



# PUBLIC SECTOR AUDITING

## A. Statutory Framework for Public Sector Auditing

3.1. Effective scrutiny by the legislature to ensure effective implementation of fiscal and expenditure policies needs comprehensive, competent, external audits that are underpinned by International Standards on Auditing.<sup>11</sup> The environment for an effective Supreme Audit Institution (SAI) requires a comprehensive approach to public financial management. Supreme Audit Institutions are not stand-alone institutions. They are part of a PFM architecture that includes budgeting, accounting, internal control, audit and legislative oversight, and government response. Improving the way the supreme audit institution functions is integral to providing information for improving the overall PFM system. But the action must be within the executive branch, yet under the watchful eyes of the legislature and the public. A strong demand for good public sector external auditing is necessary for the Supreme Audit Institution to have any impact. This requires the willingness of the executive branch to accept and respond to external scrutiny over its management of funds and to ensure that reform action is taken. It also requires public presentation of the audit reports to ensure public support for effective action. All of these requirements are covered by the INTOSAI and IFAC Auditing Standards. These should be adopted by the Auditor General.

3.2. The diagnostic questionnaires collected information describing current arrangements and the apparent gaps in the country for the following areas:

- Institutional framework for the Supreme Audit Institution,
- Process for setting auditing standards,
- Use of code of ethics or conduct,
- Arrangements to ensure accountability in the Supreme Audit Institution,
- Arrangements to ensure independence,
- Arrangements to ensure adequate skills and qualifications for the auditors,
- Arrangements for providing training,
- Arrangements to ensure auditor competence, and
- Arrangements for quality assurance.

Those areas with significant scope for improvement are discussed below.

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<sup>11</sup> *Scope, quality, and follow-up of external audit is performance indicator No. 26 in the PFM performance measurement framework supported by the Bank and other development agencies.*



## Statutory framework

3.3. **The Audit Act should make provision for conducting other specialized audits.** The Constitution establishes the Auditor General. Annex C gives the relevant extracts from Part XII of the Interim Constitution and from the Audit Act 2048 (1991) relating to the Auditor General. The Interim Constitution authorizes the Auditor General to audit and certify accounts of the Legislative-Parliament, Constituency Assembly, Commission for Investigation of Abuse of Authority, Office of the Auditor General, Public Service Commission, Election Commission, National Human Rights Commission, Government offices, Constitutional bodies, Nepal Army, Nepal Police, Nepal Armed Police, Supreme Court and other lower courts, corporate bodies fully owned by the Government of Nepal, and other public organizations required by law to be audited by the Auditor General. The Audit Act 1991 specifies that the Auditor General-with due regard to the regularity, economy, efficiency, effectiveness and propriety-shall audit a specified set of matters but does not generalize the authority, so that it covers all types of audits (see Annex C). The Audit Act should be amended to authorize the Office of the Auditor General to conduct other specialized audits, such as environment audit and forensic audit.

3.4. **The Financial Procedure Act should contain an adequate Offences clause.** Full cooperation by auditees and ethical behavior by auditors are essential for effective audit. Current legislation is inadequate in responding to significant lack of cooperation by the auditee. A culture of impunity must be strictly guarded against, and the auditee should be punished for non-cooperation by amending the Financial Procedure Act.

## Setting auditing standards

3.5. **The Audit Act should adopt Nepal Standards on Auditing (NSA) and International Standards on Auditing.** The Office of the Auditor General developed Government Auditing Standards in 1996 based on the INTOSAI Auditing Standards. These Government Auditing Standards were updated in 2005 to accord with the revised INTOSAI Auditing Standards. These Government Auditing Standards are too general and do not describe in sufficient detail the audit procedures. The ICAN-developed Nepal Standards for Auditing are based on the IFAC-issued International Standards on Auditing (ISA). The Office of the Auditor General should also adopt the Nepal Standards for Auditing for government audits. The Office of the Auditor General should ensure that recently developed guidelines prepared as per the INTOSAI standards are implemented. Adequate resources need to be ensured to implement guidelines recently developed. The International Audit and Assurance Standards Board is progressively rolling out International Standards on Auditing. The INTOSAI is moving from maintaining its own auditing standards toward supporting the IAASB in order that the IAASB Auditing Standards appropriately reflect the interests of the international public sector audit community.

