GOVERNMENT ACCOUNTING AND AUDITING MANUAL

VOLUME III

December 19, 1991

COMMISSION ON AUDIT CIRCULAR NO. 368-91

TO : All Heads of Departments, Bureaus and Offices of the National Government; Managing Heads of Government-Owned and/or controlled Corporations, Boards and Commissions; Provincial Governors; City/Municipal Mayors; Chief Accountants/Corporate Treasurers; Local Treasurers; COA Directors and Auditors; and All Others Concerned.

SUBJECT : Instituting a Government Accounting and Auditing Manual and Prescribing its Use

The Commission on Audit has in recent years perceived the need to revise and update accounting and auditing rules and regulations embodied in the National Accounting and Auditing Manual and the Revised Manual of Instructions to Treasurers in order to keep abreast with modern trends of government accounting and auditing and progressive legislation on the subject. The endeavor to fill this need now finds fruition in a new Government Accounting and Auditing Manual (GAAM) which is hereby instituted and prescribed for use by all government agencies pertaining to the national, local and corporate sectors.

The Government Accounting and Auditing Manual consists of three volumes, viz:

Volume I — Government Auditing Rules and Regulations

Volume II — Government Accounting

Volume III — Government: Auditing Standards and Procedures

and Internal Control System

On the main, it integrates pertinent laws and administrative issuances as well as judicial and quasi-judicial decisions relative to the financial operations of Government.

A supplement embodying the procedural aspects on accounting and auditing in local government units will be issued. This supplement will form an integral part of the Government Accounting Manual.

The National Accounting and Auditing Manual and the Revised Manual of Instructions to Treasurers are deemed supplanted and superseded by the new Government Accounting and Auditing Manual and its supplement.

All others Circulars, Memoranda and regulations inconsistent or in conflict with the provisions of the Government Accounting and Auditing Manual are hereby repealed, modified and/or amended accordingly.

This Government Accounting and Auditing Manual will take effect on January 1, 1992.

EUFEMIO C. DOMINGO

Chairman

BARTOLOME C. FERNANDEZ, JR ROGELIO B. ESPIRITU

Commissioner Commissioner

HOW TO USE THE GOVERNMENT ACCOUNTING

AND AUDITING MANUAL (GAAM)

The Government Accounting and Auditing Manual is divided into three volumes.

Volume I	—	Government Auditing Rules and Regulations.
Volume II	—	Government Accounting
Volume III	—	Government Auditing Standards and Procedures and Internal Control System

Unless specifically mentioned that the same are only applicable to a particular sector, the laws, rules and regulations embodied in this manual are applicable to national government agencies, local government units and government-owned and/or controlled corporations.

Detailed instructions to local fiscal officers to serve as their guide in the administration of the financial affairs of the provincial, city and municipal governments shall be issued to supplement the GAAM.

This manual supersedes the National Government Accounting and Auditing Manual and the Revised Manual of Instructions to Treasurers.

Title 1. GOVERNMENT AUDITING

STANDARDS AND PROCEDURES

Chapter 1. Introduction

SECTION 1. COA's Constitutional mandate. — The Constitution, PD 1445, and other laws clearly prescribe the broad auditorial functions of the Commission on Audit. The COA has the power, authority and duty to examine, audit and settle all accounts pertaining to the revenues, and receipts, expenditures of funds and uses of property, owned or held in trust by, or pertaining to the Government. In addition it has the exclusive authority to define the scope of its audit and establish the required examination techniques and methods. The COA also promulgates accounting and auditing rules and regulations which include the prevention and disallowance of irregular, unnecessary, excessive, extravagant, or unconscionable expenditures, or uses of government funds and properties.

Pursuant to such mandate, the COA conducts a comprehensive audit that includes financial and performance audits. Government audit follows public funds and property wherever and however used.

SECTION 2. Standards defined. — A mode of conduct of general application arising from convention or advocated or imposed by higher authority. It refers to an acceptable level of quality which must be maintained.

Auditing standards are measures or gauges by which the quantity, quality, and adequacy of the auditor's examination can be judged. They control the nature and extent of evidence to be obtained by means of auditing procedures.

SECTION 3. Prescribed Government Auditing Standards. — The government auditing standards prescribed in this volume shall govern the conduct of audits of government agencies, programs, activities, and functions, and of government funds received by non-profit and other non-government organizations. Auditing standards issued by accounting organizations, such as Audit Standards and Practices Council (ASPC), shall only be made applicable upon formal adoption by the Commission Proper.

The hierarchy determining state accounting and auditing practice in the Philippines in the order of authorities is as follows.

a. Constitutional provisions

b. Provisions of law, such as PD 1445, and applicable jurisprudence

c. Rules and regulations issued by the Commission on Audit, and COA decisions and resolutions

d. Rules and regulations issued by other government agencies.

e. The State Accounting Standards (SAS) and the State Comprehensive Auditing Standards (SCAS)

f. Where the SAS and SCAS are silent on specific areas of concern, the issuances and practices of other accounting and auditing bodies may be followed, so long as these do not contravene the hierarchy:

1. Standards and other issuances of the International Organization of Supreme Audit Institutions (INTOSAI)

2. Standards and issuances of United Nations specialized committees and agencies on accounting and auditing

3. Practices, standards and issuances of professional organizations and authorities concerned with accounting and auditing, such as:

a. Philippine Institute of Certified Public Accountants (PICPA)

b. International Federation of Accountants (IFA)

c. International Institute of Internal Auditors(IIIA)

d. Other International organizations of CPAs

SECTION 4. Types of audit. — The types of audit conducted by the COA are the following

a. Financial audit includes financial statement and financial related audits

1. Financial statement audits determine whether

— the financial statements of an audited entity present fairly the financial position, results of operation and cash flows or changes in financial position in accordance with generally accepted accounting principles, and

— the entity has complied with laws and regulations for those transactions and events that may have a material effect on the financial statements.

2. Financial related audits determine whether

— financial reports and related items, such as elements, accounts, or funds are fairly presented,

— financial information is presented in accordance with established or stated criteria, and

— the entity has adhered to specific financial compliance requirements.

b. Performance audits include economy, efficiency, and program audits.

1. Economy and efficiency audits determine

— whether the entity acquires, protects, and uses its resources (personnel, property and spaces) at minimum operating costs and systematic manner

— the causes of inefficiencies or uneconomical practices, and

— whether the entity has complied with laws and regulations concerning matters of economy and efficiency.

2. Program or effectiveness audits determine

— the extent to which the desired results or benefits of the program or activity established by the legislative or other authorizing body are achieved,

— Whether the entity has complied with laws and regulations applicable to the program

Chapter 2. General Auditing Standards

SECTION 5. Qualifications. — The staff assigned to conduct the audit should collectively posses adequate professional proficiency for the audit tasks.

The Commission should ensure that the audit is conducted by the staff members who have the audit knowledge and skills. They should also have a thorough knowledge of the government, its environment and government auditing.

These knowledge and skills apply to the Commission as a whole and not necessarily to every individual auditor. Evaluation of contemporary government operations requires the auditors to be abreast with acceptable knowledge and skills in such areas as accounting, statistics, law, engineering, audit design and methodology, automatic data processing, public administration, economics, political science, and actuarial science, etc. Modern auditing has become a collective effort of various professions and disciplines.

a. Qualifications of staff members conducting government audits:

1. Appropriate academic qualifications as prescribed by the COA qualifications standards.

2. Knowledge and skills of the methods and techniques applicable to government auditing.

3. Knowledge of government organizations, programs, activities, and functions.

4. Skills to communicate clearly and effectively, both orally and in writing.

5. Keep abreast with all developments in accounting, auditing and related fields, and a general awareness of new developments in public administration, commerce and industry.

6. Skills appropriate for the conduct of audit work For instance:

a. If the work requires use of statistical sampling, the staff or consultants to the staff should include persons with skills in statistics.

b. If the work requires extensive review of computerized systems, the staff or consultants to the staff should include persons with computer audit skills.

c. If the work involves review of complex engineering data, the staff or consultants to the staff should include persons with engineering skills.

d. If the work involves the use of non-traditional audit methodologies, the staff or consultants to the staff should include persons with the necessary skills.

7. The following qualifications are needed for financial audits that lead to an expression of an opinion:

a. The auditor should be proficient in the appropriate accounting principles and standards and in government auditing, and

b. The auditor should be preferably licensed certified public accountants or with formal education in accounting.

b. Hiring of multi-disciplinary professionals

1. Comprehensive auditing creates the need for a multi-disciplinary audit approach among the ranks of state auditors beyond accounting and auditing skills. The integration of professionals such as engineers, EDP specialists, social scientists, statisticians, and others becomes necessary for more effective state comprehensive audits.

2. The multi-disciplinary professionals would require training in the rudiments of state auditing before integration into auditing units/audit teams.

3. The audit team composed of multi-disciplines can have a better understanding of particular operations or projects with the results of audit credible and more useful.

c. Recruitment and promotion of auditors and staff

The Commission has provided for qualification standards (QS) which prescribe the minimum requirements for the hiring and promotion of auditors in terms of education, training and experience and other qualities to ensure successful performance. It also includes qualifications of the multi-disciplinary group needed for economy, efficiency, and effectiveness audits.

d. Upgrading the skills of auditors and staff

To cope with the increasing demands for audit services, the Commission has to maintain and upgrade technical competence of its auditors through formal education and sustained on-the-job training. To prepare state auditors and staff for these specialized functions, the COA has developed and sustained the in-house training of state auditors and their staff. The Ladder-Type Approach to training is on-going designed to specific positions of auditors and staff. Foreign and local scholarships are available to COA personnel which include study grants and fellowships abroad. These studies cover graduate and post-graduate degree programs, non-degree technical courses and seminars and workshops on the various areas of audit and other relevant fields funded by the government or sponsoring agency. Academic scholarships abroad are arranged and funded by foreign entities. Local scholarships are funded by other government institutions.

SECTION 6. Independence. — On matters of audit work, the Commission and the individual auditors should be free from personal and external impairments to independence. As an institution it should be organizationally independent.

This standard places upon the COA auditor and the Commission the responsibility to be objective and impartial in auditorial opinions, conclusions, judgments, and recommendations.

Independence refers to the objectivity of the auditor. It is the personal quality to be honest and impartial in the performance of his work. This requires the objective consideration of facts and the exercise of an unbiased judgment in the report.

The qualities of independence and impartiality in the auditor should inspire other persons of the professionalism of the audit performed.

As one of the constitutional commissions, the COA is assured of institutional independence. The Constitution has several provisions to safeguard such independence:

a. No member of the Commission shall hold any other office or employment or engage in the practice of any profession or in the active management or control of any business.

b. The salary of the Chairman and the Commissioners shall be fixed by law and shall not be decreased during their tenure.

c. The Commission shall appoint its officials and employees in accordance with law.

d. The Commission shall enjoy fiscal autonomy.

e. The Commission shall audit all Government agencies including government corporations and non-governmental entities receiving subsidy or equity from the government.

f. The Commission shall have exclusive authority to define the scope of its audit, establish the techniques and methods required therefor, and promulgate accounting and auditing rules and regulations.

g. No law shall be passed exempting any entity of the Government from the jurisdiction of the Commission on Audit.

Independence of an auditor may be impaired if during the period of the audit or at the time of expressing opinion, he or any member of his immediately family —

a. acquires any direct or material indirect financial interest in the enterprise, or

b. has connection with the enterprise in any capacity equivalent to that of a member of management or as an employee.

Personal impairments may also arise in the following circumstances:

a. Subsequent performance of an audit by the same individual who had previously approved invoices, payrolls, claims and other proposed payments of the agency being audited.

b. Concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records to be audited.

c. Continuous uninterrupted assignment of an auditor in an agency for years as a result of which the auditor has lost objectivity and independent attitude towards the agency being audited and official financial matters.

SECTION 7. Due professional care. — Due professional care should be used in conducting the audit and in preparing related reports.

This standard requires the COA auditor to follow all applicable standards in conducting government audits. In case of failure to follow an applicable standard, the COA auditor should report the fact, the reasons therefor, and the effects of the deviation from the standard on the results of the audit. This should be documented in the working papers.

Exercise of due care is not an assurance of infallibility nor an in insurance against pure errors of judgment. It simply requires that the auditor perform his examination with reasonable care, diligence, and the professional competence necessary to accomplish the audit work according to applicable auditing standards.

Exercising due professional care means using sound judgment in establishing the scope, selecting the methodology, and choosing tests and procedures for the audit. The same sound judgment should be applied in the actual evaluation, audit and reporting on the audit results. The scope of the audit to be conducted, the methodology, and the extent of tests and procedures to be used require consideration of:

a. Conditions necessary to achieve the audit objectives.

b. Materiality and/or significance of matters to which the tests, procedures, and methodology are applied.

c. Effectiveness and/or efficiency of internal controls.

d. Cost versus benefits of the audit and the extent of the work being done. (However, situations may occur in which the COA auditor has to conduct an audit even though the cost of the audit, exceeds the benefits to be derived.)

e. Reporting time frames that must be met.

The quality of audit work and related reports depends upon the degree to which:

a. the audit scope, methodology, and the tests and procedures used in the audit meet the audit objectives.

b. findings and conclusions are based on a systematic evaluation of pertinent evidence.

c. findings and conclusions in the reports are fully supported by sufficient, competent, and relevant evidence obtained or developed during the audit.

d. the audit process conforms with the field work standards and the reporting standards.

e. supervisory review is made of the audit work conducted together with the audit report.

To ensure that the selected methodology, tests and procedures are appropriate the COA auditor should possess the technical knowledge on the types of audit and the applicable techniques therefor.

Due professional care also includes a mutual understanding of the audit objectives and scope between the audited entity and those who authorized or requested the audit. Also necessary is an understanding of the operations to be audited and the performance measurement criteria (including laws and regulations). When the criteria are vague or not available, the COA auditors should consult with the other interested parties.

a. Materiality and Significance

1. The auditor should consider materiality and significance in planning, implementing and reporting the audit. One of the criteria of the materiality is the monetary value of the item. However, materiality and significance often depend on the cumulative effect and impact of immaterial items, the objectives of the work undertaken, and the use of the reported information by the user or groups of users of the information. Decision on these criteria are based on the auditor's professional judgment. In government audits the materiality level and/or threshold of acceptable risk be lower than in the private sector because of public accountability, the various legal and regulatory requirements, and the visibility and sensitivity of programs, and functions of government.

In determining materiality and/or significance and audit risk, the auditor may consider the following:

a. Amount of revenues and expenditures

b. Newness of the activity or change in its condition

c. Adequacy of internal controls

d. Results of prior audits

e. Level and extent of review or other from of independent oversight

f. Management's adherence to applicable laws and regulations

g. Audit report user's expectations

h. Public perceptions and political sensitivity of the areas under audit

i. Audit requirements

b. Relying on work of others

1. One factor underlying government auditing is that national, corporate, and local government auditors cooperate in auditing programs of common interest or programs where the three government sectors have integrated operations. This allows the auditors to use each other's work and avoid duplicate audit efforts. In conducting an audit, auditors may rely on the work of others to the extent feasible once they satisfy themselves of the quality of the others' work by appropriate tests or by other acceptable methods.

