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## PUBLIC SECTOR AUDITING

### A. Institutional Framework for Public Sector Auditing

23. Effective scrutiny by the legislature through comprehensive, competent external audit underpinned by International Standards on Auditing (ISA) enables accountability for the implementation of fiscal and expenditure policies. 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 also includes budgeting, accounting, internal control, audit and legislative oversight, and government response. Improving the way the Sri Lanka Supreme Audit Institution functions is integral to providing information for improving the overall PFM system, but the action must take place within the executive branch 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 willingness of the executive branch to accept and respond to external scrutiny over its management of funds and to ensure that the relevant reform action is taken. It also requires public disclosure of the audit reports to ensure public support for effective action.

24. The diagnostic questionnaires collected information describing the current arrangements in Sri Lanka and the apparent gaps in the following areas:

- Institutional framework for the supreme audit institution,
- Process for setting auditing standards,
- Use of Code of Ethics or Codes of Conduct,
- Arrangements to ensure accountability in the supreme audit institution,
- Arrangements to ensure independence,
- Arrangements to ensure adequate skills and qualifications for the auditors,
- Arrangement for providing training,
- Arrangements to ensure a desired level of competence for the auditors, and
- Arrangements for quality assurance.



## (1) Institutional Framework

25. **The appointment and powers of the Auditor General should be specified in a new National Audit Act.** The Constitution and relevant laws<sup>4</sup> provide for the President to appoint the Auditor General with a mandate to audit all government bodies. In practice, commercial state-owned enterprises are audited by accounting firms and reviewed by the AG Department, but the provisions are not very specific about the type of audit report required. The Auditor General does not have the powers or the status to secure implementation of his recommendations, despite the severe problems in public financial management that are identified in his reports.

26. **Negotiations with donors over the implementation of the institutional strengthening program should be completed.** In October 2005, the Government of Sri Lanka approved the drafting of a National Audit Bill and an Institutional Development Plan to modernize the AG Department. The Ministry of Finance is being asked to liaise with donors for the necessary funding. Further discussions are needed to decide the best way to manage the process, including the possibilities for a sector-wide approach to the development.

27. **A review of PFM high-level indicators should be conducted.** Given the strong interdependencies among the elements of the PFM system, coordinated or integrated development programs would be important for successful implementation. Merely strengthening the AG Department will not work without the strengthening of internal controls and the legislative scrutiny processes. In this context, the use of indicators for measuring PFM performance would be very helpful.

28. **The new National Audit Act should provide a broader base to undertake all forms of audit and an adequate offences clause to ensure cooperation.** Forensic and performance audit are needed as part of a balanced audit program.

## (2) Setting Auditing Standards

29. **The National Audit Act should specify arrangements to adopt INTOSAI and IAASB Auditing Standards.** The INTOSAI Auditing Standards supported by the detailed IFAC-issued International Standards on Auditing underpin a modern audit process. The International Audit and Assurance Standards Board (IAASB) is progressively rolling out international auditing standards. The INTOSAI is moving from maintaining its own auditing standards by seeking to support the IAASB's development of auditing standards. This is being done especially so that the IAASB audit standards appropriately reflect the interests of the international public sector audit community. The AG Department's current auditing approach is based together with some public sector elaboration on the ICASL Auditing Standards; but no document sets out the public sector audit standards as such. Without a formal document, there is no authoritative and credible basis for enforcement of standards.

30. The IFAC-issued International Standards on Auditing represent best international practices for the auditing profession, particularly in such areas of fundamental auditing practice as the following:

- audit evidence,

<sup>4</sup> Finance Act No. 38 of 1971, Ch. 252; Municipal Council Ordinance, Ch. 255; Urban Council Ordinance, Ch. 255; Pradesiya Sabha Act, No. 15 of 1987 (local government); and Lanka Accounting and Auditing Standards Act 1995.

- documentation,
- audit materiality,
- fraud,
- audit errors,
- audit opinions,
- audit planning,
- control environment assessments, and
- supervising the work of audit staff.

