

INTOSAI



# *Fundamental Principles of Compliance Auditing*

*Exposure draft*

Comments due 15 February 2013

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

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PSC-SECRETARIAT

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## INTRODUCTION

1. Professional standards and guidelines are essential for the credibility, quality and professionalism of public sector auditing. The International Standards of Supreme Audit Institutions (ISSAIs) developed by the International Organization of Supreme Audit Institutions (INTOSAI) aim to promote independent and effective auditing and support the members of INTOSAI in the development of their own professional approach in accordance with their national laws and regulations and mandate.
2. ISSAI 400 Fundamental Principles of Compliance Auditing provides an overview of the nature, the elements and the principles of compliance auditing as conducted by Supreme Audit Institutions (SAIs).
3. ISSAI 400 has to be read and understood in conjunction with ISSAI 100, which includes the fundamental principles for public sector auditing in general. The principles of ISSAI 100, including specifically those relating to ethics, independence and quality control, also apply to compliance auditing. ISSAI 400 builds on the fundamental audit principles in ISSAI 100 and develops some of them further to suit the specific context of compliance auditing.
4. ISSAI 400 explains the nature of and constitutes the basis for auditing standards in compliance auditing in accordance with the ISSAIs. ISSAI 400 provides detailed information on the following:
  - The purpose and authority of the ISSAIs on compliance auditing
  - The nature of compliance auditing and different ways in which it is performed
  - The elements of compliance auditing
  - The principles to be applied in conducting a compliance audit
5. The overall objective of compliance auditing is to enhance confidence in the public sector by promoting good governance and sound management of the execution of public budgets and by assessing whether funds, management and due process rights of citizens are dealt with in accordance with applicable authorities. Compliance auditing is described as a field of public sector auditing within the specific constitutional arrangement of a SAI and by virtue of its office and mandate<sup>1</sup>.
6. Compliance auditing in the public sector has two main pillars:
  - compliance as the basis of sound governance, both with rules, laws and regulations and with general principles of sound public sector financial management and conduct of public sector officials<sup>2</sup> (collectively defined as authorities<sup>3</sup>), and
  - an approach to auditing oriented by the objective to obtain assurance and to provide confidence<sup>4</sup> in the trustworthiness and accountability of the public sector.

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<sup>1</sup> ISSAI 100 paragraph 10.

<sup>2</sup> See paragraph 20 Regularity and propriety.

<sup>3</sup> See page 10 Authorities and criteria.

<sup>4</sup> See page 12 Assurance in compliance auditing.

7. Both these pillars are further explained as basic elements of compliance auditing and need to be identified by the SAI before applying the fundamental principles of compliance auditing. These principles are divided into **general principles**, which are those that the auditor should consider prior to commencement and throughout the entire audit process, and **principles related to the audit process**, which are those related to the identified steps in the audit process itself. For the purpose of clarity ISSAI 400 distinguishes between *compliance auditing* as a field of public sector auditing and a *compliance audit*, which is the conducting of a specific audit.

## PURPOSE AND AUTHORITY OF THE FUNDAMENTAL PRINCIPLES OF COMPLIANCE AUDITING

8. The purpose of the set of ISSAIs<sup>5</sup> on compliance auditing is to provide INTOSAI members with a comprehensive set of principles, standards and guidelines for compliance auditing of a wide range of subject matters, both in terms of audit scope and of qualitative and quantitative nature, being performed by applying various audit approaches and reporting formats.
9. ISSAI 400 Fundamental Principles of Compliance Auditing provides the SAI with a fundamental basis for the adoption or development of standards and guidelines relevant for compliance auditing.
10. The Fundamental Principles of Compliance Auditing are the generally recognized principles that underpin effective, independent auditing of compliance in public sector entities. The principles can be used in two ways:
- To form the basis on which standards are developed or consistent national standards are adopted.
  - To form the basis for adoption of the Compliance Audit Guidelines (ISSAI 4100 or 4200) as the authoritative standards.
11. Accordingly, ISSAI 400 provides the basic principles for adoption of, or development of, standards and guidelines relevant to compliance auditing in the public sector. ISSAI 400 constitutes principles and should not be applied as authoritative standards. SAIs may choose to develop or adopt national standards based on or consistent with these fundamental auditing principles.
12. SAIs should only make reference to the Fundamental Principles of Compliance Auditing (ISSAI 400) in audit reports or auditor's reports if the standards they have developed or adopted fully comply with all relevant principles of ISSAI 400. A principle is considered relevant when it deals with the type of audit or combinations of audit types and the circumstance or procedure is applicable. The principles do not override national laws, regulations or mandates. SAIs adopting ISSAI 4100 or 4200 as their authoritative standards make reference to these in their reports.
13. The Fundamental Principles of Compliance Auditing are developed to address the key principles related to an audit dealing with the responsibility of the SAI to monitor that the

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<sup>5</sup> ISSAI 400 and ISSAI 4000 series.

activities of public sector entities are in accordance with applicable authorities that govern such entities. This involves reporting on the degree to which the audited entity follows rules, laws and regulations, policy, established codes, agreed upon terms or general principles of sound public sector financial management and conduct of public sector officials. The Fundamental Principles of Compliance Auditing provide the foundation for auditing standards related to compliance audits. INTOSAI members are encouraged to develop or adopt standards based on these principles.