2. Relying on the work of others reduces the amount of work necessary for the auditor to accomplish the audit objective.

3. In determining whether to rely upon the work of others, the auditors should consider the following guidelines.

a. When the other auditors are also COA Auditors, the auditors should consider whether to (1) conduct additional tests such as reviewing the audit procedures and results of the audit conducted by the other auditors, and (2) reviewing the audit programs, working papers, assessment of internal controls, tests of compliance, and the conclusions reached.

b. When the other auditors are internal auditors, tests should include to (1) determine whether they are qualified, (2) determine whether they have sufficient independence to conduct the audit objectively, (3) determine whether their work is acceptable by examining, on a test basis, the documentary evidence of the work conducted, and (4) conduct tests of the work. These tests may be done on (i) some of the transactions, balances, or work examined by the internal auditors or (ii) similar transactions, balances, or work, but not those actually examined by internal auditors. Based upon this review, the auditors should decide what additional work has to be done in order to accept the work of the internal auditors.

c. When relying upon the work of non-auditors (consultants, and, specialists, etc., other than those hired to assist in the audit), the auditors should satisfy themselves as to the non-auditors' professional reputation, qualifications, and independence. The auditors should also consider whether to (1) review the procedures followed and the results of the work conducted, (2) review the work program, (3) review the working papers, (4) make supplemental tests of the work conducted, and/or (5) evaluate the methods or assumptions used.

d. When auditors decide to rely on the work of others, but take no full responsibility for that work, the auditors should indicate in the scope section of the audit report the delineation of responsibility and the magnitude of the audit work completed by others.

c. Audit follow-up

Due professional care also includes follow-up on known findings and recommendations from previous audits. The management of the audited entity is primarily responsible for directing action and follow-up on recommendations. The auditor's report should disclose the status of known but uncorrected significant or material findings and recommendations from prior audits that affect the current audit objective. Government auditors should keep track of the status of management's actions on significant or material finding and recommendations.

d. Responsibility of auditors the detection of fraud and other unlawful activities

1. An audit made in accordance with the laws and regulations issued by the Commission, and the accepted standards, will not guarantee the discovery of all fraud and other unlawful activities that might have been committed. Subsequent discovery of fraud, and other unlawful acts during the audit period does not necessarily mean that the auditor's performance was inadequate. If the audit was made in accordance with these standards, the auditors have fulfilled their professional responsibility.

2. Auditors should be alert to situations or transactions that are indicative of fraud and other unlawful activities. If such evidence exists, extend audit steps and procedures to identify the effects of the findings on the entity's operations and programs.

SECTION 8. Quality control. — The Commission should have an appropriate internal quality control system in place.

This standard places responsibility on the Commission to have an appropriate internal quality control system in place and to participate in an external quality control review program.

The internal quality control system established by the Commission should provide reasonable assurance that it. (a) has established, and is following, adequate audit policies and procedures and (b) has adopted, and is following, applicable auditing standards. The nature and extent of an organization's internal quality control system depends on a number of factors, such as its size, the degree of operating autonomy allowed its personnel and its audit offices, the nature of its work, its organizational structure, and appropriate cost-benefit considerations. Thus, the systems established by individual organizations will vary, as well as the extent of their documentation.

Chapter 3. Standards of Field Work for Government Financial and Performance Audit

SECTION 9. Planning. — Work is to be adequately planned and assistants are to be properly supervised. Planning should include the audit requirements of different levels of government.

The auditor should thoroughly plan the audit. This includes defining the audit objectives, setting up procedures and determining the nature and extent of tests to realize the audit objectives. The plan should ensure optimum use of audit resources. The details of the audit plan should be included in the audit program.

Adequate planning is especially important in performance audits because the methodology implementing steps and procedures employed in such audits are varied and complex.

a. Considerations in Planning

1. The information needed by the auditor to plan an audit varies with the audit objectives and the entity to be audited.. In many instances, an audit survey of the entity may be made before preparing a plan for conducting the field work. The survey is an effective method to help identify specific audit areas and to obtain information for use in planning. It is a process of quick gathering of information without detailed verification on the entity's organizations.

2. A survey provides information about the key system and procedures used for managing finances and operations. It also gives information about the size and scope of the entity's activities, its internal control weaknesses, uneconomical or inefficient operations, lack of effective goal achievement, or lack of compliance with laws and regulations. However the tests to determine the significance of such matters are generally conducted in the detailed audit work as specified in the audit programs.

3. Adequate planning should include consideration of:

a. Audit objectives, scope, and methodology

b. Criteria for assessing performance (where applicable)

c. Coordination with other government auditors on work already conducted and other work that may be intended

d. Skill and knowledge of the personnel to staff the assignment and the use of consultants, and specialists

e. Assessment of internal controls

f. Materiality and/or significance and audit risk

b. Audit objectives, scope and methodology

1. Determining audit objective, scope, and methodology requires logical and systematic thinking.

2. The first step in planning an audit is to define carefully the audit objectives. The statement of audit objectives should be clear on what the audit is to accomplish. It is rare for just one audit to cover all aspects of performance. This is critical in establishing the audit boundaries.

3. Audit findings should contain criteria. causes, and effects. However, the elements needed for a complete finding and report depend on the objectives of the audit. Thus, the, objectives should be worded to identify those finding and reporting elements to be developed. For example, the auditor may have as an objective to ascertain the level of performance, or to go a step further, and determine if that level of performance is satisfactory. If not satisfactory, the auditor may or may not have as an objective identifying the cause and making recommendations. Knowing what finding and reporting elements are to be developed is critical in planning so that one gathers the evidence necessary to support the finding elements that may be required.

4. The objectives of an audit extend to every phase of the audit, the selection of scope, methodology, and staff, the conduct of the audit and the timing and nature of reports. Time invested in determining audit objectives is time well spent because an audit with dear objectives can avoid waste of resources, delays, and poor quality reports. In analyzing possible audit objectives, the auditors should consider the significance of an issue, the contribution auditors can make, and the availability of data and resources.

5. Decisions about the scope of audit work are based on such factors as the availability and recentness of data, and the ease and appropriateness of analytical techniques to be applied. Questions to be considered include: What period should be considered? Will the results be projected? What level of validity is needed in documenting the existence of a problem and its cause? What comparisons will be made.

6. "Methodology" refers to the process used to gather and analyze data to be able to reach conclusions and recommendations The methodology selected must provide evidence to support the objectives of the audit.

c. Criteria

Criteria are standards against which the adequacy of performance can be assessed. In the selection of criteria, auditors have a responsibility to use only criteria that are suitable or those that are relevant to the matters being audited.

d. Coordination

1. In audits involving field work at different locations, coordination with other government auditors is necessary ensure audit efficiency and effectiveness.

2. The functional interrelationships among the different components of the Commission provide the framework of coordination for the attainment of all audit objectives.

3. Overall-policies, rules and regulations and standards of performance which are recommended by the Chairman as Chief Executive Officer, the Commissioners. Assistant Commissioners, Central Office Directors, COA Directors in the Regions, and Unit Auditors are submitted to, deliberated upon and approved by the Commission Proper.

4. Implementation of approved policies, rules and regulations and standards together with all the programs of the Commission rests with the Chairman, who, as Chief Executive Officer, is in command of the administrative machinery of the Commission.

5. The Central Offices provide staff assistance to the Chairman in the implementation.

6. At the regional level, management, coordination and evaluation of the delivery of audit services and programs approved by the Commission Proper are done by the COA Directors assigned in the regions.

e. Personnel

Staff planning should include:

1. Assigning staff with appropriate skills and knowledge for the job.

2. Assigning an adequate number of experienced staff and supervisors to the audit. Consultants should be used when necessary.

3. Providing for on-the-job training of staff.

f. Supervision

1. The audit staff who are involved in accomplishing the objectives of the audit should receive appropriate guidance and supervision to ensure that the audit work is properly conducted and the audit objectives are accomplished.

2. Proper supervision ensures the quality of the audit work and expedites the progress of an assignment. Supervision adds seasoned judgment to the work performed by less experienced staff and provides them necessary and incidental training.

3. Proper assignment and use of staff is important to satisfactory achievement of objectives. Since skills and knowledge vary among auditors, work assignments must be commensurate with abilities.

4. Supervisors should satisfy themselves that staff members clearly understand their assigned tasks before starting the work. Staff should be informed of the what, how, and why of the work to be conducted. The supervisor may outline the scope of the work and leave details to assistants. With less experienced staff, the supervisor performs many details and specifies to the staff how to conduct specific data gathering and use analysis techniques. Supervision should determine that there is (a) conformance with audit standards, (b) the audit programs are followed, (c) that audit work is done with due professional care, (d) the working papers adequately support findings and conclusions and provide sufficient data to prepare a meaningful report, and (e) the audit objectives are met. Supervisory reviews of the work conducted should be documented in the working papers.

SECTION 10. Legal and regulatory requirements. — A test should be made of compliance with applicable laws and regulations.

a. Compliance with laws and regulations is important in government auditing. In government, the organizations, programs, activities, and functions are usually created by law and are subject to specific rules and regulations.

b. The need and nature of assessment for compliance with requirements of laws and regulations, vary with the objectives of the audit. The auditor should design steps and procedures to provide reasonable assurance that the audited entity has adhered to the requirements of laws and regulations.

c. Management is responsible for establishing an effective system of internal control to ensure compliance with laws and regulations. Auditors should consider the entity's system of internal control.

d. The nature of the requirements of laws and regulations that the auditor might assess are illustrated below.

1. Economy and efficiency: Compliance with laws and regulations that could significantly affect the acquisition, protection, and use of the entity's resources, and the quantity, quality, timeliness, and cost of the products and services it produces and delivers.

2. Program: Compliance with laws and regulations pertaining to the objectives of the entity's programs, activities, and functions; the manner in which programs and services are to be delivered; the population a program or service is to be served; and whether the programs, activities, and functions are being carried out in conformity with these laws and regulations.

e. Auditors are responsible for determining which requirements of laws and regulations are to be considered in the audit. This responsibility requires that those planning the audit be knowledgeable of the compliance requirements that apply to the subject under audit. The auditors need to exercise professional judgment in determining how those laws and regulations might have a significant impact on the audit objectives.

f. A variety of sources exists for information on requirements of laws and regulations. The audited entity is a good first source. When funding from another level of government is involved and the source is known, auditors can obtain and/or corroborate information about the applicable requirements from the funding entity. Auditors should seek appropriate legal advice concerning application and the interpretation of laws and regulations.

g. The Auditor should design the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives.

h. In conducting audits, the auditors choose and perform audit procedures and techniques that can obtain sufficient competent, and relevant evidence to serve as basis for our judgments and conclusions.

i. When audit techniques and procedures indicate that abuse or illegal acts have or may have occurred, the auditors need to determine the extent to which these acts significantly affect the audit results.

j. Detecting noncompliance resulting from illegal acts is generally difficult. Doing so commonly requires special techniques, and auditors are expected to devise and apply such steps as may be effective like an assessment of the control structure.

k. Auditors should be alert to situations or transactions that are indicative of abuse or illegal acts.

l. When information comes to the auditor's attention (through audit procedures, tips, or other means) indicating abuse or illegal acts, the auditor should consider the potential impact of these acts on the audit results. If these acts could significantly affect the audit results, extend the audit steps and procedures (1) to determine whether the acts occurred and, (2) if so, to determine the extent to which these acts significantly affect the audit results.

m. The auditor should be aware of his responsibility to detect and report errors, irregularities and illegal acts in the audit of agency accounts.

Errors refer to unintentional misstatements or omissions of amounts or disclosures in financial statements. Errors may involve —

1. Mistakes in gathering or processing accounting data from which financial statements are prepared.

2. Incorrect accounting estimates arising from oversight or misinterpretation of facts.

3. Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.

Irregularities refer to intentional misstatements or omissions of amounts or disclosures in the accounts, such as:

1. Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared.

2. Misrepresentation or intentional omission of events, transactions, or other significant information.

3. Intentional misapplication of accounting principles relating to amounts, classifications, manner of presentation, or disclosure.

Illegal acts refer to violations of laws or governmental regulations. Illegal acts are acts attributable to the agency whose financial statements are under audit or acts by management or employees acting on behalf of the agency. These acts are the results of inadvertence, negligence, and/or intent.

The auditor's training, experience and understanding of the agency and its operations may provide a basis for recognition that some agency acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law.

The Auditor should assess the risk that errors, irregularities and illegal acts may cause the financial statements to contain a material misstatement. He must understand the characteristics of errors, irregularities and illegal acts and must design and perform appropriate audit procedures.

The auditor should exercise (a) due care in planning, performing, and evaluating the results of audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

In developing an audit plan, the auditor should consider factors influencing audit risk that relates to several or all account balances and obtain an understanding of the internal control structure. These matters often have effects pervasive to the financial statements taken as a whole and also influence the auditor's consideration of risk at the account or balance or class-of-transaction level.

An assessment of the risk of material misstatements should be made during planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements. The factors considered in assessing risk should be considered in combination to make an overall judgment; the presence of some factors would not necessarily indicate increased risk. Factors such as the following may be considered:

1. Management operating and financing decisions are dominated by a single person.

2. Management reputation in the business community is poor.

3. Organization is decentralized without adequate monitoring.

4. Many contentious or difficult issues are present.

5. Significant difficult-to-audit transactions or balances are present.

The auditor's responsibility to detect and report misstatements resulting from errors, irregularities and illegal acts has a direct and material effect on the determination of reliability of financial statement accounts.

In applying audit procedures and evaluating the results of those procedures, the auditor may encounter specific information that may indicate possible illegal acts, such as the following:

1. Unauthorized transactions, improperly recorded transactions or transactions not recorded in a complete or timely manner in order to maintain accountability for assets.

2. Violations of laws or regulations cited in reports of regulatory agencies that have been made available to the auditor.

3. Large payments for unspecified or undefined services or goods.

4. Payments on contracts not subjected to public biding or not covered by certificate of availability of funds.

n. Auditors should exercise due professional care and caution in pursuing indications of illegal acts that could lead to future investigations and/or legal proceedings. Due care would include consulting appropriate legal counsel and/or the applicable law enforcement organization before proceeding.

o. Circumstances may exist in which laws, regulations, or policies require auditors to promptly report indications of illegal acts to law enforcement or investigatory authorities before extending audit steps and procedures. The auditor may also be required to defer further work on the audit or a portion of the audit in order not to interfere with an investigation. However, the auditor should consider whether this would restrict the completion of the remaining portion of the audit or interfere with the auditor's ability to form objective opinions and conclusions. If it restricts or interferes, the auditor should report accordingly to higher authorities and recommend to discontinue further action until completion of the investigation.

p. Auditors are responsible for being aware of the characteristics and types of vulnerabilities and potential illegal acts associated with the area being audited in order to be able to identify indications that these acts may have occurred.

SECTION 11. Internal control. — Understand the internal control structure in order to plan the audit and to determine the nature, timing, and extent of tests to be performed. An assessment should be made of applicable internal controls when necessary to satisfy the audit objectives.

a. Management is responsible for establishing an effective system of internal controls. The lack of administrative continuity in government units because of continuing changes in elected legislative bodies and in administrative organizations increases the need for an effective internal control system.

b. Internal control includes the plan of organization and methods and procedures adopted by management to ensure that its goals and objectives are met; that resources are used consistent with laws, regulations, and policies; that resources are safeguarded against wastage, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

c. The need to assess internal controls and the focus of that assessment vary with the objectives of the audit. Apropos are these considerations:

1. An assessment is required in audits having as their objective the assessment of the adequacy of particular internal controls. Here, the auditor should design techniques and procedures to assess the effectiveness of the prescribed control procedures or actual control practices.

2. An assessment of internal controls is a natural adjunct in audits having as their objective an assessment of the adequacy of the process (e.g., procedures and practices) for carrying out a particular program, activity, or function. Here, the auditor should design techniques and procedures to determine if controls needed in the process exist and if existing controls are adequate to achieve the desired objectives.

3. An assessment may be necessary in audits having as their objective to determine the underlying cause of unsatisfactory performance (e.g., lack of improvement achieved by recently installed automation intended to increase productivity). If the unsatisfactory performance occurs from weaknesses in internal controls, the auditor should design techniques and procedures to assess the

adequacy of those specific controls and show how their weaknesses could cause the unsatisfactory performance.

d. The focus of the assessment of internal controls varies with the objective of the audit being conducted. Hence, in:

1. Economy and efficiency audits, the auditors may assess those policies, procedures, practices, and controls applicable to the economic and efficient implementation of the programs, functions, and activities, under audit to the extent necessary, as determined by the audit objectives.