### (3) Code of Ethics

31. **The AG Department should adopt a specific Code of Ethics that is relevant to auditors.** Along with INTOSAI's Lima Declaration of Guidelines on Auditing Precepts,<sup>5</sup> the INTOSAI Code of Ethics is considered an essential complement to the INTOSAI Auditing Standards. A Code of Ethics is considered as a statement of values and principles guiding the daily work of the auditors. The Sri Lanka Supreme Audit Institution has not adopted the IFAC-issued Code of Ethics for Professional Accountants or the INTOSAI Code of Ethics.

### (4) Accountability in the Supreme Audit Institution

32. **The Institutional Development Plan should pay particular attention to achieving the 2003 peer review recommendations.** A 2003 peer review by The Netherlands Supreme Audit Institution satisfied the requirement for competent assessment of the accountability of the Sri Lanka Supreme Audit Institution. Its recommendations need to be implemented to complete the accountability process.

### (5) Independence

33. **The proposed National Audit Act is needed to provide effective independence to the Auditor General.** Five of the eight core principles of SAI independence that were set out by INTOSAI are only partially, if at all, met by the current legislative and administrative framework. The five core principles are:

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

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<sup>5</sup> Lima Declaration of Guidelines on Auditing Precepts, October 1977, INTOSAI



## (6) Qualifications and Skills for the Auditors

34. The quality of accounting and auditing educational and training arrangements in the government's schools is not fully satisfactory. It does not meet the needs of modern accounting and financial management.

## (7) Training

35. **A better training institution that meets international standards should be introduced.** The AG Department staff has good basic accounting qualifications. However, the Institutional Development Plan highlights a dearth of required auditing expertise. The proposed CIPFA training program would cover the training of both accountants in the certificate and diploma scheme initially and then move to the full CIPFA professional qualification as adapted for Sri Lanka circumstances.

36. **A skills analysis program based on international standards for competencies should be conducted.** The AG Department does not have basic facilities for training, research, and development. A proper need-based approach is required to be implemented to support the introduction of an audit methodology, and international accounting and auditing standards. The Institutional Development Plan needs to be used to strengthen the internal AG Department training facilities.

## (8) Audit Competence

37. **Systems, methodologies, and facilities should be updated in accordance with the Institutional Development Plan to enable modern audit to be undertaken by the staff.** There is a need to develop specialist forensic audit and computerized audit capabilities. The audit orientation has to change from transaction to risk-based systems audit. It is necessary to strengthen the technical and professional competence of the AG Department and improve its operational capacity to produce and disseminate quality audit reports that meet international standards and serve the needs of the stakeholders. The AG Department needs to improve training, and to build in-house capacity for financial performance, fraud, environmental and computerized audits. An audit management system is needed that is supported by an up-to-date software and hardware configuration.

## (9) Quality Assurance

38. **To improve quality assurance, the new Audit Methodology Manual, which would be prepared in accordance with the methods described in the Institutional Development Plan, is needed.** There is no quality assurance program currently in use. Audit supervision is expected to ensure quality. However, current audits are not timely, many findings lack materiality; the audit programs, which focus on compliance and financial (attestation) audits, are not at par with the best of international practices. Given the lack of acceptance within the AG Department of a previous manual prepared by consultants during the 1990s, it is crucial that the new manual be prepared by AG Department staff in consultation with experts and practitioners, with external consultants providing guidance, but not actually writing the manual.

## B. Auditing Standards as Practiced

39. The diagnostic questionnaires have been used to collect information about the current arrangements for the audit methodology and the apparent gaps in the country for:

- 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.

### (1) Audit Planning

40. **The new Audit Methodology Manual should introduce more comprehensive planning requirements based on the specific objectives of the audits.** Audit planning is not sufficiently tailored to suit the needs of the audit client. Recent modifications have sought to specifically identify those areas of concentration, but this is still insufficient for meeting international standards of audit planning. Most of the audits are aimed at identifying regulatory breaches. The reports of these audits are of minimal assurance value to either the preparers or users of the financial reports, or wider stakeholders. Nor are they of much value to those responsible for managing systems of internal control. Results from audits should hold the executive accountable for its fiscal and expenditure policies and their implementation.

### (2) Audit Supervision

41. **A more comprehensively structured working paper system is needed for the audit to attain the normal audit objectives regarding the validity of transactions.** Current supervision is hampered by inadequate working paper systems and a poor audit methodology.