14. The Compliance Audit Guidelines are intended to support the application of auditing standards based on the Fundamental Principles of Compliance Auditing in providing more detailed guidance and supporting these principles. ISSAI 4000-4200 are the best example of how the Fundamental Principles of Compliance Auditing can be applied. For compliance audits performed together with the audit of financial statements, the Compliance Audit Guidelines supplement the Financial Audit Guidelines (ISSAIs 1000-2999).
15. As the Compliance Audit Guidelines have been developed to reflect best practice, SAIs are encouraged to strive towards full adoption of them as their authoritative standards. INTOSAI recognizes that in some environments this might not be possible due to lack of basic requirements in government structure or due to laws or regulations that will not allow for the premises attached to a compliance audit in accordance with level 4. SAIs in such environments has the option to develop standards based on or adopt national standards consistent with the Fundamental Principles of Compliance Auditing.

16. When adopting or developing auditing standards based on or consistent with the INTOSAI Fundamental Auditing Principles, reference to these in the auditor's report may be done by stating:

*... We conducted our audit in accordance with [national standards] based on (or consistent with) the Fundamental Auditing Principles (ISSAI 100-999) of the International Standards of Supreme Audit Institutions.*

17. SAIs in some jurisdictions may choose to adopt the Compliance Audit Guidelines as the authoritative standards for their work. Reference to the use of them as standards may be done by stating:

*... We conducted our audit (audits/compliance audits) in accordance with the International Standards of Supreme Audit Institutions (on compliance auditing).*

The reference may be included in the auditor's report or audit report or it may be communicated by the SAI in a more general form covering a defined range of engagements.

18. When the ISSAIs on level 4 are used as authoritative standards for a compliance audit conducted together with an audit of financial statements, auditors of public sector entities respect the authority of both the Compliance Audit Guidelines and the Financial Audit Guidelines<sup>6</sup>.

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<sup>6</sup> ISSAI 1000-1810.

## THE NATURE OF COMPLIANCE AUDITING

### *The objective of compliance auditing*

19. Compliance auditing is the independent assessment of whether a particular subject matter is in compliance with applicable authorities identified as criteria. Compliance auditing is performed by obtaining assurance as to whether activities, financial transactions and information are, in all material respects, in compliance with the authorities<sup>7</sup> which govern the audited entity.
20. The objective of compliance auditing is to enable the SAI to report to the appropriate bodies on the audited entity's compliance with a particular set of criteria. This involves reporting on the degree to which the audited entity is accountable for its actions and exercises good public governance. The reporting take different forms, either as brief standardized opinions, various forms of conclusions, short or long form reporting. Compliance auditing may encompass the assessment both of compliance with formal criteria of *what should be*<sup>8</sup> (regularity) and/or with the general principles of sound public sector financial management and conduct of public sector officials of *what could be* (propriety). **Regularity** is the main focus of compliance auditing, as most audits assess compliance with formal and explicit criteria. In addition, **propriety** may be pertinent due to the public sector context where expectations as to sound financial management and conduct of public sector officials also exist. Depending on the mandate of the SAI, the audit may, due to these expectations, include propriety aspects which would be part of the audit scope<sup>9</sup>. In other cases, and depending on the SAI's reporting framework, it may also report on propriety findings which might have been found during regularity audits<sup>10</sup>.

### *Characteristics of compliance auditing*

21. Compliance auditing may be applied in relation to a wide range of subject matters and can be performed with two levels of assurance<sup>11</sup>. Compliance auditing comprises several audit approaches, types of criteria, evidence gathering procedures and reporting formats.
22. Compliance auditing is often an integral part of the audit mandate for most audits of public sector entities. This is because legislation and other authorities are the primary means by which legislators control income and expenditure, management and due process rights of citizens in the public sector.
23. Laws, regulations and principles of sound financial management and conduct of public sector officials (authorities) regulate the activities public sector entities carry out for the citizens, any limits or restrictions on such activities, the overall objectives to be achieved and how due process rights of individual citizens are protected. Furthermore, public funds are entrusted to public sector entities for their proper management. It is the responsibility of these public sector bodies and their appointed officials to be **transparent** about their actions, **accountable** to the

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<sup>7</sup> See page 10 Authorities and criteria.

<sup>8</sup> ISSAI 100 paragraph 36.

<sup>9</sup> See paragraph 40 Criteria.

<sup>10</sup> ISSAI 100 paragraph 21.

<sup>11</sup> See paragraphs 53 & 54 Reasonable and limited assurance.

citizens for the funds with which they are entrusted, and to exercise **good stewardship** over such funds.