3.6. International Standards on Auditing and Nepal Standards on Auditing represent best international practices for the auditing profession, particularly in the areas of fundamental auditing practice such as:

- audit evidence,
- documentation,
- audit materiality,
- fraud,
- audit errors,
- audit opinions,
- audit planning,



- environment assessments, and
- supervising the work of audit staff.

**3.7. The Auditor General has already adopted the INTOSAI Auditing Standards as the core of its own auditing standards.** INTOSAI Auditing Standards are internationally recognized, credible, and readily available. However, it is generally recognized that INTOSAI Auditing Standards need the underpinning support of the more detailed International Standards on Auditing. With the decision by INTOSAI to adopt International Standards on Auditing and to prepare public sector practice notes, where necessary, to support each of these Standards, the way is open for Nepal to use the more comprehensive International Standards on Auditing and Nepal Standards on Auditing. This is quite appropriate as Nepal is a member of INTOSAI and its regional group, the Asian Organization of Supreme Audit Institutions (ASOSAI).

**3.8. The audit opinion needs to be provided on the consolidated government financial statement.** Currently, the consolidated financial statements of the Government of Nepal do not contain an audit opinion. While implementing the Cash Basis IPSAS, it is recommended that the audit opinion is also provided to the consolidated government financial statements.

### Code of ethics

**3.9. An effective monitoring system should be put in place.** The Office of the Auditor General adopted the INTOSAI Code of Ethics in 1996 and also developed its own INTOSAI-based Code of Ethics for its staff in 1999, incorporating provisions of various acts. The Office of the Auditor General needs to revisit its Code of Ethics to ensure that it is practical and realistic, and then set up a more rigorous monitoring system to ensure compliance.

### Accountability in the Supreme Audit Institution

**3.10. The Office of the Auditor General needs to prepare a five-year corporate plan and adopt the system of peer review.** The Office of the Auditor General is basically functioning without a long-term plan. It should prepare and implement a five-year corporate plan. The Office of the Auditor General recently requested the Malaysian National Audit Department to review OAG work; such a practice should continue on a regular basis by inviting peer reviewers from other supreme audit institutions to review the quality of the audit and offer guidance to enhance the capability of the OAG staff.

### Ensuring independence

**3.11. The Audit Act needs to be amended to provide effective independence.** Core principles of SAI independence were set out by the INTOSAI. Some of these principles were only partially, if at all, met by the current legislative and administrative framework:

- financial and managerial autonomy and the availability of appropriate human, material, and monetary resources;
- independence of the SAI Heads, including security of tenure and legal immunity in the normal discharge of their duties;
- sufficiently broad mandate and full discretion in the discharge of SAI functions; and the freedom to decide on the content and timing of their reports and to publish and disseminate them; and
- existence of effective follow-up mechanisms on SAI recommendations.

**3.12. More statutorily independent arrangements for establishing the budget should be put in place by legislation.** The Auditor General should be vested with more financial powers. The

annual OAG budget needs to be placed and approved by the Ministry of Finance, unlike other ministries, and passed by the Parliament without voting. The best international practice is for the Public Accounts Committee to discuss the OAG budget and then submit it to the Parliament without specific need for the approval of the Ministry of Finance, but usually with some comment by the Ministry of Finance.

3.13. **Legislation should mention the period within which the Annual Audit Report is to be submitted and require the Report to be made public.** The Law should fix the period within which the Auditor General should submit the Annual Audit Report to the Parliament through the Prime Minister. The Law should provide that immediately after submission to the Prime Minister, the Report is presented to the Parliament for discussion and concurrent publication. Submission and publication within six months of the end of the financial year is generally considered best practice.