2. Program audits, the auditors may assess those policies, procedures, practices, and controls which specifically bear on the attainment of the goals and objectives specified by the law or regulations for the organization, program, activity, or function under audit to the extent necessary, as determined by the audit objectives.

e. Auditors may be assigned to audit or assess particular internal controls. Such assessments should be made in accordance with the standards in this statement.

f. Internal auditing is an important part of internal control, and the auditors should consider this in conducting audit. Where an assessment of internal controls is called for, COA auditors should consider the extent to which the work of the internal auditors can be relied upon to help provide reasonable assurance that internal control is functioning properly and to prevent duplication of effort.

g. In view of the wide range in the size and nature of government organizations, programs, activities, and functions and the variety of their organizational structures and operating methods, no single pattern for internal audit and review activities can be specified. Many government entities have these activities identified by other names, such as inspection, appraisal, investigation, organization and methods, or management analysis. These activities assist management by reviewing selected functions or activities.

h. The statement of internal control standards and the detailed procedures in the evaluation of the internal control structure of the agency are discussed separately in Title 2 of this Manual.

SECTION 12. Evidence. — Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditors' judgments and conclusions regarding the organization, program, activity, or function under audit. A record of the auditors' work is to be retained in the form of working papers. Working papers may include tapes, films, and discs.

a. Types of evidence

1. Physical evidence: Physical evidence is obtained by direct inspection or observation of (a) activities of people, (b) property, or (c) events. Such evidence may be documented in the form of memoranda summarizing the matters inspected or observed, photographs, charts, maps, or actual samples.

2. Documentary evidence: Documentary evidence consists of created information such as letters, contracts, accounting records, invoices, and management information of performance.

3. Testimonial evidence: Testimonial evidence is obtained from others through statements received in response to inquiries or through interviews. Statements important to the audit should be corroborated when possible with additional evidence. Testimonial evidence also needs to be evaluated from the standpoint of whether the individual may be biased or has only a partial knowledge about the subject under inquiry.

4. Analytical evidence: Analytical evidence includes computations, comparisons, reasoning, and separation of information into components.

b. Tests of evidence

1. The evidence should meet the basic tests of sufficiency, relevance, and competence. The working papers should reflect the details of the evidence and disclose how it was obtained.

a. Sufficiency: Sufficiency is the presence of enough factual and convincing evidence to support the auditors' findings, conclusions, and any recommendations. Determining the sufficiency of evidence requires judgment. When appropriate, statistical methods may be used to establish sufficiency.

b. Relevance: Relevance refers to the relationship of evidence to its use. The information used to prove or disprove an issue is relevant if it has a logical, sensible relationship to that issue. Information that is irrelevant should not be included as evidence.

c. Competence: To be competent, evidence should be valid and reliable. In evaluating the competence of evidence, the auditors should carefully consider whether reasons exist to doubt its validity or completeness. If so, the auditors should obtain additional evidence or reflect the situation in the report.

2. The following presumptions are useful in judging the competence of evidence. However, these presumptions are not to be considered sufficient in themselves to determine competence.

a. Evidence obtained from an independent source is more reliable than that secured from the audited organization.

b. Evidence developed under a good system of internal control is more reliable than that obtained where such control is weak, unsatisfactory, or nonexistent.

c. Evidence obtained through physical examination, observation, computation, and inspection is more reliable than evidence obtained indirectly.

d. Original documents are more reliable than copies.

e. Testimonial evidence obtained under conditions where persons may speak freely is more credible than testimonial evidence obtained under compromising conditions (e.g., where the persons may be intimidated).

3. Auditors should, when they deem it useful, obtain from officials of the audited entity written representations concerning the relevance and competence of the evidence they obtain.

c. Reliability of evidence from computer-based systems

1. Auditors should satisfy themselves that the computer-processed data are relevant and reliable. This is important whether the data are provided to the auditor or he independently extracts them. To determine the reliability of the data, the auditors may either (a) conduct a review of the general and application controls in the computer-based systems including such tests as are warranted or, (b) if the general and application controls are not reviewed or are determined to be unreliable, conduct other tests and procedures.

2. When computer-processed data are used by the auditor, or included in the report, for background or informational purposes, and are not significant to the audit results, citing the source of the data in the report will usually satisfy the reporting standards for accuracy and completeness.

a. Review of General and Application Controls

In reviewing the general and application controls, the auditor is to consider the effectiveness of those general controls relevant to the application system being reviewed. General controls are normally applicable to all data processing being carried out within an installation and provide a control environment affecting the applications being processed. Application controls apply on an individual basis, and may vary among applications.

Review of General Controls

1. General controls include the plan of organization and methods and procedures that apply to the overall computer operations in an agency. In reviewing the general controls, the auditor should determine whether the controls (a) have been designed according to management direction and known legal requirements and (b) are operating effectively to provide reliability of, and security over, the data being processed. The objectives and procedures followed in conducting this work are discussed in the three areas below.

2. Organization and management controls: The auditor should determine whether (a) there is a clear assignment of responsibilities and accountability for planning, managing, and controlling the functions of the data processing organization, (b) personnel are qualified and adequately trained and supervised, and (c) there is proper separation of duties. Such controls will help ensure that the organization's objectives are achieved, and that errors or irregular acts are prevented or detected.

3. Security controls: The auditor should determine whether adequate security is provided over the computer programs, data files, telecommunications network, and input and output materials. These

controls, such as physical restrictions and the use of passwords to limit system access, help ensure that only authorized persons are granted access to the computer system for authorized purposes.

4. Systems software and hardware controls: Computer systems are controlled by systems software such as operating, data base management, and program library systems. Systems software and hardware normally include built-in error-checking features to detect any errors during processing. The auditor should be aware (a) of the procedures used to ensure that the systems software and hardware are functioning properly, and (b) that when errors are detected, appropriate and authorized corrective actions are taken. The auditor should also be aware of the controls the systems software can exercise over the system, how these controls can be bypassed or over-ridden, and how modifications to the software are controlled.

Review of Application Controls

Application controls are designed to ensure the authority of data origination, accuracy of data input, integrity of processing, and verification and distribution of output. The auditor should review the application controls upon which he is relying to assess their reliability to process only authorized data and to process them promptly, accurately, and completely. This includes a review of the controls used to ensure that application software and later modifications are authorized and tested before implementation. These controls are intended to protect the integrity of the application software.

b. Testing for data reliability

The degree of testing needed to determine data reliability generally increases to the extent that the general or application controls were determined to be unreliable or were not reviewed. Testing procedures may include:

1. Confirming computer-processed data with independent sources, such as third parties, and knowledgeable internal sources, such as regular users of the data, and suppliers of data.

2. Comparing the data with source documents or physical counts and inspections.

3. Reviewing agency test procedures and results, and processing test transactions through the application.

d. Working papers

1. Working papers are the link between field work and the audit report. They should contain the evidence to support the findings, judgments, and conclusions in the report. The Commission establishes policies and procedures for the preparation and maintenance of working papers, including safe custody and retention for a time sufficient to satisfy legal and administrative requirements.

2. As general guidelines, working papers should:

a. Contain a written audit program cross-referenced to the working papers.

b. Contain adequate indexing and cross-referencing, schedules, and summaries.

c. Be dated and signed by the preparer.

d. Be reviewed by a supervisor. That review should be documented in the working papers.

e. Be complete and accurate to provide proper support for findings, judgments, and conclusions, and to enable demonstration of the nature and scope of work conducted.

f. Be understandable without oral explanations. They should also be complete and yet concise. Anyone using them should be able to readily determine their purpose, data sources, the nature and scope of the work conducted, and the preparer's conclusions. Conciseness is important, but clarity and completeness should not be sacrificed just to save time or paper.

g. Be as legible and neat as practicable. Otherwise the working papers may lose their worth as evidence.

h. Be restricted to matters that are significant and relevant to the objectives of the assignment.

3. There are no substitutes for a working understanding of the audit objectives, the reasons for conducting a specific task, and knowing how the task will satisfy the objectives. This understanding comes from well-planned and well-organized work programs and effective instructions by supervisors. The practice of having all working papers contain clear statements of purpose is very helpful in ensuring that information accumulated is properly related to audit objectives and reporting.

Chapter 4. Reporting Standards — Financial Audits

SECTION 13. Conformity with Generally Accepted State Accounting Principles (GASAP). — The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

The term "principles of accounting", as adopted by the COA, includes not only accounting principles but also the methods of applying them. The principles incorporated are those deemed to have reached accepted status by usage, not by design. They are not uniform, as they include "broad objectives," standards of accounting performance and measurement and standards of disclosure.

SECTION 14. Consistent application of GASAP. — Consistency ranks as a major reporting standard, since it is vital to the comparability of financial statements.

Accounting principles should be applied on a consistent basis. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period. A change in accounting principles, if its effect is material, must form part of the state auditor's opinion. Thus, a failure to disclose a material change and its effect on the financial reports would be manifestly deceptive.

SECTION 15. Informative disclosures. — Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

This standard assures the fairness of presentation of financial statements. This means that all information necessary for understanding the financial statements which cannot practically be incorporated in the statements should be included in the notes to financial statements. Disclosure in the financial statements and related notes is a responsibility of the management; the COA auditor determines the adequacy of such disclosure for a fair presentation of the financial statements.

The auditor makes a statement on matters to which he takes exception, the extent of its effect to the related financial report. This statement is made in the audit report and is issued when the exception is material enough to affect the fairness of financial statement presentation. Such effect is usually quantified and indicated in the report. It is explained further in the notes to Financial Statement or in the findings.

Notes to Financial Statements

a. These are explanatory notes on the accounts and/or accounting policies which will give additional information value to the financial statements. Notes to financial statements are generally prepared by management. The auditor may add supplementary notes whenever necessary.

b. In presenting the notes to financial statements, the overriding considerations are full disclosure, materiality, conciseness and consistency. The other concepts of correctness, clarity and understandability, fairness, etc. should also be considered.

c. To distinguish notes to financial statements from findings, and to reduce duplication of information, notes shall be confined to factual explanations without conclusions. Conclusions with corresponding recommendations should be in the section reserved for findings and recommendations.

d. Notes to Financial Statements may include the following:

1. Explanation of major accounting policies such as, the depreciation and/or amortization policies, the valuation applied to inventories, etc.

2. Description of contingent accounts

3. Notes on unusual accounts

4. Disclosure of the use of exception to generally accepted accounting principles, such as whether cash, accrual or modified basis, etc.

5. Subsidies

6. Comments on extraordinary gains and losses

7. Restatement or adjustments of prior year's accounts

8. Disclosure of events that occurred or became known subsequent to the statements date, such as collection of receivables, payment of debts, unusual losses or gains, sale or expansion of plant facilities, and plans for new financing

SECTION 16. Expression of opinion. — The-report shall contain an expression of opinion regarding the financial statements taken as a whole or an assertion that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination if any, and the degree of his responsibility.

a. The audit opinion is the heart of the audit report. It features the auditor's overall conclusion as to the reliability of the audited financial statements. Without the opinion, the report would be meaningless and the users of the statements would have no way of knowing the extent of reliance they should place on these statements.

b. The auditor's standard report states that the financial statements present fairly the entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion of the auditor should be based on the audit performed in accordance with generally accepted auditing standards.

c. The basic elements of the audit report are the following:

1. A title that includes the word "Independent"

2. A statement that the financial statements identified in the report were audited

3. A statement that the financial statements are the responsibility of the agency's management and that the auditor's responsibility is to express an opinion on the financial statements based on his audit

4. A statement that the audit was conducted in accordance with generally accepted state auditing standards

5. A statement that generally accepted state auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement/s

6. A statement that the audit includes

— Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements

— Assessing the accounting principles used and significant estimates made by management

— Evaluating the overall financial statement presentation

7. A statement that the auditor believes that his audit provides a reasonable basis for his opinion

8. An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in accordance with applicable laws and regulations and in conformity with generally accepted government accounting principles.

9. The manual signature of the auditor's firm

10. The date of the audit report

d. The suggested form of the Auditor's standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement/s. Our audit included examining, on a test basis, evidence supporting the amount and disclosures in the financial statements. We also included assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audit provides reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and its cash flows for the year then ended in accordance with applicable laws and regulations and in conformity with generally accepted state accounting principles.

(Signature)

(Date)

e. The report should be addressed to the head of the agency audited. In the case of a government-owned or controlled corporation or a non-governmental entity, the report should be addressed to its board of directors.

f. Depending on the circumstances of each engagement, the auditor shall express any of the following opinions on the financial statements:

1. Unqualified opinion. — An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the agency in conformity with generally accepted government accounting principles and in accordance with

applicable laws and regulations. This is the opinion expressed in the standard audit report discussed in Section 16(d) above

In the event of any conflict between the application of law and/or regulation and of accounting principles, the former shall prevail over the latter.

An unqualified opinion cannot be issued if any of the generally accepted government accounting principles and state auditing standards has been violated.

Modification of standard reports

The auditor should modify his opinion the financial statements or deny an opinion thereon, whenever any one or more of the following circumstances are encountered:

a. Limitation on the scope of examination that precludes applying one or more necessary auditing procedures.

b. Non-conformity with applicable laws and regulations and/or generally accepted state accounting principles.

c. Inconsistency in the application of laws and regulations and/or generally accepted accounting principles.

d. Non-disclosure or inadequate disclosure of material item in the financial statement.

e. Financial statements are affected by an uncertainty concerning an event, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report.

f. The agency's continued existence is uncertain.

g. Auditor's opinion is based in part upon the report of another auditor.

h. Auditor wishes to emphasize a matter regarding the financial statements.

2. Qualified opinion — This opinion communicates a favorable opinion on the financial statements "except for" the effects of a particular matter, such as

a. The scope of the auditor's examination is restricted.

b. The financial statements depart from pertinent laws and regulations and/or generally accepted state accounting principles.

c. Applicable laws and regulations and/or generally accepted state accounting principles have not been applied consistently.

Each of these circumstances for issuing an "except for" opinion assumes that the effect upon the financial statements is moderately material rather than highly material.

Illustrations of qualified opinion:

1. Violation of law and/or regulation:

"As discussed in our Finding No. 2, the agency used its savings in Maintenance and Operating Expenses for the construction of a building amounting to P5.8M in violation of existing laws and regulations."

"In our opinion, except for the effect of the above mentioned violation, the accompanying statements present fairly . . ."

2. Scope limitation:

"As discussed in Finding No. 10, the agency did not conduct a physical inventory of its supplies and materials at year-end, valued in the books at P200,000. The inadequacy of its records did not permit us to apply adequate alternative procedures to determine the validity of this account."

"In our opinion, except for the effect of any adjustments which might have been made had the agency conducted a physical count of its inventories as of December 31, 19XX or had the record allowed us to apply alternative procedures, the accompanying statements present fairly . . ."

3. Adverse opinion — This opinion communicates an unfavorable signal that the financial statements do not present fairly the financial position, results of operations and cash flows in accordance with applicable laws and regulations and/or generally accepted state accounting principles. An adverse opinion is issued when the effect upon the financial statements of the following is material:

a. Departure from generally accepted state accounting principle

b. Violation of law or regulation

c. Inconsistency in the application of generally accepted state accounting principle

d. Uncertainty as to estimates of future transactions or events.

Illustration:

"In view of the materiality of the account of disallowances in the certificate of settlement which were not booked, we are of the opinion that the accompanying financial statements DO NOT present fairly . . ."

4. Disclaimer of opinion — This opinion communicates neither a favorable or unfavorable signal in that the auditor DOES NOT express an opinion on the financial statements. Generally, a disclaimer of opinion is resorted to when a scope limitation or uncertainty is SO material that a qualified opinion is unwarranted.

Illustrations:

a. Inability of the auditor to establish correctness of beginning balances of the accounts due to time constraints caused by previous refusal of management to have accounts audited.

"We conducted our audit in accordance with generally accepted auditing standards . . . However, because the agency management permitted us to audit the accounts only after the end of the year under audit, we were unable to establish the correctness of the beginning balances of the accounts."

"Since the beginning balances of the accounts for the year 19XX have not been correctly established, we are unable to express an opinion on the financial statements."

b. Inability to confirm receivables due to inadequacy of records:

"As discussed in Finding No. 11, we were unable to confirm directly with debtors the agency's receivables at year-end totaling P1M due to inadequacy of the records, and neither could we apply alternative procedures to establish the validity of this account"

"Because the receivables referred to in the preceding paragraph constitute a material portion of the agency's assets, we cannot express and we do not express an opinion on the financial statements."