24. Compliance auditing promotes **transparency** by providing reliable reports as to whether funds, management and due process rights of citizens are dealt with in accordance with laws and regulations and by identifying the legal basis of an entity, hence contributing to improved transparency of the division of responsibility within the state. Compliance auditing promotes **accountability** by reporting deviations and violations from laws and regulations, so that corrective action may be taken, and so that those accountable may be held responsible for their actions. Compliance auditing promotes **good stewardship** both by revealing weaknesses and deviations from laws and regulations and by assessing propriety where appropriate laws and regulations are insufficient or where there are obvious gaps in legislation. Fraud and corruption are by their nature elements undermining transparency, accountability and good stewardship. Hence, compliance auditing promotes good governance in the public sector by addressing the risk of fraud in relation to compliance.
25. Depending on the organizational structure of the public sector and the mandate of the SAI, compliance auditing can cover all levels of government: central, regional, as well as local. Compliance auditing may also be applied to audits of private entities when they are tax payers or involved in the management of public property or services, for instance through partnership arrangements or as recipients of public grants or subsidies.
26. In certain countries, the SAI is a court, composed of judges, which has authority over state accountants who must render accounts to it. This jurisdictional function requires the SAI to make sure that whoever is charged with dealing with public funds is accountable for those funds and is in this regard subject to its jurisdiction. There exists an important complementary relationship between this jurisdictional authority and the characteristics of compliance auditing. This means that in compliance auditing there might be additional requirements for auditors operating in an environment with a judicial role, such as in court of accounts.

### *The different perspectives of compliance auditing*

27. Compliance auditing as performed by SAIs may cover a wide range of subject matters and may vary widely between different jurisdictions. Compliance auditing comprises several audit approaches, types of criteria, evidence gathering procedures and reporting formats.
28. Compliance auditing can be carried out in combination with other audit types, but is generally performed either:
  - related to the audit of financial statements (in which case ISSAI 4200 provides additional guidance), or
  - separately from the audit of financial statements (in which case ISSAI 4100 provides additional guidance), or
  - performed together with performance auditing.

### Compliance auditing performed related to the audit of financial statements

29. The premises and decisions of the legislature are the origins of the authorities governing cash flow in the public sector. The legislature as a part of a public democratic process, establishes the priorities concerning public sector income and expenditure, and concerning calculations of and purpose of expenditure and income. These decisions and premises of the legislature form the basis of compliance as the broader perspective of the audit of financial statements in the execution of the budget.

30. The audit of compliance with relevant authorities is often an important part of the audit mandate and integrated with the audit of the financial statements to report on the execution of public budgets.
31. Laws and regulations are important both in compliance auditing and in the audit of financial statements. Compliance auditing is the independent assessment of whether a particular subject matter is in compliance with applicable authorities identified as criteria. An audit of financial statements focuses on obtaining a general understanding of the legal and regulatory framework applicable to the entities environment and to obtain sufficient and appropriate audit evidence regarding those laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements.<sup>12</sup> When performing compliance auditing in relation to the Audit of Financial Statements, auditors use their knowledge of the entity and apply professional judgment to decide whether specific laws and regulations have an effect on the financial statements, and whether to apply the ISSAIs on Financial Audit and/or Compliance Audit as principles to base their auditing standards on or using the ISSAIs on level four as authoritative standards.
32. **ISSAI 4200** provides guidance to compliance auditing performed related to the audit of financial statements. These guidelines should be read together with INTOSAI's Financial Audit Guidelines (ISSAI 1000-2999).

#### Compliance auditing performed separately from the audit of financial statements

33. Compliance auditing may also be planned, performed and reported on separately from the audit of financial statements, and **ISSAI 4100** provides guidance on this. Compliance auditing performed as a task of its own may be carried out on a regular basis or on an ad hoc basis as a separate, identifiable audit task related to a specific subject matter chosen for audit.

#### Compliance auditing performed together with performance auditing

34. When compliance auditing is performed as a part of a performance audit, compliance is one of many aspects of economy, efficiency and effectiveness. Non-compliance might be the cause of, an explanation for or a consequence of the state of the activities under scrutiny in a performance audit. When performing compliance auditing related to a performance audit, auditors make use of their professional judgment to decide whether performance or compliance is the primary purpose of the audit, and whether to apply the ISSAIs on Performance Audit and/or Compliance Audit as principles to base their auditing standards on or using the ISSAIs on level four as authoritative standards.

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<sup>12</sup> ISSAI 1250.

## ELEMENTS OF COMPLIANCE AUDITING

35. Compliance auditing is performed by obtaining assurance as to whether activities, financial transactions and/or information are, in all material respects, in compliance with the authorities which govern the audited entity. The elements of public sector auditing are described in ISSAI 100. This section outlines additional aspects of the elements relevant for compliance auditing. The elements need to be identified by the SAI before conducting a compliance audit. They form the basis for the strategic decision of the SAI of which auditing standards will be applied, which audit or other engagements will be carried out and with what priority.<sup>13</sup> This includes determining whether the audit approach of ISSAI 4100 or ISSAI 4200 is relevant.