3.14. **Improved Public Accounts Committee and departmental administrative processes are needed for following up audit reports.**<sup>12</sup> There is an enormous backlog by the Public Accounts Committee in hearing audit observations. Due to political instability and dissolution of the Parliament in 2002, there were no arrangements for public scrutiny of the Auditor General's Audit Reports. The Public Accounts Committee was not in existence for almost four years. Recently, Parliament has been reinstated as a result of major political movements. A Public Accounts Committee has been constituted. Since its constitution, PAC has begun to play an active role instigating public debate on outstanding irregularities as reported by the Annual Audit Reports, and reiterating the need for financial discipline for effective public financial management. Due to this four-year gap, there would obviously be a need for major institutional strengthening of the Public Accounts Committee. No doubt, under a democratic system, the Public Accounts Committee should be made more effective to complete hearing of the Audit Reports within the period specified by Parliament. The respective Secretariat of the Ministry should form a separate cell to resolve audit irregularities in coordination with the respective auditee, Financial Comptroller General Office, and the Office of the Auditor General.

### Qualifications and skills for the auditors

3.15. **Basic qualifications should include an accounting or auditing specialization for all appointees.** The current OAG recruitment criteria for financial auditors require a candidate to have graduated in commerce/management for officer level and 10+2 for non-officer. The criteria do not require specialization in accounting or auditing. As a result, the staff do not possess the necessary skills to conduct quality audits. In order to bring the existing staff up to mainstream levels of competency, extensive training for longer durations will be needed. New recruitment at all levels should require an academic degree specializing either in accounting or auditing. Emphasis should move toward providing more professional training and encouraging staff to acquire professional diplomas or degrees. The Office of the Auditor General would be required to make a substantial investment in developing its human resources. Through its last IDF grant, the Office of the Auditor General prepared a medium-term Human Resource Development Plan. The success of the Plan will be seen only when it is judiciously implemented; for this to happen, additional resources for implementation are needed.

### Training

3.16. **The Office of the Auditor General should provide extensive orientation training on recruitment and operate a continuing professional development program for its staff.** Newly recruited staff should be provided with at least 10 weeks of extensive training on IES-recommended topics

<sup>12</sup> *Legislative scrutiny of external audit reports is performance indicator No. 28 in the PFM performance measurement framework supported by the Bank and other development agencies.*

and Government Auditing Standards as well as audit guidelines. In-service training should be provided on regular basis under a continuing education program, as per the Human Resources Development Plan, to enhance and update the audit skills for conducting specialized audits in accordance with the internationally accepted best practices. The Office of the Auditor General could work with other supreme audit institutions or professional organizations to arrange for OAG staff to participate in other established, continuing education programs.

### Auditor competence

3.17. **It is necessary to strengthen the technical and professional competence of the OAG staff to produce quality audit reports that meet international standards and serve the need of the stakeholders.** The Office of the Auditor General has developed various audit guidelines; a separate directorate is working within the Office on policy-making, maintenance and updating of guidelines. The existing capacity of OAG personnel to implement these guidelines has not reached the desired level, thus requiring more training and practical experience. The adoption of the Nepal and international auditing standards will help staff to understand audit methodologies. The Office of the Auditor General concentrates on regularity and performance audits, but now needs to improve implementation through training so as to build its in-house capacities to focus more on performance audits to assess the results. These will need to measure development outputs and outcomes, and in a progressive prioritized manner, introduce forensic, environmental, and information technology audits. The Office of the Auditor General needs to create a few core groups of specialized professional accountants to conduct these specialized audits. Technology software support is needed for the audits of entities with information technology-based accounting. All these would require Government's commitment for significant reform of the Office of the Auditor General, by providing scaled-up resources, both financial and human resources, to comply with focus on new requirements.

### Quality assurance

3.18. **Improved structures and indexing of more comprehensive audit working papers is required to help audit supervisors to ensure specified quality standards.** The Government Auditing Standards, consisting of policy standards and operational guidelines, provide guidance on supervision, audit planning, compliance with laws, internal control, audit evidence, review and interpretation of audit findings, materiality, report and presentation, peer review, and debriefing for quality control. The quality of the audit is assured through direction in the form of audit plan and program, close supervision, discussion on accounting and auditing issues with appropriate authority, and a review process. Moreover, the supervisor and higher-level personnel review the work of assistants and finalize the audit findings, conclusions, and recommendations, taking into consideration the materiality and significance of the audit findings. But due to lack of trained personnel, the audit standards cannot be suitably implemented and audit working papers are not maintained properly as specified, in some cases. A robust quality assurance regime needs to be put in place and operate effectively. Working papers should be properly organized and maintained; they should be indexed for easy cross-reference, quality control review, and recording quality supervision. There is a practice of internal post-audit quality review (peer review) to some extent. Such a review system can be further enhanced through the use of external reviewers.