SECTION 17. Statement of auditing standards. — A statement should be included in the auditor's report that the audit was made in accordance with generally accepted state auditing standards.

The above statement refers to all the applicable standards that the auditors should have followed during their audit. The statement need not be qualified when standards that were not applicable were not followed. However, the statement should be qualified in situations where the auditors did not follow an applicable standard. In these situations, the auditors should modify the statement to disclose in the scope section of their report the applicable standard that was not followed, the reasons therefor, and the known effect that the deviation from the standard had on the results of the audit.

SECTION 18. Report of compliance. — The auditors should prepare a written report on their tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or a separate report, should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. It should include all material instances or indications of illegal acts which could result in criminal prosecution.

a. Positive assurance consists of a statement by the auditors that the tested items were in compliance with applicable laws and regulations. Negative assurance is a statement that nothing came to the auditors' attention as a result of specified procedures that caused them to believe the untested items were in compliance with applicable laws and regulations. When the financial audit did not require tests of compliance with laws and regulations, the report should contain a statement that the auditor did not perform such tests of compliance.

b. All material instances of noncompliance related to the entity's financial statements or the program, fund, or group of accounts being audited should be reported. Instances of noncompliance that separately may not be material, but cumulatively, could have a material effect on the financial statements or results of the financial related audit, should be reported. All instances of illegal acts in the audited entity that could result in criminal prosecution of persons liable should also be reported.

c. Other non-material instances of noncompliance need not be disclosed in the compliance report but should be reported in writing to the audited entity, thru a Certificate of Settlement and Balances or a management letter, whichever is appropriate under the circumstances. Such instances of noncompliance reported to top management should be referred to in the report on compliance. All communications should be documented in the working papers.

d. In reporting material noncompliance, the auditors should place their findings in proper perspective. The extent of non-compliance should be related to the number of cases examined to give the reader a basis for judging the prevalence of noncompliance. In presenting the findings, the auditor should follow the report contents standards discussed in Article VI.

e. If in the audit of a government entity the COA auditors become aware of illegal acts or indications of such acts, they should promptly report to the top official of that entity and appropriate officials of the Commission. If the top official is believed to be a party to such acts or if the acts involved funds received from other government entities, the auditor should report to appropriate officials of the Commission who shall furnish copy of the report to the appropriate oversight body and/or proper officials of the funding entity. Generally, auditors should not release information or reports containing information of such acts or data that such acts were omitted from reports, without consulting with appropriate legal counsel. Otherwise this could interfere with legal processes, subject the implicated individuals to undue publicity, or subject the auditor to potential legal action.

f. Internal government auditors auditing a government entity should report to the top official of the entity (unless the official is believed to be party to such acts) and/or appropriate investigative entity.

g. In the audit of government funds received by a non-government entity, the auditors should promptly report to the appropriate government entity requiring or arranging for the audit and such other officials designated by law or regulation to receive the audit report.

SECTION 19. Report on internal controls. — The auditors should prepare a written report on the entity's internal control structure and assessment of control risk made as part of a financial statement audit or a financial-related audit. This report may be included in the auditor's report on the financial audit or a separate report. The auditor's report should include: (1) the scope of the auditor's work in obtaining an understanding of the internal control structure and assessing the control risk, (2) the entity's significant internal controls or control structure including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements and results of the financial-related audit; and (3) the conditions, including the identification of the material weaknesses, identified as a result of the auditor's work in understanding and assessing the control risk.

a. In identifying the scope of the auditor's work, the report should include a description of the work conducted. Generally accepted state auditing standards require the auditor to understand and assess the audited entity's internal control structure. This consists of the control environment, accounting systems, and specific internal control procedures, to plan the financial audit. The extent of the auditor's assessment can vary from one audit to another and within different elements of an entity's internal control structure.

b. The auditor may limit the consideration of the internal control structure for a number of reasons. These include:

1. An adequate internal control structure does not exist for reliance thereon because of the small size of the entity.

2. The auditor may conclude that it would be inefficient to evaluate the effectiveness of internal control structure policies and procedures and that the audit can be conducted more efficiently by expanding substantive audit tests, thus placing very little reliance on the internal control structure.

3. The existing internal control structure may contain so many weaknesses that the auditor has no choice but to rely on substantive testing, thus virtually ignoring the internal control structure.

4. The objectives of a financial related audit do not require an understanding or assessment of the internal control structure.

c. The above circumstances should be documented in the working papers and included in the report on internal control.

d. In identifying the significant internal controls, the report should list those controls identified by the auditor.

e. The following are examples of different ways in which. the internal control structure might be classified. Auditors may modify these examples or use such other classifications as are appropriate for the particular circumstances on which they are reporting.

1. Cycles of the entity's activity

Treasury or financing

Revenue/receipts

Purchasing/disbursements

2. Financial statement captions

Cash and cash equivalents

Receivables

Inventory

Property and equipment

Payables and accrued liabilities

Debt

Fund balance

3. Accounting applications

Billings

Receivables

Cash receipts

Purchasing and receiving

Accounts payable

Cash disbursements

Payroll

Inventory control

Property and equipment

General Ledger

4. Controls used in administering compliance with laws and regulations

General controls

Specific controls

f. In reporting reportable conditions, the auditors should identify those that are material weaknesses. The auditors should also follow report content standards, as appropriate, for objectives, scope and methodology, audit results, and views of responsible officials, and the report presentation standards, discussed in Chapter 5, Title I of this Manual.

g. The ACPC's statement on auditing standards, gives guidance on reporting conditions that relate to an entity's internal control structure observed during an audit.

h. Non-reportable conditions in an audited entity's internal control structure, not included in the required reports, should be separately communicated to the audited entity, preferably in writing. Such control structure conditions usually communicated in a management letter to top management should be referred to in the report on internal controls. All communications should be documented in the working papers.

SECTION 20. Reporting on financial related audits. — Written audit reports are to be prepared giving the results of each financial related audit.

The ASPC reporting standards, to the extent that they are relevant, also apply to financial related audits. However, if the ASPC reporting standards are not relevant, the reporting standards in Chapter 5 should be followed by the auditor in reporting on financial related audits to the extent appropriate.

SECTION 21. Privileged and confidential information. — If certain information is prohibited from general disclosure, the report should state the nature of the information omitted and the requirement that makes the omission necessary.

a. Certain information may be prohibited from general disclosure by laws or regulations. However, such information are generally made available to the auditor as required by law and because of his position.

b. Reports should state whether any significant pertinent information has been omitted because it is deemed confidential. The-nature of such information should be described and the law or other basis under which it is withheld should be stated.

c. Auditors should consult with appropriate legal counsel before releasing reports which refer to the fact that illegal acts or indications of such acts were omitted from the reports.

Chapter 5. Reporting Standards — Performance Audits

SECTION 22. Timeliness. — Written audit reports are to be prepared promptly to communicate the results of the audit in the prescribed form.

a. The state auditor in the exercise of his power and functions in the examination, audit and settlement of the accounts, funds, financial transactions and resources of the agencies under his audit jurisdiction, shall submit a report of audit on the date prescribed through the Commission to the head of the governing body of the agency.

b. In general, the date of the report should be the date of completion of substantive tests provided that the state auditor has satisfied himself as to the overall picture. If not, the report should bear the date when all material issues are dated.

c. This standard is not intended to limit or prevent discussion of findings, judgments, conclusions, and recommendations with persons who have responsibilities involving the area being audited. On the contrary, such discussions are encouraged. However, a written report should be prepared regardless of such discussions.

d. Written reports are necessary to 1) communicate the results of audits to officials at all levels of government, 2) make the results less susceptible to misunderstanding, 3) make the results available for public inspection, and 4) facilitate follow-up to determine whether appropriate corrective actions have been taken.

e. When an audit is terminated prior to completion, the auditor should communicate the termination to the auditee and other appropriate officials, preferably in writing. The auditor should also prepare a memorandum for the record briefly summarizing the results of the work conducted and explaining why the audit was terminated.

f. The report must be timely. A carefully prepared report may be of little value to decision makers if it arrives too late. Therefore, the auditor should plan for the timely issuance of the audit report and conduct the audit with this goal in mind.

g. Significant observations or findings during the audit which require immediate attention by management should be reported in a management letter to the agency head and/or officials concerned for them to take corrective action before the final report is completed.

SECTION 23. Report contents. — The report should include a statement of the audit objectives and a description of the audit scope and methodology.

Knowledge of the audit objectives, scope and methodology helps the readers to understand the purpose of the audit, judge the merits of the audit work and report, and understand any significant limitations.

a. Objectives

1. The statement of objectives explains why the audit was made and states what the report is to accomplish. Articulating what the report is to accomplish normally involves identifying the audit subject and the aspect of performance examined.

2. The statement of objectives tells the reader the boundaries of the audit. To preclude misunderstanding, clearly define the audit boundaries by stating objectives that were not pursued.

b. Scope and methodology

1. The statement of scope describes the depth and coverage of audit work conducted to accomplish the audits objectives. It should, when applicable, explain the relationship between the universe and what was audited, identify organizations and geographic locations at which. audit work was conducted and the time period covered, cite the kinds and sources of evidence used and the techniques used to verify it, and explain any quality or other problems with the evidence. State unverified data used. Disclose any constraints imposed on the audit approach by data limitations or scope impairments.

2. The statement on methodology also explains the evidence gathered and analysis techniques used to accomplish the audit's objectives. The explanation should identify any-assumptions made in conducting the audit, describe any comparative techniques applied, measures and criteria used to assess performance. If sampling is involved, describe the sample design and state why it was chosen.

3. Avoid any misunderstanding by the reader concerning the work that was and was not done to achieve the audit objectives, particularly when the work was limited by relying on internal controls or constraints on time or resources.

c. Audit findings and conclusions

The report should include a full discussion of the audit findings and, where applicable, the auditor's conclusions

1. Findings

a. Sufficient, competent and relevant information about the findings should be included to promote adequate understanding of the matters reported and to provide convincing but fair presentations in proper perspective. Appropriate background information that readers need to understand the findings should also be included.

b. Audit findings often contain the elements of criteria, condition, and effect, plus cause when problems are found. However, the elements needed for a complete finding depend entirely on the objectives of the audit. Thus, a finding or set of findings is complete when audit objectives are satisfied and the report clearly relates those objectives to the finding's elements.

2. Conclusions

The report contains conclusions when called for by the audit objectives. Conclusions are specified and not left to be inferred by readers. The report should be written not on the basis that a bare recital of facts makes the conclusions inescapable.

d. Causes and recommendations

The report includes the causes of problem areas noted in the audit, and recommendations to correct the problem areas and to improve operations, when called for by the audit objectives.

1. Causes

a. When problems are reported, discuss the causes. The audit objectives call for development of the reasons for the problems. In some audits, the objective may be limited to identifying the problem with no requirement for identifying the cause.

b. Identifying the underlying cause of problems found helps in making constructive recommendations to achieve corrective action. When auditors know why something happened, they can readily determine what action is needed to prevent its recurrence.

c. Auditors need to clearly demonstrate and explain with applicable evidence and reasoning the link between the problem and the factor or factors they identified as the cause. In some cases, the auditors may need to describe how they isolated the stated cause or causes from other plausible factors. This is not a requirement for proof of a causal relationship, but a requirement for reasonable persuasive argument.

2. Recommendations

a. The report contains recommendations for significant improvement in operations and performance as substantiated by the reported findings and recommendations called for by the audit objectives. Recommendations to effect compliance with laws and regulations and improve internal controls should also be made when significant instances of noncompliance are noted or significant weaknesses in controls are found. The auditor's report should also disclose the status of known uncorrected significant findings and recommendations from prior audits that affect the objectives and findings of the current audit.

b. Reports which contain constructive recommendations can encourage improvements in the conduct of government programs and activities. Recommendations are most constructive when they are directed at resolving the cause of identified problems, are action-oriented and specific, and are addressed to parties concerned. Recommendations also need to be feasible and cost-effective.

e. Statement on auditing standards

1. The report includes a statement that the audit was made in accordance with generally accepted state auditing standards and discloses when applicable standards were not followed.

2. The statement of conformity refers to the applicable standards that the auditors should have followed during the audit. The statement need not be qualified when standards that were not applicable were not followed. The auditors should modify the statement to disclose in the scope section of their report the required standard that was not followed, the reasons therefor, and the known effect the deviation from the standard had on the results of the audit.

f. Internal controls

1. The report identifies the significant internal controls that were assessed, the scope of the auditor's assessment work, and any significant weaknesses found during the audit.

2. Reporting on internal controls will vary depending on the significance of any weaknesses found and the relationship of those weaknesses to the audit objectives.

3. In audits having as their objective an assessment of performance, auditors may identify weaknesses in internal controls of such significance as to be a key source of the deficient performance. In reporting findings, identify the controls and the weaknesses.

g. Compliance with laws and regulations

The report includes all significant instances of non- compliance, abuse, and all indications or instances of illegal acts that could result in criminal prosecution that were found during or in connection with the audit.

1. Noncompliance

a. The auditors' report should include all significant instances of noncompliance found in connection with the audit, even those not resulting in a legal liability of the entity or persons responsible. All instances of illegal acts that could result in the entity, or an official or employee of the entity, being subject to criminal prosecution should also be reported.

b. In reporting significant instances of noncompliance identified in response to the audit objectives, the auditors should relate to the universe the number of cases examined and quantify them in terms of money value, if appropriate.

2. Abuse and illegal acts

a. During an audit or in connection with an audit, when COA auditors become aware of abuse or illegal acts or indications of such acts that could affect the government entity, they should promptly report to the top official of that entity and appropriate officials of the Commission. If the top official is believed to be a party to such acts or otherwise implicated or if the acts involve funds received from other government entities, the auditor should in all cases report to appropriate officials of the Commission who shall furnish copy of the report to the appropriate oversight body and/or proper officials of the funding entities.

b. In the case of an audit of government funds received by a non-government entity, the auditors should promptly report to the appropriate government entity requiring or arranging for the audit, and such other officials designated by law or regulation to receive the audit report.

c. Abuse or illegal acts or indications of such acts that auditors become aware of should be covered in a written report and submitted in accordance with the preceding paragraphs. Such acts may be covered in a separate report if including them in the overall report would compromise investigative or legal proceedings or otherwise preclude the report from being released to the public. Auditors generally should not release information or reports containing information on potential illegal acts that could result in the entity, or officer or employee of the entity, being subjected to criminal prosecution, or reports with references that such acts were omitted from the reports, without consulting with appropriate legal counsel, since this could interfere with legal processes or subject the implicated individuals to undue publicity, or might subject the auditor to potential legal action.

h. Views of responsible officials

1. The report includes the pertinent views of responsible officials of the organization, program, activity, or function audited concerning the auditors' finding's, conclusions, and recommendations.

2. One of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible auditee officials and others as may be appropriate Except for the possibility of fraud or other compelling reasons which may require different treatment, the auditor's tentative findings and conclusions should be reviewed with officials. With the views of

responsible officials a report is produced that shows not only what was found and what the auditors think about it, but also what the responsible persons think about it and what they plan to do about it.

3. The auditor should normally request that the responsible officials' views be submitted in writing on significant findings, conclusions, and recommendations adversely affecting the audited entity. When written comments are not obtained, oral comments should be requested.

4. Advance comments should be objectively evaluated and recognized, when appropriate, in the report. A promise or plan for corrective action should be noted for follow-up in subsequent audits but should not be accepted as justification for dropping a significant point or a related recommendation.

5. When the comments oppose the report's findings, conclusion, or recommendations, and are not in the auditors' opinion valid, the auditors may choose to state their reasons for rejecting them. Conversely, the auditors should modify their report if they fund the comments valid.

i. Noteworthy accomplishments

1. The report should include a description of any significant noteworthy accomplishments, particularly when management improvements in one area may be applicable elsewhere.