### *Authorities and criteria*

36. The first element of compliance auditing is authorities. Authorities are the sources of audit criteria. The authorities relevant for compliance auditing depend on the specific constitutional arrangement of a SAI, its office and mandate.

37. Authorities include rules, laws and regulation, budgetary resolutions, policy, established codes, agreed upon terms or general principles of sound public sector financial management and conduct of public sector officials. Most authorities originate from the premises and decisions of the legislature, but may be issued at a lower level of the organizational structure of the public sector.

38. Compliance auditing generally comprises the assessment of compliance with formal criteria, such as authorizing legislation, regulations issued under governing legislation and other relevant laws, regulations and agreements, including budgetary laws (regularity: *what should be*). Where formal criteria are absent or there are obvious gaps in legislation due to a lack of formalization of requirements, compliance auditing may also encompass compliance with the general principles of sound public sector financial management and conduct of public sector officials (propriety: *what is expected*). A compliance audit of propriety is based on suitable criteria, either generally accepted<sup>14</sup> or national or international best practice.

39. Because of the variety of authorities, their provisions may be conflicting with one another and may be subject to differing interpretations. Also, subordinate authorities may not be consistent with the directions or limits prescribed by the enabling legislation, and there might be gaps in legislation. As a result, an assessment of compliance with authorities in the public sector requires considerable and sufficient knowledge of the structure and contents of authorities themselves. This is of particular importance throughout the audit process as the sources of the audit criteria can themselves be a part of the audit, both in terms of identifying the audit scope and in terms of being a part of the audit findings.

40. Criteria are the benchmarks used to evaluate or measure consistently and reasonably a subject matter. The auditor identifies criteria on the basis of authorities. Suitable criteria should be relevant, reliable, complete, objective, understandable, comparable, acceptable and available. Criteria should be suitable both in the audit of regularity and of propriety. Without the

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<sup>13</sup> ISSAI 100 paragraph 12.

<sup>14</sup> In some cases criteria may be uncodified, implicit or based on overriding principles of law.

frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding.

### *Subject matter*

41. **The underlying subject matter** of compliance auditing is the phenomenon that is measured or evaluated by applying criteria. The underlying subject matter can be activities, financial transactions, procedures etc. The underlying subject matter is the state of affairs or actual condition falling within the scope of the audit; for example the schools to be constructed within a social program or an actual internal control procedure. Depending on the type of audit<sup>15</sup> the underlying subject matter is either measured or evaluated by a party other than the auditor (in which case the auditor examine whether the information provided is in compliance with the identified criteria) or by the auditors themselves.
42. The result of the measurement or evaluation of the underlying subject matter constitutes **the subject matter information** of the audit. The subject matter information might, for example, be the statistics in an annual report on how many schools were constructed within a social program or a report on implementation of internal control procedures. The subject matter information in compliance auditing may either be provided by a party other than the auditor or by the auditor. The scope of a compliance audit may be related both to whether an underlying subject matter and/or the subject matter information is in compliance, in all material respects, with relevant criteria. The audit of subject matter information is often related to situations where there is established a standardized reporting framework. The audit of underlying subject matters often occurs when the auditor needs to identify the criteria of the audit. Since compliance auditing may encompass both the audit of underlying subject matters and the audit of subject matter information, the term **subject matter** is from hereon used as a common term for both.
43. The subject matter of a compliance audit depends on the mandate of the SAI, the relevant authorities and the scope of the audit. Hence, the content and scope of compliance audit subject matters vary widely. Compliance audit subject matters may either be general or specific in nature. Some subject matters are quantitative and can often be easily measured (for example; payments which do not fulfill certain conditions), while others are qualitative and more subjective in nature (for example; behavior or adherence to procedural requirements).

### *The three parties of compliance auditing*

44. An audit is a three party relationship, where **an auditor** aims to obtain sufficient, appropriate audit evidence in order to express a conclusion designed to enhance the degree of confidence of **the intended users**, other than **the responsible party**, about the measurement or evaluation of a subject matter against criteria.
45. In compliance auditing the responsibility of *the auditor* is to identify the legal basis of the entity, assess whether a particular subject matter is in compliance with the identified criteria and issue a compliance audit report.

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<sup>15</sup> See page 12 Assurance in compliance auditing.

46. *The responsible party* is the executive branch of government and/or its underlying hierarchy of public sector officials and entities responsible for the management of public funds and the exercise of authority under the control of the legislature. Their responsibility is to manage funds and exercise authority in accordance with the authorities. The responsible party in compliance auditing is responsible for the subject matter<sup>16</sup> of the audit.
47. *The intended users* are the individuals, organizations or classes thereof for whom the auditor prepares the audit report. In compliance auditing the users usually include the legislature as representatives of the citizens, who are the ultimate users of compliance audit reports. The legislature is making decisions and fixing priorities concerning calculations of and purpose of public sector expenditure and income. The primary user in compliance auditing is often the entity issuing the authorities identified as criteria of the audit.
48. The relationship between these three parties differs depending on the audit approach in a particular audit. The relationship needs to be viewed within the context of the specific audit and may differ between direct and attestation engagements.<sup>17</sup> The three parties may also differ between different public sector entities.

