented in a meeting with the management before they are forwarded to the council.

The auditor's reporting is - in the light of his/her integrity - in line with the needs from the municipality, so that it can be used as a tool in the political and administrative steering process. The following examples of reporting will be relevant:

- w Ongoing oral dialogue with the management and personnel from the municipality.
- w 1 - 2 meetings per year with management as well as relevant politicians.
- w Management letters after each audit.
- w The annual financial statement and other required statements and specifications are supplied with audit reports.

6.6.2 Engagement letter

An engagement letter is an agreement between the auditor and the municipality for the conduct of the audit and related services. It should specify how the auditor will perform the audit and other services. It should also state any restrictions to be imposed on the auditors work, deadlines for completing the audit, assistance to be provided by the client's personnel in obtaining records, and documents, and schedules to be prepared for the auditor. The engagement letter is also a means of informing the municipality that the auditor cannot guarantee that all acts of fraud will be discovered.

Engagement letter information is important in planning the audit principally because it affects the timing of the tests and the total amount of time the audit and other services will take. When auditing municipalities a significant portion of the audit must be done before the end of the year.



6.6.3 Interim audit report or management letter

Interim audit reports or management letters are both reporting about the audit done before the end of the year. The difference between the two kinds of reporting is that the interim audit report is for the council and the management letter is only for the management. The latter is mostly for recommendations to management and can be seen as a value-added service of the audit.

In light of the importance of the auditors findings he/she decides if the finding is reported in the interim audit report or in the management letter.

The interim audit report or management letter should inform about the auditor findings before the end of the year. The reports contain information on all important findings and are at the same time intended for improving any aspect of the tasks of the municipality. The recommendations focus on suggestions for more efficient operations. The combination of the auditor's experience in the tasks of municipalities and thorough understanding gained in conducting the audit place the auditor in a unique position to provide council and management with information about his findings and with assistance and in that way add value to the municipality tasks beyond the audit service provided.

The auditor also reports in the interim audit report on the result of his/her test of the effectiveness of internal control and the control environment.

6.6.4 Reporting and presentation of results from Performance Auditing

Presentation of audit results should be in the form of an interim report and an oral presentation. The result of the project depends on how well the presentation is prepared and carried out. The reports are sent to the municipal board and are open to the public.

The final stages of Performance Auditing involves reaching conclusions based on the investigations, making recommendations and drafting the report. Unless the results are presented in a clear, comprehensible manner, the project will not achieve the intended results.

Conclusions must be based on reliable, up-to-date information. The report itself should be concise, clear and easy to read. In order to make the information interesting and easy to read, the text should, if possible, be mixed with graphics.

A summary of the report including main findings should be used. special attention should be given to the framing of recommendations so the decision makers can choose the right solutions.

6.6.5 Annual audit report

The annual audit report is the final reporting of audit carried out by the auditor to the council and other relevant external bodies.

At the end of the annual audit the auditor should prepare an annual audit report, as appropriate, setting the findings in an appropriate form. Its content should be easy to understand, clear and precise and only include information which is supported by competent



and relevant audit evidence. Finally the report shall be independent, objective, fair and constructive.

6.6.6 Audit of the annual accounts and financial statement.

The audit of the annual accounts and financial statements shall establish the accounts are made on basis of the bookkeeping and in accordance with rules and regulations for accounting. During the audit it must be assessed whether the accounts contain the necessary information for evaluation of how the appropriations issued by the municipal council have been applied during the accounting year.

Regarding the financial status it must be ensured that assets shown in financial status are real and that the municipality has possession. It must furthermore be ensured that the valuation of assets is reasonable and that debts and other obligations have been properly included in the annual accounts. Thus assuring that the financial status gives a proper and realistic view of the financial position of the municipality at the end of the year in question closely in accordance with the budget and accounting provisions from the ministries.

6.7 Auditors use of IT

To day it is more and more common that the auditor uses the computer as an audit tool. The objectives and scope of audit do not change when an audit is performed in an it environment.

It is possible to buy software tools designed specifically for auditing professionals, as well as applications that have been developed of the audit firm or unit.

Information technology normally will improve the effectiveness and efficiency of auditing procedures.

Information technology can be used in performing various auditing procedures, e.g.:

- w Data analysis
- w Work flow systems
- w Know how databases
- w Web download

Data analysis

Data analysis can be used to test of details of transactions and balances or for analytical procedures for example identifying inconsistencies or significant fluctuations.

The advantage is that the data analysis can handle large volumes of data in a very short time.