2. Significant management accomplishments identified during the audit, which were within the scope of the audit necessary to accomplish the audit objectives, should be included in the audit report, along with the deficiencies. The requirement of including recognition of noteworthy accomplishments ensures balanced reporting and enables the auditor to pinpoint effective management measures, the benefit of which can be extended to other areas. The inclusion of such accomplishments may lead to improved performance by other government organizations that read the report.

Issues needing further study

1. The report should include a listing of any significant issues needing further study and consideration.

2. If during the audit, the auditor identifies significant issues that warrant further audit work, but the issues are not directly related to the audit objectives and the auditor does not expand the audit and pursue them, the auditor should:

a. refer the issues to the appropriate auditors within the audit organization responsible for planning future audit work, and

b. disclose the issues in the report and the reasons the issues need further study.

k. Privileged and confidential information

1. The report should include a statement about any pertinent information that was omitted because it is deemed privileged or confidential. The nature of such information should be described and the basis under which it is withheld should be stated.

2. Certain information may be prohibited and thus excluded from general disclosure by national laws or local ordinances or regulations. Such information may be provided on a need-to-know basis only to persons authorized by law or regulations to receive it. Before omitting pertinent data from the report, the auditors should obtain assurance that a valid requirement for the omission exists and, where appropriate, consult with legal counsel.

3. Auditors should generally consult with appropriate legal counsel before releasing reports with references that illegal acts or indications of such acts were omitted from the report.

SECTION 24. Report presentation. — The report should be complete, accurate, objective, and convincing, and be as clear and concise as the subject matter permits.

a. Complete

1. Being complete requires that the report contains all pertinent information needed to satisfy the audit objectives, promote an adequate and correct understanding of the matters reported, and meet the applicable report content requirements. It also means including appropriate background information.

2. Giving readers an adequate and correct understanding means providing perspective on the extent and significance of reported findings, such as the frequency of the occurrence relative to the number of cases or transactions tested and the relationship of the findings to the entity's operations.

3. Except when necessary to make convincing presentations, detailed supporting data need not be included. In most cases, a single example of a deficiency is not sufficient to support a broad conclusion or a related recommendation. All that it supports is that there was a deviation, an error, or a weakness.

b. Accurate

1. Accuracy requires that the evidence presented be true and that findings be correctly portrayed. The need for accuracy is based on the need to assure readers that what is reported is credible and reliable.

One inaccuracy in a report can cast doubt on the validity of an entire report and can divert attention from the substance of the report. Also, inaccurate reports can damage the credibility of the issuing audit organization and reduce the effectiveness of reports it issues.

2. The report should include only information, findings and conclusions that are supported by competent and relevant evidence in the auditor's working papers. That evidence should demonstrate the correctness and reasonableness of the matters reported. Correct portrayal means describing accurately the audit scope and methodology, and presenting findings and conclusions in a manner consistent with the scope of the audit work.

Objective

1. Objectivity requires that the presentation throughout the report be balanced in content and tone. A report's credibility is significantly enhanced when it presents evidence in an unbiased manner so that readers are persuaded by the facts.

2. The audit report should be fair and not be misleading, and should place the audit results in proper perspective. This means presenting the audit results impartially and guarding against the tendency to exaggerate or overemphasize deficient performance. In describing shortcomings in performance, auditors should present the explanation of responsible officials including the consideration of any unusual difficulties or circumstances they faced.

3. The tone of reports should encourage favorable reaction to findings and recommendations. Titles, captions, and the text of reports should be stated constructively. Although findings should be presented in clear, forthright terms, the auditors should keep in mind that one of their objectives is to be persuasive, and that this can best be done by avoiding language that unnecessarily generates defensiveness and opposition. Although criticism of past performance is often necessary, the report should emphasize needed improvements.

d. Convincing

Being convincing requires that the audit results be responsive to the audit objectives, that the findings be presented in a manner that is persuasive and that conclusions and recommendations follow logically from the facts presented. The information presented should be sufficient to persuade the readers of the validity of the findings, the reasonableness of the conclusions, and the desirability of their accepting the recommendations. Reports designed in this manner can do much to focus the attention of responsible officials on the matters in reports that warrant attention and to stimulate corrective actions.

e. Clear

1. Clarity requires that the report be easy to read and understand. Reports should be written in language as clear and simple as the subject matter permits.

2. Use of straightforward, non-technical language is essential to simplicity of presentation. If technical terms and unfamiliar abbreviations and acronyms are used, they should be clearly defined. Acronyms should be used sparingly.

3. Both logical organization of material and accuracy and precision in stating facts and drawing conclusions, are essential to clarity and understanding. Effective use of titles and captions and thesis and topic sentences makes the report easier to read and understand. Visual aids, such as pictures, charts, graphs, and maps, should be used when appropriate to clarify and summarize complex material.

f. Concise

1. Being concise requires that the report be no longer than necessary to covey the message. Too much detail detracts from a report, may even conceal the real message, and may confuse or discourage readers. Needless repetition should be avoided.

2. Although room exists for considerable judgment in determining the content of reports, those that are complete, but still concise, are likely to receive greater attention.

SECTION 25. Report distribution. — Written audit reports are to be submitted for approval to appropriate officials of the Commission, after which copies of said reports shall be furnished to the head of the Agency audited and to other officials authorized to receive such copies.

a. Audit reports should be distributed to as many interested officials as is practicable. In some cases, the subject of the audit may involve material that is classified for security purposes or is not releasable to particular parties or the public for other valid reasons. Generally, however, the report should be distributed to officials directly interested in the results. Such officials include those designated by law or regulation to receive such reports, those responsible for acting on the findings and recommendations, legislators, and those of other levels of government that have provided funds to the audited entity.

b. Audit report distribution is regulated by the Commission (COA Res. No. 84-40, August 21, 1984.)

1. Audit reports shall be released only to those authorized to receive them.

2. Requests for copies of audit reports shall be addressed to appropriate officials of the Commission for approval.

Chapter 6. COA Audit Procedures and Techniques

SECTION 26. Audit procedures. — Audit procedures are the acts to be performed in conducting an examination of accounts. The proper application of these audit procedures will achieve the objectives of the audit program.

The audit program is an integral part of audit planning and guides the actual audit. It clearly spells out the scope of the audit, the audit objectives, the specific audit procedures to follow, the staff assignment, and the estimated time required to carry out the audit procedure.

The audit procedures enumerated for each type of account under Title II of the State Audit Manual may be adopted and followed by the Auditor in designing his audit program. The Auditor, however, is not limited to these audit procedures but should exercise his best judgment in the choice of those procedures which will be most appropriate and effective for his purposes.

SECTION 27. Audit of assets. — Assets are the economic resources of a business or government entity which are expected to be used in the entity's operations. In government accounting the total amount of the assets is equal to the sum of the liabilities and surplus.

The asset accounts of a government entity are classified into the following principal items:

a. Current Assets

— Cash

— Receivables

— Inventories

b. Other Assets

— Miscellaneous Assets and Deferred Charges

c. Contingent Assets

d. Investments and Fixed Assets

— Investments

— Acquired Assets

— Fixed Assets-Land and Land Improvements

— Fixed Assets-Buildings and Structures

— Fixed Assets-Furniture, Fixtures, Equipment, Work

Animals and Books

Asset account balances are the end results of cumulative effects of all transactions, both expenditures and revenues, before the trial balance date. The verification procedures in relation to asset accounts relies heavily upon the vouching work having already been properly executed during the audit of expenditures and revenues. This previously executed vouching work will have ensured (1) that the original transactions were correctly recorded, distinguishing between expenditures of a capital and expense nature, and (2) that the transactions were properly authorized at the appropriate level in accordance with regulations.

The examination and audit of assets shall be performed with a view to:

a. ascertaining the existence, ownership, valuation and encumbrances as well as propriety, of items composing the respective asset accounts;

b. determining their agreement with records;

c. proving the accuracy of such records;

d. ascertaining if the assets were utilized economically, efficiently, and effectively; and

e. evaluating the adequacy of controls over the accounts.

The auditor's concern at the final review stage is to complete the verification process, which includes the following objectives:

a. Valuation — that assets are fairly valued, and that depreciation or obsolescence charges, if any, are reasonable and have been fully taken into account on an acceptable basis consistent with that adopted in previous years;

b. Existence — that the assets exist;

c. Ownership — that the audited agency is in fact the beneficial owner of the assets concerned and that the liens or encumbrances have been recognized and recorded;

d. Completeness — that all assets owned are included and properly recorded;

e. Economy and efficiency — that assets are acquired, utilized and disposed of to full advantage, and that internal controls are adequate and operating effectively;

f. Effectiveness — that results from the use of the assets contribute to the achievement of the agency goals and mission.

SECTION 28. Audit of liabilities. — Liabilities are economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations but are recognized and measured in conformity with generally accepted accounting principles.

Obligations are amounts which are committed to be paid by government which arise from an act of duly authorized administrative officer which binds the government to the immediate or eventual payment of a sum of money.

Liabilities are classified into current, contingent, and fixed or long-term.

a. Current liability — A short-term debt, regardless of its resources, including any liability accrued and deferred and unearned revenue that is to be paid out of the current assets or is to be transferred to income with relatively short period, usually one year or less, or a period greater than a year but within the business cycle of an enterprise.

b. Contingent liability — Claims pending litigation or decision of courts or authorities concerned. An obligation relating to a past transaction or other event or condition, that may arise in consequence, as a future event now deemed possible but not probable. If probable, the obligation is not contingent but real (ordinarily, a current liability), and recognition in the accounts is required, notwithstanding that its amount must be estimated in whole or in part. The mere possibility of a future loss, as from a fire, not linking with a past event, does not give rise to contingent liability.

c. Fixed liability — long-term liability. — An obligation which will not become due within a relatively short period, usually a year. Examples: mortgages, mortgage bonds; debentures; secured note issues, funded debt generally.

In his audit of liabilities, the auditor shall seek to establish that all obligations of the agency have been accurately recorded; only bona fide obligations of the agency have been included; the obligations incurred are properly authorized; all provisions of trust indentures or mortgages are complied with; and mortgages and other encumbrances are fully disclosed.

SECTION 29. Audit of surplus or networth. — The terms Surplus, Owners' Equities, Capital, Proprietorship and Networth represent the difference between total assets and total liabilities.

The audit of surplus or networth shall seek to determine the nature of the surplus, whether current or invested surplus; the amount of current surplus available to cover appropriations for the operational expenses of the government; the propriety of the ledger accounts and the balance sheet presentation account; and the proper authority and recording of changes in capital structure made during the period under audit.

SECTION 30. Audit of revenue/receipts. — The revenues/receipts of government are classified into:

a. Tax revenues — Tax revenue refers to the income derived from the regular system of taxation enforced under authority of law or ordinances, and accrues more or less regularly every year. They include —

Income Taxes Property Taxes

Taxes on Goods & Services

Taxes on International Trade & Transactions

Other Taxes

b. Non-tax revenues — Non-tax revenues, or receipts, refers to income realized from operation and activities of the of the government, or received by it in the exercise of its corporate functions. Receipts from this source are grouped under the following classification:

Operating & Service Income

Income from Public Enterprise/Investment

Miscellaneous Income

c. Other governmental receipts — Other financial resources of government are derived from receipts in the form of borrowings, repayment of loans/advances granted by the government and other extraordinary income such as:

Repayment of Loans

Other Extra-Ordinary Income

Borrowings

The examination and audit of revenue accounts shall be performed with a view to ascertaining that all earned revenues have been duly recorded; all recorded revenues have been earned; and appropriate classifications of revenues have been consistently followed.

SECTION 31. Audit of expenditures. — Expenditures represent the amount of cash paid or to be paid for a service rendered or an asset purchased. The audit of expenditures starts with the evaluation and verification of the budget formulation and execution processes to ensure that funds are properly allocated and utilized solely for the specific purposes for which they have been appropriated. Specifically, the system of budgetary control shall:

a. establish and maintain the accountability of officials

b. ensure that resources are used only for the purposed intended, and

c. ensure disclosure of material errors in the accounts, unauthorized transactions or loss of assets.

The examination of expense accounts ascertains that all expenses incurred have been duly authorized; adequately funded and documented; properly recorded; all recorded expenses have been actually incurred; and the classifications of expenses are appropriate and have been consistently followed.

Title 2. INTERNAL CONTROL SYSTEM

Chapter 1. Concepts

SECTION 32. Definition of internal control. — Internal control comprises the plan of organization and all the methods and measures adopted within an agency to ensure that resources are used consistent with laws, regulations and policies; resources are safeguarded against loss, wastage and misuse; financial and non-financial information are reliable, accurate and timely; and operations are economical, efficient and effective.

SECTION 33. Distinction from other systems within the organization. — Except for the Internal Audit Office which is part of the internal control system, internal controls are not separate specialized systems within an agency. They consist of control features interwoven into and made an integral part of each system that management uses to regulate and guide its operations. In this sense, internal controls are management controls.

SECTION 34. Need for strengthening internal control. — An adequate internal control system is essential in any organization.

a. Adequate and strong internal controls in government — have been found to be more effective than detailed audit in ensuring the integrity of operations of the agency and the entire range of administrative, financial, operating and reporting systems.

1. Government agencies lack managerial continuity because of changes imposed by legislative enactments and constant turnover of elected officials. Basic strength in internal control systems can help agencies withstand organizational instabilities caused by such changes.

2. Adequate internal controls ensure that control systems are in place to achieve the organization's objectives, safeguard its resources and promote efficiency and economy in the use thereof.

3. The installation and effective implementation of good internal control methods and measures provide management and outside parties with reasonable assurance that managerial controls are effectively working throughout the organization and are carried out in transactions and events that continuously and simultaneously occur in various parts of the entity from day to day.

4. Strong internal control provides accountability for the custody and use of government resources.

5. A reliable internal control system reduces the extent of examination that would be necessary for an external auditor to pass judgment on the overall reliability of the financial statements. It allows the use of statistical sampling and thereby greatly reduces audit cost.

b. Weak internal controls lead to waste and misuse of government resources and non-accomplishment of objectives.

1. Poorly controlled government programs and projects generate frauds, wastage and abuse that result in tremendous losses aggregating to millions of pesos in government funds and property.

2. Weak internal controls foster an environment that facilitates illegal acts and corrupt practices which channel funds intended for government purposes to private uses, thereby depriving intended beneficiaries of needed public services and defeating the objective of public organizations.

3. Inadequate internal controls render the management of agencies unable to perform their functions independently. Where internal controls are weak, the practice is to depend on COA, an external auditor, for the determination of the propriety of the transactions. This in turn requires detailed audit which increases audit time and cost.

SECTION 35. Objectives of internal control. — In order to achieve the goals of the state "all resources of the government shall be managed, expended or utilized in accordance with laws, and regulations, and safeguarded against loss or wastage, illegal or improper disposition, with a view to ensuring efficiency, economy, and effectiveness in the operations of government." (Sec. 2, PD 1445). Internal controls should achieve the following objectives:

a. Compliance with applicable laws, rules and regulations in the management of resources

b. Safeguarding of resources against waste, loss, unauthorized use and misappropriation

c. Use of resources in the most economical and efficient manner and in such a way as to attain the goals of the agency

d. Proper recording and reporting of transactions to ensure that reports are reliable, accurate and timely

SECTION 36. Responsibilities of agency management for internal control. — The responsibilities are shared by the following personnel:

a. Primary responsibility of agency head —

It shall be the primary responsibility of the head of agency to install, implement and monitor an adequate system of internal control under such guidelines prescribed by the Commission on Audit.

In line with this primary responsibility, the head of the agency has the following responsibilities:

1. To develop and install the internal control structure of the agency to include the control environment, accounting system and control procedures.

2. To maintain the internal control environment in order to safeguard assets, produce reliable accounting data and promote operational efficiency and effectiveness.