### *Assurance in compliance auditing*

49. Audit is a process in which the auditor performs procedures to reduce or manage the risk of providing incorrect conclusions (audit risk), recognizing that there are inherent limitations in all audits. These limitations mean that an audit can never provide absolute assurance of the condition of the subject matter, which should be communicated in a transparent way to the users.<sup>18</sup> An audit will in most cases not cover all elements within a subject matter, which means that an approach for sampling in qualitative and/or quantitative terms needs to be applied.
50. The audit approach in compliance auditing may take two basic forms; either as attestation engagements or as direct engagements. In *attestation engagements* a party other than the auditor measures and evaluates the underlying subject matter against established criteria. A party other than the auditor, which may be the responsible party, also often presents the resulting subject matter information in a report or statement (e.g. a statement of compliance). The purpose of the audit in an attestation engagement is to obtain sufficient and appropriate audit evidence as to whether the subject matter information is in compliance with the identified criteria or with the underlying subject matter. Attestation engagements are often related to situations where there is established a standardized reporting framework as criteria of the audit.
51. In *direct engagements* the subject matter information is provided by the auditor (during or after having finalized the audit process), sometimes with the same purpose as when information is provided by the responsible party, but sometimes also to provide new information on compliance with authorities, and where appropriate, to issue recommendations. Direct engagements often occur when the auditor needs to identify the criteria of the audit.

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<sup>16</sup> See page 11 Subject matter.

<sup>17</sup> See page 12 Assurance in compliance auditing.

<sup>18</sup> ISSAI 100 paragraph 22.

52. Compliance auditing performed by obtaining assurance enhances the confidence of the intended users in the information provided by the auditor or a party other than the auditor. The users of the audit reports expect that the conclusions are well founded, balanced and reliable.<sup>19</sup>
53. Both attestation engagements and direct engagements have two types of *assurance levels*: reasonable assurance and limited assurance. In a **reasonable assurance audit** the auditor reduces audit risk to an acceptably low level in the circumstances of the audit. The auditor's conclusion is expressed in a positive way, conveying that in the auditor's opinion the subject matter is / is not in compliance, in all material respects, with the stated criteria. The conclusion is often expressed in a form that conveys the auditor's opinion on the outcome of the measurement or evaluation of the subject matter.
54. In a **limited assurance audit** the auditor reduces audit risk to a level that is acceptable in the circumstances of the audit, but where the risk is greater than in a reasonable assurance audit. The auditor's conclusion is expressed in a form that conveys that, based on the procedures performed, nothing has come to the auditor's attention to cause the auditor to believe the subject matter is not in compliance with the relevant criteria. The set of procedures performed in a limited assurance audit is limited compared with what is necessary in a reasonable assurance audit, but it is planned to obtain a level of assurance that is, in the auditor's professional judgment, meaningful to the intended users. The limited assurance report communicates the limited nature of the assurance obtained.

## PRINCIPLES TO BE APPLIED IN CONDUCTING A COMPLIANCE AUDIT

55. A compliance audit is a systematic process of objectively obtaining and evaluating evidence of whether a particular subject matter is in compliance with identified criteria. The principles below are fundamental to the conducting of a compliance audit. The nature of the audit is iterative and cumulative, but for the purposes of presentation in this ISSAI the principles have been grouped into principles that the auditor should consider prior to commencement and at more than one point throughout the audit process (general principles) and those principles related to steps in the audit process itself (principles related to the audit process).

### *General principles*

#### Legal basis

56. **Auditors should identify the legal basis at the outset of a compliance audit.** Public sector entities are usually established by legislation and their operations are governed by various authorities. Management of public sector entities is accountable for operating in accordance with the provisions of the relevant laws, regulations and other authorities governing them. Identifying the legal basis implies identifying the elements<sup>20</sup> related to a particular compliance audit.

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<sup>19</sup> ISSAI 100 paragraph 22.

<sup>20</sup> See Elements of compliance auditing, page 10-13.

Quality control**57. Auditors should take responsibility for the overall quality of the compliance audit**

The auditor is responsible for the performance of the compliance audit and should implement quality control procedures during the audit. The quality control procedures are aimed at ensuring that the audit complies with the applicable standards and that the audit report, conclusion or opinion is issued in the appropriate circumstances.

Audit team management and skills**58. Auditors should have access to the necessary skills.**

The individuals in the audit team should collectively possess the knowledge, skills and expertise necessary to successfully complete the compliance audit. This includes an understanding of and practical experience of the type of audit being undertaken; an understanding of the applicable standards and authorities; an understanding of the entity's legal basis and operations; and the ability and experience to exercise professional judgment. Consistent for all compliance audits are the needs for recruiting personnel with suitable qualifications, developing and training employees, the preparation of manuals and other written guidance and instructions concerning the conduct of audits, and the assignment of sufficient resources for the audit. Auditors should maintain professional competence through continuing professional development.