Work flow systems

Another possibility for the auditor is to design the total audit process in a work flow system. That means electronic, for example:

- Audit programmes



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- Audit planning and risk assessment
- Working papers

The advantage by using the work flow system is that effectiveness and efficiency may be improved.

It will also be easier to make quality control of the auditors work for example because of the standard of working paper documentation.

Know how databases

Databases with information needed of the auditors, about legislation, audit firm policies and other relevant information for the auditor.

Web download

The widespread use of the web has also made a dramatic impact on how a modern auditor works. Thanks to web-based tools, auditors can now access, read, analyse and manipulate data files drawn from all sorts of sources including legacy mainframe systems, and present that information in a user-friendly format.



7 EU requirements regarding control and audit

In order to avoid having to pay back the EU subsidies, the main concern of the municipality should be to obtain certainty that projects are successfully carried out and in accordance with the relevant rules.

When involved with EU projects, one must pursue the aims which are laid down in the different EU programmes and at the same time ensure that the operations financed by the EU are properly carried out. In other words, the taxpayers must be sure to get value for their money.

This chapter gives a brief introduction to the set up of the EU monitoring system and in general terms it also describes the tasks to be carried out by the auditor in relation to the auditing of, and rendering of accounts for, EU financed projects.

In order to ensure a high standard in the auditing of - and rendering of accounts for - EU financed projects the accounting and auditing must respect both EU and national regulation. It is important to notice that EU regulation, rules and policies varies from fund to fund. Therefore it is necessary to find out how to follow the rules at project level.

In the following we will deal with the specific rules primarily for the structural funds and community initiatives but also other programmes within more specific areas such as environment, culture etc.

The basis of EU control

In article 280 of the EU Treaty, you will find the following fundamental principle which relates to control and auditing as a measure in protecting the EU against fraud:

"Member States shall take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interests.

Without prejudice to the other provisions of the Treaty, Member States shall co-ordinate their action aimed at protecting the financial interests of the Community against fraud. To this end they shall organise, with the help of the Commission, close and regular co-operation between the competent departments of their administrations."

In practice the control is carried out in co-operation with the EU control bodies and the competent departments of the Member State's administration (joint inspections). Inspections can also be carried out when the Commission considers it necessary (autonomous inspections). The rights for the EU officials to make these checks come from the Treaty.

On EU's side the European Court of Auditors is responsible for the external auditing and the commission for internal auditing and control. In practice the control work of the commission is mainly done by Financial Control, although those Directorates which CO-finance programmes or projects in Member States have their own control units.

The main purposes of the EU control

According to different EU regulations the main objectives of EU control are summoned as follows:

w to ensure the effective use of community contribution



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- w to ensure that the projects are in conformity with the provisions of the treaties
- w to ensure that the projects are in conformity with the community policies (rules on competition, environmental protection, equal opportunities)
- w to verify the regularity of payment requests

Different programmes/projects lead to different audit

There is a very large spectrum of different programmes/projects where EU money is sent to the member states. It is essential to understand that the management, control and auditing systems are also different. The legal background for these can in some cases be listed directly in the treaty or specific council regulations but in many cases it is either in the programme documents, contracts or aid decisions. The conditions for aid or guidance for control may also be stated in these documents. This means that the depth, aims, methods and reporting related to accounting and auditing of EU financed projects depends on where the subsidy comes from.

The implementation and control systems of the Structural Fund's programmes are partly written in council regulations, partly in programme documents and decisions (or in their annexes). There are regulations which are valid for all Funds and each Fund also has its own council regulation. The commission has also made some decision concerning the implementation provisions. These are normally mentioned in the programme document (or annexes).

As mentioned the EU Treaty states that the member states shall take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interest.

As far as the Structural Funds are concerned, the roles of the Member States and the Commission are defined in Article 23 of Council Regulation (EEC) no. 4253/88:

"The Member States bear prime responsibility and are required to prevent and take action against irregularities, recover any amounts lost and inform the Commission of the measures taken for those purposes and, in particular, of the progress of administrative and judicial proceedings."

There are differences in the way in which the EU projects are managed and controlled in the individual member states. The nature of the project (for instance a project of a Structural Fund programme, projects financed directly by the Commission, contract or subsidy) leads to different regulations. Each project has its own rules and needs for the rendering of accounts and for the auditing. Decisions made in the Member State concerning the project may have their own provisions for the projects.

All these regulations, rules and decisions from all levels related to the project should be familiar to the project responsible and the auditor.

Requirements related to accounting and auditing

In the following please find a brief description of those special requirements which on one hand the auditor has to be aware of and which on the other hand could be useful information to the project responsible as well.