3. To evolve a system of evaluation and to implement appropriate corrective action.

b. Responsibility of the Chief, Financial Office —

1. To review and assess the applicability of proposed system improvements.

2. To identify laws, regulations and policies which need amendment/revision to improve the internal control system.

c. Responsibility of the Chief, Operating Offices

1. To identify inherent risks and potential errors and irregularities in their areas of operation.

2. To ensure compliance with specific internal control policies and applicable laws and regulations.

3. To evaluate existing systems.

4 To review the proposed system improvements including the cost and benefit aspects.

5. To identify laws, regulations and/or policies which need amendment/revision to improve controls or eliminate unnecessary controls.

d. Responsibility of the Internal Control Office (ICO)

1. To identify potential errors, risks or irregularities, instances of inadequate or excessive controls and breakdowns in controls.

2. To document the existing internal control system.

3. To monitor the agency's compliance with laws, regulations and internal policies.

4. To document and evaluate the internal control system.

5. To recommend measures to improve the existing controls

SECTION 37. The role of the Commission on Audit in internal control. — The role of the COA in internal control is outlined as follows:

a. The Commission on Audit is mandated by the 1987 Constitution to audit all government agencies. Where the internal control system of any audited agency is inadequate, the Commission may adopt such measures, including temporary or special pre-audit, as are necessary and appropriate to correct the deficiencies.

b. In addition to the above, the Commission is required to perform the following functions:

1. The Commission shall ascertain the installation of an adequate internal control system by the agency.

2. The Commission shall be responsible for the design and preparation of the accounting system, including the chart of accounts for all agencies and shall ensure compliance therewith by the agencies.

3. The Commission shall have the authority to evaluate the internal control system of any agency to determine its adequacy and may adopt measures that are deemed necessary and appropriate to correct deficiencies of such system.

SECTION 38. Components of internal control system. — Internal control systems basically consist of two components: a plan of organization and the coordinate methods and measures used by the agency to attain its goals.

a. Plan of organization

The organizational structure and the personnel which enable the organization to carry out its functions comprise the plan of organization. This plan defines and distributes powers, functions and responsibilities to various units and personnel in the organization to enable the various parts to meet the overall objectives.

To operate efficiently the agency's normal set up allows specialization of functions. A basic distinction is made between operating and administrative functions. Operating offices are structured to perform the main tasks of the-agency. Administrative offices provide planning, budgeting, personnel, accounting and similar support services to operating offices to ensure the efficient functioning of the organization.

The details of the distribution of functions to different offices are drawn in an organizational chart. This chart is revised from time to time to reflect management decisions resulting in structural changes.

b. Coordinate methods and measures

This pertains to systems of authorization, policies, standards, accounting systems and procedures and reports used by the agency to control its operations and resources and enable the various units to meet its objectives.

SECTION 39. Types of internal controls. — Internal controls can be categorized into accounting controls, financial controls and administrative controls.

a. Accounting controls

Accounting controls pertain to the plan of organization, the procedures, and records that ensure the accuracy and the reliability of financial records. They provide reasonable assurance of the following:

1. Transactions are executed in accordance with management's general or specific authorization.

2. Transactions are recorded to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements.

b. Financial controls

Financial controls include the methods and procedures concerned with the safeguarding of assets and are designed to ensure that:

1. Transactions are executed in such a way as to maintain accountability for assets

2. Access to assets is permitted only in accordance with management's authorization.

3. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

c. Administrative controls

Administrative controls include, but are not limited to, the plan of organization, the procedures and records concerned with the management decision processes authorizing the transactions. They include controls over administrative offices such as personnel records and administrative functions. Authorization is carried out and described below.

1. Authorization of transactions is a management function directly associated with the responsibility of achieving the objectives of the organization and is the starting point for establishing accounting control of transactions.

2. Authority and responsibility must be identified, separated and delegated in such a manner as to meet organizational objectives efficiently and effectively.

SECTION 40. Limitations of internal control. — Internal control systems only provide reasonable assurance that transactions are being executed in accordance with the objectives of internal control. Consider the following limitations:

a. Internal controls must be attained at reasonable cost. Some necessary controls may be sacrificed to avoid additional costs in terms of personnel, time and materials.

b. Good internal control methods and measures are not foolproof. They are vulnerable to collusion.

c. Strong internal controls are still subject to human fallibility such as negligence, errors of judgment and lack of complete understanding.

d. Organizational changes may render internal control systems and manuals obsolete. Thus, internal control systems and manuals must be constantly reviewed and updated to be relevant and effective.

e. The degree of compliance with internal control systems strongly influences their effectiveness. Too often, expensive internal control manuals remain unused because of management's non-implementation.

Chapter 2. General Standards of Internal Control

SECTION 41. Purpose. — Internal control systems must be evaluated and measured against standards to determine their adequacy. Standards define the minimum level of quality acceptable for internal control systems and the criteria to evaluate these systems. These established standards cover the traditional management areas and the conduct of operations While the standards are applicable to all government operations and administrative functions, they do not intend to limit or interfere with prescribed agency policies or with pertinent legislations.

SECTION 42. Personnel competence. — Officers and employees should possess technical competence and professional integrity commensurate with their assigned responsibilities.

a. Competent, trustworthy personnel

Organizations are run by people. The core of a strong internal control system is a professional and competent staff that adheres to high standards of integrity. To develop this type of work force, the organization must:

1. Formulate recruitment policies and procedures which establish qualifications standards suitable to the agency's functions, and carefully hire personnel in accordance with these standards.

2. Continuously train personnel to keep them open to new ideas, alert and fit for the effective performance of their functions.

3. Fix responsibility for the performance of each duty to promote operating efficiency and identify accountabilities for specific actions.

4. Develop written job descriptions which define the duties and responsibilities of personnel in various offices to clearly provide lines of authority and responsibility. This promotes harmony and efficiency in the work place.

Job descriptions must also be reasonable and realistic and must be available to the staff and supervisor.

5. Properly design and implement policies and procedures for supervision, evaluation and reward of employees.

b. At a personal and professional level, officials and employees involved must:

1. Possess personal and professional integrity and be always aware of their obligations under the Code of Conduct and Ethical Standards.

2. Maintain a level of competence or skill sufficient to perform the work assigned.

3. Understand the prescribed procedures on internal control.

4. Be independent in performing assigned functions.

SECTION 43. Supportive attitude. — Officers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.

a. This standard requires agency officers and employees to be attentive to internal control matters and to take steps to promote the effectiveness of the controls. Attitude affects the quality of performance and, as a result, the quality of internal controls. A positive and supportive attitude is initiated and fostered by management and is ensured when internal controls are a consistently high management priority.

b. Attitude is not reflected in any one particular aspect of officers' actions. It is fostered by the officers' commitment to achieving strong controls through actions concerning agency organization, personnel practices, communications, protection and use of resources, and general leadership. One important way for management to demonstrate its support for good internal controls is its emphasis on the value of internal auditing and its responsiveness to information developed through internal audits.

c. The organization of an agency provides its management with the overall framework for planning, directing, and controlling its operations. Good internal control requires clear lines of authority and responsibility, appropriate reporting relationships, appropriate separation of functions and occasional rotation of work.

d. General leadership is critical to maintaining a positive and supportive attitude toward internal controls. Employees tend to reflect the general attitude of management. Adequate supervision, training and motivation of employees in the area of internal control is vital to ensuring the adequacy of internal controls.

SECTION 44. Control objectives. — Internal control objectives are to be identified or developed for each agency activity. They are to be logical, applicable, and reasonably complete.

a. Control objectives should be tailored to the agency's operations. All operations of an agency can generally be grouped into one or more categories called cycles. A cycle comprises all the specific activities required to process a particular transaction or event. Cycles should be compatible with the agency's organization and division of responsibilities.

b. Examples of cycles are:

1. agency management cycle covers the overall policy and planning, organization, data processing and audit functions:

2. financial cycle covers the traditional control areas concerned with the flow of funds (revenues and expenditures), related assets, and financial information:

3. program (operational) cycle refers to agency activities that relate to the missions of the agency and which are peculiar to a specific agency and

4. administrative cycle consists of activities that provide support to the agency's primary mission.

c. Complying with this standard calls for identifying the cycles of agency operations and analyzing each in detail to develop the cycle control objectives. The internal control objectives are the internal control goals or targets to be achieved in each cycle. The objectives should be tailored to fit the specific operations in each agency and be consistent with the overall objectives of internal control.

SECTION 45. Control techniques. — Internal control techniques are to be designed for and operated in all agency activities to accomplish the control objectives consistently, efficiently and effectively.

a. Internal control techniques are the mechanisms to achieve control objectives. Techniques include such things as specific policies, procedures, plans of organizations (including separation of duties), and physical arrangements (such as locks and alarms), etc. This standard requires that internal control techniques continually provide a high degree of assurance that the internal control objectives are being achieved.

b. To be effective, techniques should fulfill their intended purpose in actual application. As for efficiency, techniques should be designed to derive maximum effort. Techniques tested for effectiveness and efficiency are those in actual operation and should be evaluated over a period of time.

SECTION 46. Reasonable assurance and cost. — Internal control systems are to provide reasonable assurance that the objectives of the systems will be accomplished at a reasonable cost.

a. The standard of reasonable assurance refers to a satisfactory level of confidence under a given consideration of costs, benefits, risks and the exercise of objective judgment. This standard recognizes that the cost of internal control should not exceed the benefit derived.

b In exercising that judgment, the agencies should identify the risks inherent in agency operations, the criteria for determining low, medium and high risks, and the acceptable levels of risk, both qualitative and quantitative, under varying circumstances.

c. Cost refers to the financial measure of resources consumed in accomplishing a specified purpose. Cost may also refer to a lost opportunity such as delay in operations, decline in service levels of productivity, or low employee morale.

d. A benefit is measured by the degree to which the risk of failing to achieve a stated objective is reduced. Examples include increasing the probability of detecting fraud, waste, abuse or error; preventing an improper activity; or enhancing regulatory compliance.

Chapter 3. Specific Standards of Internal Control

SECTION 47. Documentation. — The agency internal control system, policies, procedures, accountability for resources and all financial transactions shall be clearly documented and adequately supported.

a. This standard requires written evidence of the agency's internal control systems, policies and procedures, financial transactions and other significant events. The documentation must be available and easily accessible for examination.

b. Documentation of internal control systems should be provided for in management directives, policies and accounting manuals. Documentation of transactions or other significant events should be timely, complete and accurate and should facilitate tracing of a transaction or event from its occurrence to processing until completion or recording in summary records.

c. Documentation of internal control systems should be purposeful and useful to agency management in controlling operations and to auditors and others in analyzing operations.

d. To document a system of internal control, an auditor relies upon one or more of the following:

1. Narrative memorandum which is a written description of a particular phase or phases of the control system.

2. Flowcharts consisting of interrelated symbols which diagram the flow of transactions and events through a system, or positions thereof.

3. Internal control questionnaires which are a series of questions designed to detect control weaknesses.

SECTION 48. Recording of transactions and events. — Financial transactions and events shall be promptly recorded in accordance with the state accounting standards. This would permit timely preparation of required financial statements and reports and maintaining adequate accountability for assets.

a. Transactions must be promptly recorded to maintain the relevance and value of the information to agency management in controlling operations and making decisions.

b. This standard applies to the entire process or life cycle of a transaction or event, which includes classification and summarization of records, posting to the general ledger and subsidiary ledgers and preparation of financial statements and reports.

c. This standard also requires that accounting information shall be processed, analyzed, classified, summarized and reported in accordance with prescribed state accounting standards.

d. This standard covers operating and administrative offices which should both record their activities.

e. In line with this standard, proper procedures for record-keeping must be developed to avoid unplanned and uncoordinated procedures and methods of recording and record-keeping which can lead to the chaotic accumulation of information that will eventually prove to be of little use to the agency.

Proper procedures for record-keeping include identifying the objectives of recording, e.g., the type of information required, and designing the steps of recording in such a way as to facilitate classification, summarization and analysis which will yield the desired data.

SECTION 49. Authorization and execution of transactions. — All transactions shall be executed by persons acting within the scope of their authority.

a. This standard provides assurance that assets are adequately safeguarded by requiring that transactions and other significant events must be executed by responsible personnel acting within the scope of their prescribed authority and responsibility.

Transactions subject to review must be approved by higher authority. The authorization of actions of employees by higher officials provides assurance that transactions are consistent with the policies of the agency and in accordance with its plans and programs. Authorization also provides a check on the work of employees and establishes accountabilities therefor.

b. Authorization and execution of a transaction or series of related transactions depends upon the nature, scope and frequency of the occurrence. Routine transactions need general authorization to avoid re-authorizations while projects which are unusual, material or infrequent require specific authorization each time the transaction is proposed.

SECTION 50. Segregation of duties and functions. — Key duties and functions such as authorization, custody and accounting shall be assigned to separate offices and individuals to eliminate opportunities to conceal errors and irregularities.

a. To ensure that effective check and balance exists and to prevent any one employee from perpetrating or concealing irregularities or illegal acts alone, no one person or department should be in complete control over a transaction.

The person responsible for an error cannot be expected to report its occurrence. Consequently, significant phases of transactions should be identified and each phase assigned to a different person. In this way, the work of one provides an automatic check on the work of another.

On a company-wide basis, it is suggested that the following functions and responsibilities be separated or performed by different employees/departments to avoid giving any one office or individual inordinate control over transactions and resources.

1. Transaction authorization (a management function)

2. Transaction execution (a custodial function)

3. Transaction recording (an accounting function)

4. Periodic accountability (an internal audit function)

b. To reduce the tendency of custodians to conceal the misuse of assets entrusted to them through the manipulation of records and the use of improper entries, access to records must be restricted to persons not involved with custody.

c. To reduce the opportunity for establishing complete control over functions and resources over which authority is exercised in the course of a regular job, employees occupying sensitive positions must be regularly rotated or required to take forced leave. The assignment of their tasks to other employees provides an automatic check over their functions.

d. However, even if functions are assigned to different employees, no internal control system can prevent collusion, an irregularity or illegal act conspired by two or more employees, each of whom is necessary to complete the fraudulent scheme.

SECTION 51. Supervision scheme. — Qualified and continuous supervision of subordinates shall be provided to assure adherence to approved policies and procedures.

a. One way of ensuring that internal control objectives are achieved is the continuous supervision of personnel by:

1. Making them aware of their duties, responsibilities and accountabilities.

2. Reviewing the work of each staff member systematically.

3. Approving staff output at critical points.

b. In the conduct of supervision, procedures to be followed must be simple, effective and economical. Instructions should be kept in written manuals to promote efficiency and avoid misunderstanding. Determination of whether the procedures and instructions are being carried out as planned can be done through careful supervision and review.

SECTION 52. Agency resources: physical control and access. — Tangible assets and records should be physically safeguarded. Access to these assets and records, both direct physical access and access through document processing, shall be in accordance with management's authorization.

a. Tangible assets such as cash, supplies, furniture and equipment are vulnerable to misappropriation. Physical safeguards that provide protection that is adequate and suitable to the nature of each asset should be adopted, e.g., safes for cash, storerooms for supplies and unissued equipment, lock and key for offices, etc.

Physical control includes prenumbering of accountable forms and maintaining control registers to ensure their sequential use and establish accountabilities. It also includes documentation and recording of movements of assets and restricting access to authorized personnel.

b. The reason behind restricting access to assets or resources to authorized personnel only is to reduce the risk of unauthorized use and/or loss to the government

c. Access to assets includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access is required in the normal operations of a business. However, the number and competence of personnel to whom access is authorized should be determined by the nature of the assets and its susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires some appropriate physical segregation and protective equipment or devices.

d. Controls include obtaining reasonable insurance coverage against losses. This can be done by bonding employees who hold positions of responsibility and accountability and insuring assets such as property, plant and equipment against fire, theft, and other insurable risks.

SECTION 53. Asset accountability. — Accountability for the custody and use of an asset is to be assigned and maintained and periodic comparison shall be made of the existing asset with the recorded accountability and appropriate action taken on any differences.

a. Assigning and maintaining accountability for custody and use of asset involves directing and communicating the responsibility to specific individuals within an agency.

b. This standard further requires comparison of recorded accountability with existing assets to determine whether the actual assets agree with the recorded accountability. Any discrepancy should be investigated in accordance with existing regulations and appropriate action taken thereon.

c. The frequency with which comparison of recorded accountability with assets should depend on the materiality of the assets and their susceptibility to misuse or loss through errors and irregularities.