Audits may require specialized techniques, methods or skills from disciplines not available within the SAI. External experts may be used in different ways e.g. to provide knowledge or conduct specific work. Auditors should evaluate whether the expert have the necessary competence, capabilities and objectivity and determine whether the work of the expert is adequate for the purpose of the audit.

**59. Auditors should exercise due professional care in all audits.**

The auditor should plan and conduct the audit in an alert and diligent manner. Auditors should avoid any conduct that might discredit the auditor's work. Auditors should perform their duties in accordance with technical and professional standards. Supervision, coaching and review should be conducted throughout the audit process. In compliance auditing this includes; ensuring that the audit team understands the legal basis, scope and criteria of the audit; ensuring that the work is carried out in accordance with the audit strategy and plan; addressing issues that arise during the audit; and monitoring the progress of the audit team members.

Audit risk**60. Auditors should consider audit risk throughout the audit process**

A compliance audit should be performed so as to reduce or manage, to an acceptable level in the circumstances of the audit, the risk that the auditor's report, conclusion or opinion may be inappropriate. Consideration of audit risk is relevant in both attestation and direct engagements. The auditor should consider three different dimensions of audit risk: inherent risk, control risk<sup>21</sup> and detection risk, in relation to the subject matter and the reporting format, i.e. whether the subject matter is quantitative or qualitative and whether the report is long form or short form, and either giving an opinion or conclusion. The significance of the dimensions of

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<sup>21</sup> Inherent risk and control risk together represent the overall control risk.

audit risk for the audit is affected by the nature of the subject matter, whether the audit is performed as a reasonable assurance or limited assurance audit and whether it is a direct or an attestation engagement.

## Materiality

### **61. Auditors should consider materiality throughout the audit process**

Determining materiality is a matter of professional judgment. Professional judgment of materiality is related to the legal basis of the audit and on the auditor's perception of the information needs of the users. Materiality affects the determination of the audit scope and the nature, timing and extent of audit procedures, as well as the evaluation of the results of the audit. In general terms, a matter may be judged material if knowledge of it would be likely to influence the decisions of intended users. Materiality is often considered in terms of value, but the inherent nature or characteristics of an item or a group of items may also render them material solely because of their nature. In addition to materiality by value and by nature a matter may be material because of the context in which it occurs.<sup>22</sup> The qualitative aspects of materiality generally play a greater role in the public sector than in other types of entities. The materiality of a condition in compliance auditing will among others depend on the extent to which the conditions have impact on transparency, accountability and good stewardship or have significant legal implications.

Materiality in compliance auditing consists of both quantitative and qualitative factors. Materiality is considered both for planning purposes, for purposes of evaluating the evidence obtained and for purposes of reporting. An essential part of determining materiality is to consider whether reports of compliance or non-compliance could reasonably be expected to influence the decisions of the intended users, including the consequences of potential or identified instances of non-compliance. Factors to be considered within this judgment are mandated requirements, public interest or expectations, specific areas of legislative focus, requests and significant funding. Issues at a lower level of value or incidence other than the general determination of materiality, like fraud, may also be considered material. Assessment of materiality requires comprehensive professional judgment of the auditor and is related to the scope of the audit.

## Professional judgment and skepticism

### **62. Auditors should maintain professional judgment and skepticism throughout the audit process.**

Professional skepticism and professional judgment are important throughout the audit. These principles are based on the interaction of professional and behavioral characteristics that recognize the auditor's responsibility to carry out analyses and reach conclusions based on evidence collected, whilst maintaining professional distance, open-mindedness, receptiveness to views and arguments, and an alert and questioning attitude. Professional judgment represents the application of collective knowledge, skills and experience to the audit process.<sup>23</sup>

Professional judgment and skepticism is used throughout the compliance audit process to determine the legal basis, the subject matter, suitable criteria, the audit scope, risk, materiality

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<sup>22</sup> ISSAI 100 paragraph 43.

<sup>23</sup> ISSAI 100 paragraph 44.

and the audit procedures as a response to the defined risks. Professional judgment and skepticism is also used in the evaluation of evidence and instances of non-compliance, in reporting and in determining form, content and frequency of communication throughout the audit. Specific requirements for maintaining professional judgment and skepticism in compliance auditing are the competence in analyzing the structure and contents of public authorities as a basis for identifying suitable criteria or gaps in legislation and applying professional audit concepts in the approach to known and unknown subject matters. The auditor should be able to judge the relevance and source of a variety of types of audit evidence related to the audit scope and subject matter and evaluate the sufficiency and appropriateness of evidence obtained by the end of the audit.