## B. Auditing Standards as Practiced

3.19. The diagnostics questionnaires have collected information about the current arrangements for the audit methodology and the apparent gaps in the country in the following areas:

- audit planning,
- audit supervision,
- reviewing internal controls,
- reviewing compliance with laws,
- ensuring that adequate audit evidence is collected,
- analyzing whether the financial statements accord with accounting standards,
- preparing audit opinions,
- reporting on fraud, and
- reporting on compliance.

Out of this exercise came recommended activities that will help bring local standards in line with international standards.

### Audit planning

3.20. **More comprehensive auditing requirements based on specific objectives of the audits should be planned.** The Office of the Auditor General is under-resourced with respect to personnel having knowledge to conduct all types of audit that meet the quality of its statutory obligations and experience to report within six months from the financial statement reporting date. Resource problems will be exacerbated as the Office of the Auditor General endeavors to audit all of the entities under its mandate, and to appropriately respond to the challenges of improved financial reporting over coming years. More efficient auditing processes can alleviate the problem. The Auditor General's Annual Reports should provide recommendations and advice to Parliament for improvement of the PFM system. The current introduction of comprehensive audit planning process under the Public Audit Reform and Capacity Building Project has not yet been implemented in all audits. Risk assessment, determination of materiality level, review of the internal audit work program and its preliminary assessment to identify both their strengths and weaknesses, and audit approach based on assessment of internal audit have to be specified in all audit plans. The existing system gives attention to planning timetable and human resources for the audits, but not sufficiently with risk and materiality issues. The OAG staff need to be trained in a more forward-looking and modern audit planning process.

### Audit supervision

3.21. **A more comprehensively structured working paper system is needed for all audits to attain the normal audit objectives regarding the validity of transactions.** Working papers are not filed in a systematic way. Working papers should be more structured and cross-referenced to substantiate the audit conclusion and opinion. The OAG staff need more guidance on various techniques of audit testing and process of supervision.

### Reviewing internal control

3.22. Implement internal control review process to identify audit risk recommended in the Operating Guidelines. Under the Public Audit Reform and Capacity Building Project, the Office of the Auditor General has already developed Audit Guidelines for Government audit. However, the Guidelines have not been fully implemented due to lack of sufficient technical knowledge to review internal control systems and assess audit risk appropriately. The control risk is not properly assessed and substantiated with appropriate working papers, to the desired extent. Training on Audit Guidelines and various ISA-recommended audit methodologies should be provided to the OAG staff for learning how to implement guidelines and the International Standards on Auditing, and to review internal controls for assessment



of audit risk, in addition to upgrading overall audit skills. An audit methodology should clearly outline the following points:

- audit confidence level;
- requirements for audit planning, audit work papers, and audit reporting;
- how audit materiality is determined and what is an acceptable level of audit risk and confidence;
- how to develop an appropriate mix of audit work to address audit risks.

The audit should be completed by a process that encompasses how audit errors are summarized and evaluated against audit materiality.

## Compliance with laws

3.23. **Obtain management representation letter from all government offices.** The written management representations should be obtained as required by the auditing standards from all the auditees with respect to compliance with all prevailing laws.

## Audit evidence

3.24. **The supporting documents obtained for audit evidence should be more systematically maintained.** The supporting documents obtained for audit evidence are critical in substantiating the audit findings and comments made in the audit report. Audit evidence should be properly documented, filed, and cross-referenced in the working paper file.

3.25. **Inventory and investment should be valued.** At year-end, the Office of the Auditor General should attend physical verification of inventory to obtain evidence of any impairment at some Government projects having considerable amounts of inventory. Similarly, the Government investment should be valued on the basis of share market price of shares of the entities listed in the share market and suitable valuation methods of shares of the entities not listed in the share market. Any impairment of inventory and loss on investment are to be considered for reporting in the Annual Audit Report.