SECTION 54. Built-in checks. — Proofs of accuracy and document trail of transactions are features that should be built in to the execution and recording of transactions to assure their correctness.

The double entry system of accounting should be used as a signaling device for detecting inaccuracies in recording debits and credits.

Controlling accounts should be used as extensively as possible to provide automatic checks on people's performance of their functions and to facilitate monitoring of transactions and events.

SECTION 55. Presence of appraisal activity. — Reviews of transactions and internal control shall be performed on an on-going basis for proper monitoring of adherence to prescribed policies and procedures.

a. Independent checks on performance

Actions in carrying out and recording of transactions should be subject to review and cross-checking. Knowledge that one's actions is checked from time to time is a deterrent to negligence in the performance of duties. Independent checks on performance include review systems and an internal audit office as described below.

1. Review systems

Checks on performance include the following:

a. Periodic reconciliation of accounts which involves verifying the accuracy of one set of records against an independent set of documents, and

b. Surprise counts of assets on hand.

2. Internal audit

Independent checks on performance include the creation of an internal audit office to review and monitor the effectiveness of the implementation of the control system. In small offices, an internal audit office may not need to be established. Instead, a small unit of reviewers may be created under the office of the Comptroller.

b. It is the primary responsibility of the head of the agency to monitor the system of internal control. This responsibility may be delegated by management to an internal audit department or office within the agency. The internal audit function or appraisal activity as exercised by the internal audit office or unit constitutes a separate component of internal control the objective of which is to determine whether other internal controls are well designed and properly operated.

c. The scope and objectives of internal audit may vary depending on the size and structure of the agency and the requirements of its management. Internal audit normally operates in one or more of the following areas:

1. review of accounting system and related internal controls

2. examination for management of financial and operating information. This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.

3. examination of economy, efficiency and effectiveness of operations including the non-financial controls of the agency.

4. review of compliance with policies and applicable laws and regulations.

SECTION 56. Prompt resolution of audit findings. — Officers shall promptly evaluate findings and recommendations reported by auditors, determine proper actions in response to audit findings and recommendations, and complete within established time frames all actions that correct or otherwise resolve the matters brought to management's attention.

a. The audit resolution standard requires officers to take prompt, responsive action on all findings and recommendations made by the auditor Responsive action is that which corrects identified deficiencies. Where audit findings identify opportunities for improvement rather than cite deficiencies, responsive action is that which produces improvements.

b. The audit resolution process begins when the results of an audit are reported to management and is completed only after actions are taken to (1) correct identified deficiencies, (2) produce improvements, or (3) demonstrate that the audit findings and recommendations are either invalid or do not warrant management action.

c. Auditors are responsible for monitoring the actions taken up by the audit findings and recommendations. Top management should be informed through periodic reports when audit findings and recommendations remain unacted, so that it can be assured of quality and timely resolution decisions.

Chapter 4. Internal Control System Evaluation

SECTION 57. Objectives of the evaluation. — Evaluation of the Internal Control System (ICS) is a means to determine effectiveness, correct deficiencies, and improve the system.

a. Evaluation shall be conducted periodically to ensure that the agency's internal control procedures and methods are operating as planned; and to determine whether the changed conditions call for revisions in the system; or whether the prescribed procedures are being observed correctly.

b. The objectives of evaluating an ICS vary depending on the evaluation purpose. The different evaluators of ICS and the corresponding objectives of their evaluation are:

1. The Internal Auditor or the Internal Control Office Staff of the agency undertakes the ICS evaluation as a normal part of their work to monitor and improve internal controls.

2. The COA Auditor evaluates the ICS of the agency under his jurisdiction to establish a basis for reliance that the laws and regulations are complied with and to provide for efficient, economical and effective operations. His evaluation shall also determine the nature, extent and timing of the audit test to be applied in his examination of the financial statements.

3. COA Central Operating Offices and Regional Offices evaluate ICS to provide a basis for a decision on the withdrawal of the resident auditor.

4. The COA Systems and Consultancy Division may also conduct ICS evaluation in connection with (a) an operations review project; (b) a systems and procedures manualization project; (c) determining the advisability of installing an Internal Control Office.

SECTION 58. Timing of the evaluation. — The timing and frequency of the evaluation of ICS shall depend on the evaluator and his objective/purpose of evaluation. Therefore,

a. For the Internal Auditor or ICS Staff, review shall be done on a continuous basis.

b. For the Resident Auditor, an evaluation shall be done periodically as part of his regular audits before he prepares the detailed audit program.

c. For the different COA Central Operating and Regional Offices, the evaluation may be scheduled to coincide with their program for the withdrawal of resident auditors.

d. For the Systems and Consultancy Division of the COA, the timing of evaluation is usually determined by the terms of reference of each client/engagement.

SECTION 59. Internal control evaluation steps. — The evaluation of internal controls has the following identifiable steps:

a. Familiarization with the agency's operations

1. This step includes gathering of information and obtaining a good understanding of the agency operation, its goals and objectives, the relevant laws, rules and regulations, the organizational and functional structures and the policies and procedures.

2. This information-gathering step involves desk review of the pertinent materials such as previous audit reports, outputs of past studies, the charter creating the agency, manuals of procedures and organization/functional charts.

3. For automated systems, the review process differs on the detailed procedures rather than general methods. Some procedures for the review of EDP systems are:

— Interviews

— Review of manuals and documents

— Observation of activities

— Review of systems and program flowcharts,

program-run books and console-run books, EDP

utilization records, program maintenance procedures

and EDP library procedures

— First-hand briefing from agency management

— Observation tours

4. Materials gathered at this stage shall form part of the permanent file of the agency and is a good reference for future evaluation.

b. Identification of areas for evaluation

1. After an understanding of the agency's internal control system has been obtained, the ICS shall be divided into transaction categories depending on the scope of the evaluation. The areas for evaluation are determined depending upon the evaluator and the purpose of his evaluation, as follows:

a. All areas of the ICS shall be evaluated as a basis for the withdrawal of resident COA auditors.

b. The areas to be evaluated shall be selected by the internal auditor depending on his programmed activities.

c. For COA auditors, the areas to be evaluated are the financial controls and operating controls.

2. No material differences in financial areas subject to evaluation are notable whether the agency is a national, local or corporate entity. However, difficulty is encountered in identifying non-financial areas since each agency is considered unique and distinct from the others.

3. It is preferable to have no restriction in the scope of the internal control system evaluation. However, due to cost constraints, the evaluation needs to have scope restrictions. To do this, delimitation of the scope shall be done by evaluating specific areas corresponding to selected internal control objectives. Another way of delimiting the scope shall be to cover all possible areas identified but limit the extent of compliance testing to a smaller percentage.

4. Selection of areas shall not be determined by incidence of irregularity. Instead, the selection process shall consider the risk of errors and omissions so that priority may be given to areas/systems which can prevent or reduce fraud, waste and abuse and assure maximum resources for accomplishing agency missions.

5. Once the scope of the evaluation has been determined, the internal control system shall be divided into areas for evaluation. The different approaches in doing this are the following:

— by organizational units;

— by cycle/process;

— by element of internal control;

— by financial statement (trial balance)

6. The recommended approach divides the internal control system into processes/cycles. This approach shall give a clear picture of the transaction/activity from beginning to end.

c. Documentation of existing internal control system

The identified areas for evaluation shall be documented or recorded by the evaluator using any or a combination of or all of the following tools:

1. Narrative description — This consists of narrative statements regarding the existing internal controls of the agency. The information shall be obtained through interviews and observations.

2. Flowchart — This is a schematic drawing or a map of interrelated operations specially arranged to show the movement of documents or the flow of procedures/work from origin to its final disposition/completion.

3. Questionnaire — This is a review technique which consists of a series of questions to evaluate the client's system of internal control. The design is usually general in nature. However, it may be revised to fit the requirements of a particular agency. Answers to the questionnaire shall be obtained through inquiry and observation.

The questionnaire is usually answerable by yes or no. Yes implies an adequate internal control while No suggests some weaknesses requiring some details and/or explanation before conclusions can be drawn.

d. Confirmation of documented internal control systems

1. To ensure that the reviewers' understanding of the internal control system is adequate and correct, validation of this understanding shall be made. To do this, the evaluator shall select a few transactions of each type and trace them through the internal control system from initiation to ultimate recording of the said transaction.

2. There are several ways of validating the documented internal control system, two of which are:

a. Confirmation statements of the systems description from the information provided. This shall be done for procedures which leave no documentary evidence of compliance.

b. Walk-through procedures or the tracing of one or a few of the different types of transactions through the related documents and records maintained. A Walk-through may be done by (1) selecting samples of the accomplished documents and tracing the process through which it went while comparing the actual process with the described/flowcharted system or (2) by observing a document progress through the system while comparing the actual activities with that of the systems description.

3. The confirmation of the documented internal control system may reveal discrepancies either because the flowchart and related narrative are wrong or because the system has broken down. When any information not consistent with the flowchart is discovered, it must be reconciled before proceeding with the Walk-through. This is important because it may be necessary to amend the flowchart.

If the discrepancy found is the result of breakdown in the system, it shall be considered in the internal control evaluation.

Evidence must be shown that a confirmation has been made either by seeking signatures of confirming officials and/or taking the data of the documents used in the Walk-through.

e. Analysis of the documented internal control system

The most critical and difficult part is the analysis portion wherein the auditor has to answer "what is wrong or what is strong about the system." This stage involves the following major steps:

1. Establishment of attributes of control objectives for each area documented. This is where the internal control standards, ideal systems, laws, rules and regulations become relevant.

2. Testing relevance to or compliance with control objectives. Here, sampling may be applied particularly with internal control procedures that leave an audit trail in the form of documentary evidence of compliance. Statistical sampling, however, is generally not applicable to tests of compliance with internal control procedures that depend on appropriate segregation of duties and leave no audit trail of documentary evidence.

3. Determination oœ the deviation between the actual existing system vis-a-vis the ideal one. Deviation may result into either a positive or a negative deviation:

— Positive deviation means the existing system is

better than the attributes identified.

— Negative deviation occurs when the existing system

falls short of meeting the attributes.

f. Formulation of recommendations

A determination to implement new control procedure shall be based. upon consideration of the cost of additional controls in relation to the benefits to be derived from reduction of risk. Careful consideration shall be given during the evaluation process to opportunities to eliminate control or not to institute new controls when a cost-benefit analysis suggests that such controls may not be justified.

Recommendations shall seek to achieve —

1. reduced costs;

2. improved service delivery;

3. improved operations;

4. reduced errors;

5. improved policy, planning and decision-making process;

6. compliance with laws, rules and regulations.

g. Conclusion and decisions

1. Where the evaluation has indicated that controls exist, and that they meet specified overall control objectives, the evaluation may decide to place reliance on these controls. The evaluator is entitled to place reliance on controls when he has obtained evidence that they have been functioning properly throughout the whole period under audit by carrying out suitable compliance tests.

2. Where the evaluation has disclosed weaknesses in, or the absence of, internal control, the evaluator will not be able to restrict his substantive testing. He will have to extend his tests of transactions to obtain reasonable assurance that accounting records accurately reflect the transactions of the agency.

h. Reporting on internal controls

The evaluator shall report and communicate to agency management as soon as practicable, the results of the evaluation, reporting among others:

1. an over-all statement of the adequacy or inadequacy of the internal control system;

2. an identification of material or significant internal control weakness; and

3. recommendations to improve the internal control systems.

Chapter 5. Tools/Techniques For Documentation

SECTION 60. Flowcharting. — This is an analytical technique used to document a system of internal control in a clear, concise and logical manner, showing the movements of documents through various steps from their origin to their final disposition.

A properly prepared flowchart offers the following advantages:

a. Promote efficiency through better understanding of the accounting controls over transactions from their inception to ultimate disposition;

b. Standardize workpaper preparation and documentation;

c. Improve communication of the relevant information among the members of the audit team;

d. Provide an appropriate basis initially for the auditor's Walk-through, and later for answering the pertinent Internal Control Questionnaire (ICQ).

However, the flowcharting tool can be effective only if the person who conducts the review of internal control is familiar with flowcharts and its elements.

SECTION 61. Elements of flowchart. — The main elements of a flowchart are:

a. Flowlines which denote the related activities and the direction of the activity.

b. Symbols which are the graphic representation of the inputs, processes and outputs.

c. Areas of responsibility which are the divisions and/or segregation of the various processes to the different individuals or units in the agency.

The following are the commonly used flowlines and symbols:

Generally, flowcharts should be prepared only for accounting controls with audit significance. The COA auditor may in some cases decide to include in the flowcharts administrative controls which either (1) bear upon the initiation and/or authorization of accounting transactions or (2) compensate for the absence or inadequacy of an accounting control.

SECTION 62. Criteria in flowcharting. — The following are the criteria which the COA auditor should observe when flowcharting to identify the control significance to the audit:

a. Show the procedures in sequence;

b. Explain and show the distribution of all copies of documents with accounting significance;

c. Show the flow of documentation among the organizational units of the agency;

d. Show the maintenance of files and the preparation of reports with the accounting significance; and

e. State the position and, where practicable, the name of the persons performing the procedures.

SECTION 63. Technique in flowcharting. — Briefly stated, the flowcharting technique involves the following:

a. The preparation of one flowchart for each transaction processing system or major parts thereof; and

b. A main flowline depicting the flow of the processing and of the pertinent documents involved from the inception of the transaction to its recording in the general ledger.

SECTION 64. Specific instructions in the preparation of the Flowchart. — Specific instructions in flowchart preparation are as follows:

a. Areas of responsibility should be established on flowcharts as vertical columns. This technique enables the reader to clearly identify changes in responsibility as the documents flow through the system.

b. Areas of responsibility may be departments, sections within a department or individual employee within a department. Judgment must be used in choosing the level of subdivision which one column should represent.

Example:

c. The applicable organizational unit, the title and name of the person-in-charge (if desired) should be written on top of the right side of the flow chart.

Example:

d. The area of responsibility should be shown when the flow of transaction is from one organizational unit to another (e.g. receiving department to accounting department) by using a separate page, or by drawing a horizontal line and indicating the name of the new organizational unit in either case.

Example:

e. An operation should be classified into either a process involving approval, comparison, verification or checking activities or not.

Example:

A process involving approval, comparison, verification or checking activities, thus pre-supposes a control point

The operation or process should be numbered consecutively as the activity occurs within the transaction processing system. This operation number should be indicated inside the process/operation symbol.

f. The flow of information from one document to another due to recording or as a basis of preparation is indicated by a broken line with an arrow.

g. A concise narrative description of the operations, together with the operation numbers, should be shown opposite the operation symbol.

Example:

h. A 'main (vertical) flowline' is used to depict movement of processing within an organizational unit.

Example:

i. Documents appear on the main flowline when they are created or received and need not be reflected as they move from one unit to another. They are then presumed to flow along with the processing from one department to another until their disposition is indicated. If the documents remaining on the main flowline are not evident, their symbols distinguished by brackets may be shown on the main flowline as reminder.

Example:

j. Where the flow line continues on the next page, the continuation page should be indicated on the bottom of the flowchart and the number of the preceding page should be cross-referenced on top of the continuation page.

Example:

k. Alternative procedures are flowcharted with the use of the decision symbol. Until the branch condition is accommodated, processing along the main (vertical) flowline is suspended. If the alternative (branch) processing is significant and/or extensive, it may be better to prepare a separate flowchart therefore.

Example:

l. The name of the document being flowcharted is written inside the symbol and is reflected either as a single copy or multiple copies which can be shown in two ways.

Example:

m. If a document, whether single or multiple copies is numbered serially for accounting control purposes, the letter "N" should be written on the upper right corner of the document symbol. This will signify to the auditor the agency's numerical controls.