### Documentation

#### **63. Auditors should prepare sufficient audit documentation.**

Documentation should be prepared on a timely basis. The documentation should provide a clear understanding of the criteria used, the scope of the audit, the judgments made, the evidence obtained and conclusions reached. Documentation should be in sufficient detail to enable an experienced auditor, having no previous connection to the audit, to understand from the audit documentation the following; the relationship between the subject matter, the criteria, the scope of the audit, the risk assessment, the audit strategy and audit plan and the nature, timing and extent and the results of procedures performed; the audit evidence obtained to support the auditor's conclusion, opinion or report; and to record reasoning on all significant matters that required the exercise of professional judgment and related conclusions. The auditor should prepare relevant audit documentation before the audit report or the auditor's report is issued, and the documentation should be retained for an appropriate period of time.

### Communication

#### **64. Auditors should establish good communication throughout the audit process.**

Communication takes place in all audit phases; before the audit starts, during the initial planning phase, during the performance phase, and during the reporting phase. Any significant difficulties encountered during the audit, as well as instances of material non-compliance should be communicated to the appropriate level of management or those charged with governance. Communication of the criteria determined for the audit is essential. Determining the form, content and frequency of communication is a matter of professional judgment.

## *Principles related to the audit process*

### Planning and designing a compliance audit

#### *Subject matter and criteria*

#### **65. Auditors should identify the subject matter and suitable criteria.**

Determination of the subject matter and criteria is one of the first steps to be carried out in a compliance audit. Subject matters may take many forms and have many characteristics. The subject matter and criteria may be prescribed in the mandate of the SAI or in the legislation. The subject matter may also be identified by the auditor. When identifying the subject matter, the auditor should develop an analysis of the audited entity assessing materiality and risk, whilst applying professional judgment and skepticism.

The subject matter should be identifiable and it should be possible to assess the subject matter against suitable criteria. Furthermore, the subject matter should be of such a nature that it is possible to gather sufficient appropriate audit evidence about the subject matter to support the audit report, conclusion or opinion.

The auditor should identify suitable criteria. The criteria provide a basis for evaluating audit evidence, developing audit findings and concluding on the audit scope. The criteria should be made available to the intended users and others as appropriate.

#### *Audit scope*

##### **66. Auditors should determine the audit scope.**

In cases where the mandate of the SAI or the legislation does not prescribe the audit scope, the auditor should start the audit by determining it. The scope of the audit is set by determining materiality and assessing risk. The audit scope is a clear statement of the objective of the audit related to the subject matter and the criteria. The audit process as a whole should be designed to cover the scope of the audit.

#### *Understanding the entity*

##### **67. Auditors should understand the audited entity in light of the legal basis.**

Compliance auditing covers all levels of the executive and can include various administrative levels, types of entities and also combinations of entities. Hence, the auditor should understand the structure and operations of the audited entity and the approach of the entity to achieve compliance. On the basis of this, the auditor determines materiality and assesses risk.

#### *Understanding internal control and control environment*

##### **68. Auditors should understand the control environment and the relevant internal controls**

In understanding the audited entity or subject matter relevant to the scope of the audit, the auditor should understand the control environment. A control environment is the culture of honesty and ethical behavior needed to provide the foundation for other components of internal control established to ensure compliance with authorities. In compliance auditing a control environment with focus on how to achieve compliance is of particular importance.

In understanding the audited entity or the subject matter, the auditor should understand internal controls. The particular type of controls which the auditor focuses on depends on the subject matter and the nature and scope of the particular compliance audit. The scope of the audit may be to assess a qualitative or quantitative subject matter, and hence the auditor will focus on quantitative or qualitative internal controls, or a combination thereof, according to the scope of the audit. In evaluating internal control, the auditor assesses the risk that the internal controls may not prevent or detect material instances of non-compliance. The auditor should consider whether the internal controls correspond with the control environment so as to ensure compliance with authorities in all material respects.

#### *Risk assessment*

##### **69. Auditors should perform a risk assessment.**

In light of the criteria, scope and characteristics of the audited entity, the auditor should perform a risk assessment to determine the nature, timing and extent of audit procedures to be performed. In the risk assessment the auditor considers the risk of non-compliance in the subject matter. The risk of non-compliance may arise due to fraud, error, to the inherent nature of subject matter and/or the circumstances of the audit. The identification of risks and their impact on the audit procedures should be considered throughout the audit process.

*Risk of fraud***70. Auditors should consider the risk of fraud**

If the auditor comes across instances of non-compliance which may be indicative of fraud, he or she should exercise due professional care and caution so as not to interfere with potential future legal proceedings or investigations.

Fraud in compliance auditing relates to the execution of public authority, where the instances of noncompliance with authorities constitute deliberate misuse of public authority for improper benefit. Execution of public authority includes decisions, non-decisions, preparatory work, advice, information handling and other acts in public service. The improper benefits are advantages of non-economic nature or economic value or of an intentional act by one or more individuals among management, those charged with governance, employees or third parties.

While detecting fraud is not the main objective of performing a compliance audit, the auditor should include fraud risk factors in their risk assessments, and remain alert for indications of fraud in carrying out their work.

*Audit strategy and audit plan***71. Auditors should plan the audit by developing an audit strategy and an audit plan.**

The planning of the audit should involve discussions with relevant members of the audit team to develop an audit strategy and an audit plan. Both the audit strategy and the audit plan should be documented in writing. Planning is not a distinct phase of the audit, but a continuous and iterative process.