## Analyzing financial statements

3.26. **Audit testing needs to be more directed toward forming an audit opinion.** Testing should be expanded to undertake full financial attest audits covering all financial assertions. A financial audit should be conducted to provide an audit opinion on the complete set of financial statements instead of commenting on the deficiencies found in the scrutinized transactions. The Audit Report is heavily compliance-based, identifying regulatory breaches in the transaction, and focuses on discrepancies found. The financial statements of the government budget sector and the state-owned enterprises published in the Audit Report should present the disclosures about various elements of the financial statements.

## Reporting on financial statements

3.27. **State-owned enterprises need to submit financial statements on time and have audits completed within a specified period.** At present, the state-owned enterprises do not prepare financial statements on time for submission to the auditors. The audit takes longer than the expected time because of delays in responding to the audit queries and lack of adequate cooperation from some auditees. The state-owned enterprises also do not respond to the preliminary audit within prescribed periods. This has caused substantial delays in completion of the audits and subsequent reporting on the financial statements. The state-owned enterprises should be strictly instructed to submit the financial

statements on time and help to complete audit within prescribed period. Failing to meet the deadline, the responsible officers should be held liable for any penalty as warranted through legislation.

**3.28. The requirements of ISA 700. The Auditor's Reports on Financial Statements, to form the audit opinion should be adopted in full.** The Audit Report contains the scope of audit, purpose of audit, audit standards, and methodologies used, but does not contain reference to the financial reporting framework used to prepare the financial statements and the degree of detail set by ISA 700 (in paragraphs 12 to 15). This leaves some uncertainties as to the standards used for the work. It is uncertain whether the audit provides a reasonable basis for the opinion, and if the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Office of the Auditor General should issue Audit Reports giving reference to the financial reporting framework and expressing an opinion on the complete set of financial statements of the government budget sector and the fully state-owned enterprises.

### Reporting on fraud

**3.29. There is a need for forensic audit training.** The Audit Report concentrates on non-compliance with the prevailing laws and covers fraudulent transactions. The Office of the Auditor General focuses on fraudulent transactions but not in a sufficiently systematic way. International Standards on Auditing (ISA) 240, The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements, requires the auditor to perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud. In addition, it requires the auditor to evaluate the design of the entity's related controls, including relevant control activities; and to determine whether they have been implemented. The ISA 240 also requires the auditor to inform the auditee's management and its board of any fraud and of the failure in its internal control that led to the fraud. The Audit Report should mention the reasons that led to the fraud and actions taken by the auditee to avoid recurrence of the fraud.

### Reporting on compliance

**3.30. Improve the effectiveness of the Audit Report by more efficient action on enforcement of corporate governance requirements through the Public Accounts Committee, Audit Committees, and Audit Report Review Cell.** Under the present process, a preliminary audit report is prepared on completion of the audit and provided to the entity for comment, which is then considered in preparing the report that is sent to the Responsible Account Officer/Minister for final comment. Final observations on audit irregularities are included in the Annual Audit Report that is submitted to the Prime Minister. A follow-up on actions to resolve the irregularities is carried out during the next years' audit. The Public Accounts Committee of the Parliament calls the auditee/ministry for response to unresolved audit findings. The Public Audit Reform and Capacity Building Project found that OAG Annual Audit Reports could be improved in communicating clear objectives, addressing more relevant problems, making more effective recommendations, and involving more extensive audit work. To reduce the number of unresolved audit objections to be included in the Annual Audit Report, minor irregularities are to be reported in management letters addressed to the Secretary of the respective Ministry and the Finance Ministry. The Annual Audit Report should be concise and include only major irregularities that have system wide implications. In coordination with the respective auditee, Financial Comptroller General Office, and the Office of the Auditor General, a separate Audit Report Review Cell is to be formed in each Secretariat of the Ministry to resolve audit irregularities. This will also assist in reducing the number of irregularities to be reported to the Parliament for examination by the Public Accounts Committee.