**Planning**

It is advisable for the auditor to produce specific audit plans for auditing the different types of projects and for each country. The principles in the **Protocol** (if signed by the respective country) should be followed in these plans, for instance in order to avoid double auditing.

Eligible costs

It is essential in both rendering of accounts for, and auditing of, EU projects to check that all expenditure declared from a project is eligible for EU financing. Otherwise there is a risk that the EU aid has to be paid back (at least partly).

The fact is that the eligibility rules are different even for different Structural Funds as well as other programmes/projects.

An auditor, as well as the project responsible, should be aware of the eligibility rules for the projects. Basic principle is that only the real expenditure directly related to the project and from the eligible time period is eligible for EU financing. However, there are many exceptions from this general rule.

EU polices

The projects cofinanced by EU should be in conformity with EU polices mentioned for instance in the Treaty, in Council Regulations or in Commission decisions. Examples of this kind of polices are rules on competition, environmental protection, equal opportunities or publicity of EU projects.

Performance Auditing

Performance Auditing is aimed at determining whether the operations are carried out in an appropriate way and are satisfactory from an economic point of view. As a part of the auditing the auditor must determine whether the action taken has had the desired results. The auditor therefore must see to that the provisions for the four aspects:

- w Economy
- w Efficiency
- w Effectiveness
- w Management system

have been followed.

Bookkeeping and vouchers

Project administration must follow the individual members state's national rules for bookkeeping. Furthermore, the bookkeeping must be carried out in independent account areas so that the project account can easily be separated from the beneficiary's own bookkeeping/accounts.

The vouchers related to each project expense must be original and comply with the common standards for vouchers in the individual member state.



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Auditor's report on financial statements

The audited project account must contain an audit certificate

In many cases the audit certificate is a standard audit certificate which has been defined in co-operation with or dictated by the body administrating the project. The auditor must find out whether or not such a standard audit certificate exists for the particular project before he issues the audit certificate to the project account.

If no standard audit certificate exists, the audit certificate should be produced in such a way that it relates to the specified requirements for accounting and auditing.



8 Publications and literature on audit

- w European Implementing Guidelines for the INTOSAI Auditing Standards 1998
- w Auditing and Assurance Services an Integrated Approach, Ninth Edition, Prentice Hall
- w International Federation of accountants - IFAC
- w SIGMA Baselines, Public Management Forum, Vol.V, No. 6 November/December 1999, p 6-7



9 Glossary

Audit is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent independent person.

Audit criteria's: To do an audit, there must be information in a verifiable form and some standards - criteria - by which the auditor can evaluate the information. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including clients' financial statements. Auditor also performs audits of more subjective information, such as effectiveness and efficiency.

The criteria for evaluating information also vary depending on the information being audited. For example, in the audit of the historical financial statements, the criteria usually is general accepted accounting principles.

For more subjective information, such as auditing the effectiveness of specific operations, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts.

Audit Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including oral testimony of the client, written communication with outsiders, observations by the auditor, and electronic data about transactions. It is important to obtain a sufficient quality and volume of evidence to satisfy the purpose of the audit.

Audit planning: Audit planning is developing an overall strategy for the conduct and scope of the audit. The nature, extent, and timing of planning varies with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business and tasks.

Internal control: The whole system of financial and other controls, including the organisational structure, methods, procedures and **internal audit**, established by management within the corporate goals, to assist in conducting the business of the audited unit in a regular economic, efficient and effective manner; ensuring adherence to management policies; safeguarding assets and resources; securing the accuracy and completeness of accounting records; and producing timely and reliable financial management information. (INTOSAI)

Internal audit: The functional means by which the managers of an entity receives an assurance from internal sources that the processes for which they are accountable are operating in a manner which will minimise the probability of the occurrence of fraud, error or inefficient an uneconomic practices. It has many of the characteristics of external audit but may properly carry out the directions of the level of management to which it reports. (INTOSAI)

External audit: External auditing of an organisation, where the auditors are not under the control of the organisation and may not report to objectives, set by the organisation. (xxx)



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Inherent risk: A measure of the auditors assessment of the likelihood that there are material misstatements in a segment before considering the effectiveness of internal control.

Control risk: A measure of the auditors assessment of the likelihood that misstatements exceeding a tolerable amount in a segment will not be prevented or detected by the internal controls.

Audit risk: A measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unqualified opinion has been issued.

Materiality: A misstatement in the financial statement can be considered material if knowledge would affect a decision of a reasonable user of the statement.

Sigma: Support for Improvement in Governance and Management in Central and Eastern European Countries - A joint initiative of the OECD and the European Union.