Audit evidence**72. Auditors should gather sufficient and appropriate audit evidence to cover the scope of the audit.**

The auditor should gather sufficient appropriate audit evidence to provide the basis for the report, conclusion or opinion. **Sufficiency** is the measure of the quantity of evidence.

**Appropriateness** is the measure of the quality of evidence; that is its relevance and its reliability. The quantity of evidence needed is affected by the audit risk (the greater the risk, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence does not compensate for its poor quality. The reliability of evidence is influenced by its source and nature, and is dependent on the individual circumstances under which the evidence is obtained. The auditor should consider both the relevance and reliability of information to be used as audit evidence.

The audit procedures to be applied should be appropriate in the circumstances, for the purpose of obtaining sufficient and appropriate audit evidence to cover the scope of the audit. The nature and sources of the audit evidence required are determined by the subject matter and the scope of the audit. The scope of the audit may be to assess a qualitative or quantitative subject matter, and hence the auditor will focus on quantitative or qualitative audit evidence, or a combination thereof, according to the scope of the audit. Hence, audit evidence in compliance auditing includes a variety of evidence gathering procedures of both quantitative and qualitative nature.

The auditor often needs to combine and compare evidence from different sources in order to obtain sufficiency and appropriateness of evidence in compliance auditing.

Evaluating audit evidence, concluding and reporting*Evaluating audit evidence and forming conclusions***73. Auditors should evaluate whether sufficient and appropriate audit evidence is obtained and form relevant conclusions.**

After completing the audit procedures the auditor reviews the audit evidence in order to draw a conclusion, issue an opinion or describe the findings. The auditor should evaluate whether the evidence obtained is sufficient and appropriate so as to reduce audit risk to an acceptably low level. The evaluation includes considerations of evidence that both supports and seems to contradict the audit report, conclusion or opinion on compliance/ non-compliance. The evaluation further includes considerations of materiality. After evaluating the sufficiency and appropriateness of evidence and reconsidering the assurance level of the audit, the auditor should consider which conclusion is appropriate in light of the evidence obtained.

After completing the audit procedures the auditor reviews the audit documentation to determine whether the matter has been sufficiently and appropriately audited. The auditor should also determine whether the risk assessment and determination of initial materiality were appropriate in light of the evidence collected or whether they need to be revisited.

*Reporting***74. Auditors should prepare a written report based on the principles of completeness, objectivity, timeliness and contradiction**

The principle of completeness implies that the auditor has considered all relevant audit evidence to issue a report. The principle of objectivity implies that the auditor applies professional judgment and skepticism to ensure that reports presented are factually correct and findings or conclusions are presented in a proper perspective and in a balanced manner. The principle of timeliness implies preparing the report in due time. The principle of contradiction involves checking facts with the audited entity and incorporating responses from responsible officials as appropriate. The form and content of a compliance audit report should cover these principles.

The forms of reporting may be defined by legislation or in the mandate of the SAI. Nonetheless, the audit report or auditor's report normally contains a conclusion based on the audit work performed. The report may also provide constructive and practical recommendations for improvement where appropriate.

The reporting take different forms, either as brief standardized opinions, various forms of conclusions, short or long form reporting. In either way, the report should be complete, accurate, objective, convincing, and as clear and concise as the subject matter permits. Any limitations of the scope of the audit and their reasons should be described. The report communicates clearly the level of assurance provided.

The compliance audit report itself includes the following elements (although not necessarily in the following order):

- 1 Title
- 2 Addressee
- 3 Objectives and scope of the audit, including the time period covered
- 4 Identification or description of the subject matter
- 5 Identified criteria
- 6 The legal basis of the audit
- 7 Identification of the auditing standards applied in performing the work
- 8 A summary of the work performed
- 9 Findings

- 10 A conclusion
- 11 Responses from the audited entity (as appropriate)
- 12 Recommendations (as appropriate)
- 13 Report date
- 14 Signature.

The conclusion may take the form of a clear written expression of a separate opinion on compliance, often in addition to the opinion on the financial statements. The conclusion may also be expressed as a more elaborated answer to specific audit questions. The opinion is often related to attest engagements, while the answering of specific audit questions is often used in direct engagements. Where an opinion is provided the auditor should state whether it is unmodified or modified on the basis of an evaluation of materiality and pervasiveness. Using the form of an opinion would normally require a more elaborated audit strategy and approach.

### Follow up

#### **75. Auditors should follow up the audit when appropriate**

A follow up process facilitates the effective implementation of corrective actions and provides useful feedback to the audited entity, to the users of the audit report and to the auditor in planning future audits. The need for any follow-up of previously reported instances of non-compliance will vary with the nature of the subject matter, the non-compliance identified and the particular circumstances of the audit. In some SAIs, including Court of Accounts, the follow up may include issuing legally binding reports or judicial decisions. In audits carried out on a regular basis the follow up procedures may form part of the risk assessment next year.