### (3) Reviewing Internal Controls

42. **The overall audit procedures need to be changed and supported by the new Audit Methodology Manual.** The general budget sector audits examine transactions in accordance with the rules established by the Financial Regulations. They therefore report on where controls have not been applied. They do not approach the audit from the perspective of material misstatement of an accounting figure, but rather the failure of a transaction to comply with the rules. The effect of this approach is that there is no pressure on the system to improve as all of the effort goes into argument about the transaction, not the system of control. The 2003 Auditor General Activity Report notes that past audit reports had been merely post-mortem examinations, often delayed from 5 to 15 years; and that by and large the issues were not significant. INTOSAI has issued a paper on internal control standards<sup>6</sup> that provide a good international benchmark for assessing internal controls.

<sup>6</sup> *Guidelines for Internal Control Standards for the Public Sector, Internal Control Standards Committee, International Organization of Supreme Audit Institutions.*



#### (4) Reviewing Compliance

43. **Introduce recommendations to all audit reports, monitor the implementation of the recommendations, and report on the process in the Activity Report.** The AG Department uses much of its resources for compliance type of audit work. An important issue is whether the audits are effective in dealing with instances of non-compliance. In some South Asian countries, the audit reports log large numbers of transactions for pursuit of recovery. These cases continue to be monitored until the matter is resolved, either by the Public Accounts Committee or the Auditor General. In local government matters, the Auditor General does have the power to disallow items of the accounts that are contrary to law and surcharge the responsible officer. The effectiveness of the Public Accounts Committee needs improvement. Also, it is necessary to implement stronger enforcement of surcharge processes. The 2003 Auditor General Activity Report states that recoveries of surcharges were small, with more than half the outstanding surcharges uncollected for more than 4 years. The same report recommends that for public corporations those responsible for irregularities should settle such losses.

#### (5) Audit Evidence

44. **The audit methodology and necessary supporting working papers should be more precisely defined in the new Audit Methodology Manual.** Currently working papers are organized by report paragraphs rather than the audit plan. They cover the details of the preparation and approval of the text of the audit paragraphs.

45. **The AG Department should, as per ISA 600 (8), examine on a sample basis some of the working papers of the 'qualified auditors' employed to audit government bodies.** Most certification audit work is done by accounting firms on behalf of the Auditor General, but these working papers are not reviewed by the AG Department.

#### (6) Analyzing the Financial Statements

46. **A revised audit methodology will improve the way in which the AG Department analyzes financial statements.** The AG Department uses a checklist for analyzing financial statements.

#### (7) Preparing Audit Opinions

47. **The requirements of ISA 700, *The Auditor's Reports on Financial Statements*, should be adopted in full.** The audit scope and audit opinion paragraphs for the Consolidated Financial Statements 2004 do not contain the degree of detail set by ISA 700 in paragraphs 12 to 15. This creates doubts about the auditing standards used for the work. It also makes uncertain whether the audit provides a reasonable basis for the opinion, and if the audit was planned and performed to obtain reasonable assurance that the financial statements are free of material misstatement. The scope statement notes the limitations of staff, other resources, and time available. This would normally be read by a user of the accounts as an indication that the audit opinion on the accounts is thereby qualified although this is not clearly stated in the opinion paragraph.

#### (8) Reporting on Fraud

48. **Use of forensic audit methods would reduce fraud.** Much of the audit reporting seems to relate to fraudulent behavior. This orientation comes from the compliance testing approach. The use of

specific forensic audit methods would enhance the effectiveness of the reporting on whether deficiencies arise from fraud rather than error or oversight.

## **(9) Reporting on Compliance**

49. **Improve the effectiveness of the audit report by stronger enforcement of corporate governance requirements through the audit committees.** The study reveals a number of weaknesses in the success of the present reporting system (e.g., lack of depth, irrelevance, lack of brevity, etc.) Although the Auditor General submits a supplementary report with respect to statutory boards and corporations, no serious attempt seems to have been made by the boards of such institutions for improving controls and management of resources. In general, arrangements to improve corporate governance ought to apply to the whole public sector, including state-owned enterprises.