Example:

n. Where there are information media leaving the system or entering the systems from outside the company, their disposition or origin, respectively, is signified by an arrowheaded horizontal line with a note over it as to their destination or source. Documents may join the main flowline from either the left or the right. Ordinarily, the disposition of the document is shown on the right side of the flowchart portion.

Example:

o. If the information medium is received from or is sent to another organizational unit, the media symbol should appear on the main flowline at the points where the information medium enters or leaves the processing. Appropriately referenced connector symbols (small circles with reference letter inside) are drawn with arrowheads at the end or start of the documents distribution line.

Example:

p. Page connectors are used in pairs, one at each point being cross-indexed. Each of the pairs should contain the same identifying letter of the document distribution line and the page number should be noted under the corresponding connectors.

Example:

q. Chart connectors are also used in pairs. However, reference should be made by indicating the chart numbers below the connectors. Each of the pairs may contain the same identifying numbers.

Example:

r. If the medium is filed or stored without immediate or further processing, a document distribution line connected with file/storage symbol is drawn to signify such disposition.

Example:

s. The file/storage should be used to indicate that a particular document or information medium that has left the main flowline is in the custody of the organizational unit under which the symbol appears. The filing is depicted by placing this symbol at the end of the horizontal line emanating from the media symbol. The retrieval and restoration of the media to the main flowline are depicted in the same manner. The manner of filing should also be indicated by writing inside the file symbol the applicable letter symbol below:

A — alphabetical

N — numerical

D — by dates

S — others, to be specified

Example:

SECTION 65. Walkthrough. — To confirm the COA auditor's understanding of the agency's accounting system as recorded in his flowcharts or narrative outline, he should trace one of each transaction type through such systems. The process is called a "walkthrough".

a. Generally, the following are the rules in conducting a Walk-through:

1. It should be done every year.

2. It should be performed after the flowcharts or narrative outlines have been prepared or updated.

3. The COA auditor who prepared or updated the flowchart should be the one to do the Walk-through because of the acquired familiarity with the system.

b. In simple accounting systems, particularly for small agencies, the COA auditor may decide, for greater efficiency, to do the Walk-through simultaneously with the preparation of the flowcharts.

c. The Walk-through may be started in any of the three ways.

1. At the inception of the transaction and traced towards termination;

2. At the termination of the transaction and traced back to its inception; or

3. At the middle of the transaction and traced backward and forward.

d. Every operation shown in the flowcharts should be covered by the Walk-through. The Walk-through should include the following:

1. Interview of the agency personnel as to procedures and control techniques followed.

2. Examination of evidence that the control techniques have been performed and observation of control techniques which leave no audit trail.

3. Reperformance, to the extent practicable, of the agency's control techniques in (2) above.

e. When performing the Walk-through, the COA auditor may find that some operations having audit significance were inadvertently omitted in his flowcharts. If so, he should amend his flowcharts by adding such additional operations to the flowcharts.

f. In determining transactions and selecting transactions for Walk-through, the nature and type of control procedures applied to the transaction should be considered.

g. The COA auditor should select a transaction which has recently been completed bearing in mind the following:

1. Look into the control technique relating to the temporary filing, retrieval and restoration of documents into the processing systems.

2. If a major change in the agency's control systems occurred during the year and new type(s) of transactions resulted therefrom, the auditor should consider the need to perform a Walk-through of both the old and new system.

h. However, it would not be necessary to Walk-through the old system, unless:

1. The transactions recorded under the old system are expected to constitute a significant portion of the balance sheet at year end; or

2. A malfunctioning of the old system could result in a material misclassification.

i. Even if these situations exist, the COA auditor should consider the totality of his audit procedures (both control tests and substantive tests) before deciding to do a Walk-through of the old system.

j. The Walk-through should be properly documented on a workpaper having the following characteristics:

1. When more than one transaction is dealt within a flowchart, the first part of the workpaper should briefly describe the identifying characteristics of each type.

2. The workpaper should be designed so that it can be used for more than one year.

3. The workpaper should be in columnar form listing the operation numbers of the flowcharts on the left hand side. There is no need to describe the operations as there is already adequate cross-referencing to the flowchart operation number.

4. The columns of the workpaper should be headed by the transaction types that will be subjected to the Walk-through.

5. The exceptions noted, if any, should be recorded and explained.

k. If the Walk-through has confirmed the COA auditor's understanding of the agency's control system as recorded in his flowcharts or narrative outlines, no further Walk-through work need be done. If the Walk-through revealed that his understanding was not correct, he should ascertain the control procedures actually followed by the agency, revise the flowcharts accordingly, and note the matter(s) on the Walk-through workpapers.

l. If the exception disclosed by the Walk-through is explained by the Agency as an isolated case, the COA auditor should verify additional samples for that specific control procedure giving rise to the exception to check the correctness of the agency's contention before revising his flowcharts or narrative outlines.

SECTION 66. Questionnaire. — The Internal Control Questionnaire (ICQ) is a review technique which consists of a series of questions to evaluate the agency's system of internal control. The use of an ICQ is one of the most important approaches to evaluation of internal controls.

Proper evaluation of internal controls requires understanding of the nature and relationships of the transactions, control objectives, and control techniques comprehended in the ICQ.

SECTION 67. Key concepts underlying the design and structure of the ICQ. — In designing the ICQ, the common characteristics of typical internal control system serve as a foundation for analyzing individual systems. The following key concepts underlie the design of the ICQ:

a. The consideration of the transactions in which an agency engages and the classification of these transactions into convenient groupings called "cycles."

b. The development of system control objectives (SCOs) for each grouping of transactions necessary to achieve the broad internal control objectives of proper authorization and recording of transactions and safeguarding of assets.

c. The identification of the control techniques necessary to meet each control objective.

SECTION 68. Cycles. — In designing the ICQ, the transactions in which an agency engages, are considered. In every organization, there are transactions cycles that occur, consisting of steps necessary to complete the exchange of assets or services between parties to the transaction or the transfer or use of assets within the agency. These transactions are classified into convenient groupings referred to as "transaction cycles." The major transaction cycles in a government agency include: (a) Expenditure Cycle, (b) Production Cycle, and (c) Revenue Cycle. These three cycles relate to the common operations of government agencies and are directly related to transaction flows. These cycles deal with controls over the authorization and execution of the transactions, recording in the accounts and summarization for posting to the general ledger. However those controls that are performed from time to time throughout the year, that relate to more than one of the first three cycles and/or those that do not relate to any of them are, for convenience, included in the "non-cycle." Taken together these cycles form the agency's internal accounting control system.

Identifying transaction cycles based on common transaction flows provide the following advantages:

a. It enables the COA auditor to gain an adequate understanding of the flow of transactions from inception to conclusion to make sure that he identified all significant processes and has noted and evaluated each phase of the transaction flow. Under this integrated approach, a significant part of many transactions that originate and are acted on outside the accounting department is included in the review process. This assists the auditor in identifying and evaluating significant controls provided prior to the processing and recording of transactions. For example:

— The integrity of inventory accounts is significantly affected by activities in authorizing, initiating and executing purchase transactions.

— The integrity of revenue accounts is significantly affected by the strength of the agency's control over revenue/sales transactions.

b. It enables the COA auditor to better evaluate the impact of internal control (or lack of it) on specific financial statement items affected and assists him in determining the nature, timing and extent of substantive tests to be applied to account balances generated within the transaction cycle. For example, in evaluating controls over the Expenditure Cycle, the COA auditor can associate any internal control weaknesses, and determine the nature, timing and extent of substantive tests to be applied to the following accounts generated within the Expenditure Cycle:

— Cash

— Inventories

— Accounts Payable

— Purchases and Cost of Sales

— Expenses

SECTION 69. System Control Objectives (SCO). — System control objectives necessary to achieve the broad internal control objectives of proper authorization and recording of transactions and safeguarding of assets were developed for each grouping of transactions or "cycles." This is done by converting the broad objectives into custom-designed objectives appropriate for each cycle. For example, the broad objective that "transactions should be executed in accordance with management's general or specific authorization" is translated as follows:

SCOI — "There is assurance that purchase of goods and services are appropriately authorized."

All the broad internal control objectives can be traced directly to the system control objectives.

The system control objectives to be achieved by the internal accounting system are broken down by cycle, as follows:

a. SCOs that deal with similar functions or activities have been listed side by side. This is intended to highlight similarities in the structure of various SCOs under the three cycles.

b. The non-cycle SCOs have been listed under the three cycles to emphasize that non-cycle SCOs have been classified as such only for convenience.

The focus on control objectives on a cycle-by-cycle basis allows the auditor to systematically identify the objectives and comprehend the control processes necessary to accomplish the purposes of internal accounting control. It provides the COA auditor with a frame of reference with which he can:

a. Understand the purpose of the questions in the ICQ.

b. Identify the control techniques to be the basis for determining the nature, timing and extent of audit procedures.

SECTION 70. Control techniques. — Control techniques are necessary to assure that the control objective is met. Two groupings of controls are basic controls and disciplinary controls. Basic controls ensure that transactions are recorded completely and accurately and that errors in execution of recording are detected as soon as possible, regardless of whether the error is the processing of an unauthorized transaction, the failure to process an authorized one, or the failure to process such a transaction accurately. Disciplinary controls ensure that proper and continued functioning of the basic controls and include supervision, segregation of duties, and custodial arrangements.

An important feature of the approach is the emphasis on control techniques, rather than on specific control procedures used, which may vary greatly among specific transaction types within a system. The questions in the ICQ ask for the presence of a particular type of control rather than about the details of the techniques. For example:

"Does the agency require all significant purchases of goods and services to be initiated and based on appropriate written authorization?"

This is the control technique. The control procedures that may be carried out to implement this technique may be one or a combination of the following:

— Board or pertinent committee resolutions

— Approved long-term or blanket purchase agreements

— Automatic re-order based on established minimum inventory

— Approved purchase orders or requisitions

— Approved check requests

The control technique stated asks broadly whether purchases are initiated based on appropriate written authorizations. It does not ask for the presence of a specific procedure because procedures may differ for different types of transactions within a system. The focus on control techniques allows the COA auditor to adopt his approach to fit the specific system.

SECTION 71. Detailed structure of the ICQ. — The structure the ICQ is better understood under the following considerations:

a. Common control objectives

The control objectives are designed for specific cycles as described above. The ICQ does not single out control objectives "common" to all cycles. However, the presence of "common" or identical control objectives could be inferred from study of how the control objectives were structured. For example, the expenditure, production, and revenue cycles each include a control objective related to the classification and summarization of transactions. Similarly, the control objective regarding the adequacy of perpetual inventory records could be considered common to the three major cycles. This is also true for the control objective on the recording of receivables and payables, the initial recording of transactions, and identification of unmatched items. In short, a large number of the SCOs are broadly similar.

b. Common control techniques — Conventional internal control techniques are as follows:

Internal Control Techniques	Accounting Control Purpose
1. Physical Safeguard Controls:	
Burglar Alarms	Deterrence or detection of theft of assets
Plant security guards	To deter or detect theft of assets by outsiders and by employees seeking unauthorized access to assets or records

Fireproof vaults and files for To deter theft, protect against

the storage of valuable documents, assets loss from the

negotiable instruments, currency destruction of vital records, and

and manual and computer-readable to prevent fraud by employees

accounting records seeking unauthorized access to

accounting records and other

documents

Restricted access to assets Deterrence of theft and assurance

subject to theft and unauthorized against unrecorded or unauthorized

use use of assets

Restricted access to accounting To deter fraud and theft of assets

records and computer facilities

2. Organizational Controls:

Definite written assignments Deterrence of fraud, theft, and error;

of responsibilities for the assurance that duties will be carried out by

performance of each duty required qualified personnel; and assurance of

to transact business smooth continuity of operations in the

event of personnel changes

Avoid assignments of incompatible Deterrence of fraud, theft, and error;

duties/responsibilities for assurance that fraud, thefts and errors will

(1) initiation and/or be detected rapidly and that proper
approval of transactions, (2) remedial action will be taken
custody of assets; and (3)
accounting for transactions
should be separated and
assigned to different personnel
or departments

Bonding of employees To deter fraud and theft
occupying position of trust

Enforced vacations for employees Deterrence and detection of
occupying positions of trust fraud and theft

Enforced rotation of accounting To detect and deter fraud; to assure
duties continuity of operations in the event of
unforeseen personnel changes

Establishment of sound employee Protection against fraud,
hiring practices theft, and excessive error

Establishment of fair wages To deter fraud and theft that might
and adequate fringe benefit plans otherwise be motivated by low
for employees and their families wages or family emergencies

Establishment of an internal audit function reporting to high-level management	To detect and deter fraud, theft, and error

3. Accounting Policies:

Use of perpetual financial inventory methods as opposed to the periodic method	Deterrence and detection of fraud, theft, and errors; assurance against loss of profits due to excessive inventory and obsolescence
Taking of periodic physical inventories and inventories of other tangible assets	Deterrence and/or detection of fraud, theft, and error
Use of predetermined standard costs	Assurance against pricing and costing errors
Use of control accounts	Deterrence and detection of fraud, theft and error
Strict adherence to generally accepted accounting principles	Avoidance of disclosure errors and improper financial reporting

4. Clerical Practices:

Use of prenumbered forms Deterrence and detection of
and documents fraud and error

Control over the numerical To deter and detect fraud and
sequence of forms error

Use of multiple-copy forms Deterrence of clerical error
and avoidance of manual
copying of accounting
information

Independent verification of To deter and detect fraud
clerical operations performed and error

Vertical and horizontal addition Assurance against clerical
of accounting work sheets error

Independent, routine, periodic Deterrence and detection of
reconciliations of bank fraud, theft, and error
accounts and control accounts
to subsidiary ledgers

Routine comparisons of Deterrence and detection of fraud,

tangible asset accounts balances to physical inventories of assets and appropriate adjustment of account balances	theft, and error
Use of mechanical or electronic accounting equipment	Protection against human error
Preparation of document as evidence of the performance of accounting and operating procedures	Deterrence of fraud and error
Use of authorized personnel signatures on documents to indicate authorization of transactions or to designate the performance of certain clerical functions	Deterrence of fraud and error
Matching of documents which have been prepared and relate to the processing of a transaction or accounting entry in order to determine that	To deter, detect and correct error and to detect and deter fraud

required accounting and operating

procedures have been properly

executed

There are five frequently recurring "common control techniques," namely.

1. Control over completeness of processing

2. Maintenance of subsidiary records supporting a control account

3. Postings to inventory records

4. Supervisory review and approval

5. Checking of extensions and additions

The identification of common control procedures is convenient and serves to emphasize that control procedures are applicable to many different control objectives.

SECTION 72. Control objectives/techniques applicable to major transaction types in the ICQ. —

a. Expenditure cycle

The expenditure cycle can best be explained by describing the typical transaction system and internal control applicable to purchase of goods and services. The functions and stages of the processing system involved are as follows:

1. Purchase Order Processing (Authorization) — The request for goods or services is the starting point for the cycle. Proper authorization is essential for requisitions to acquire goods or services to ensure that the goods and services purchased are for authorized agency purposes and to avoid the purchase of excessive or unnecessary items. After the requisitions are approved, the purchasing department receives and establishes control over them. An order is then initiated to purchase goods and services. The purchase order is the execution instruction that authorizes a vendor to deliver and bill on certain terms. It should be complete and specific as to delivery date, routing, and materials specifications as well as quantity and price. The copies of a purchase order is furnished to the receiving and accounting departments to authorize acceptance of the goods and permit subsequent processing of the purchase.

2. Receiving (Initial Recording of Transactions) — The receipt of goods or services from the vendor is critical point in the cycle because it is the point at which the associated liability is first recognized. When goods are received, adequate control requires examination for conformity with specifications on purchase of goods, verification of quality by accounting, weighing, or measuring and inspection of condition. Acceptance of a shipment is also reported to the accounting department through copies of the receiving report identifying the vendor, date received and quantity of goods received and their condition.

3. Accounts Payable Processing (Detailed Checking and Approval of Documentation) — The accounting department typically has the responsibility for verifying the validity of purchase transactions. When vendor's invoices are received, documentation and numerical control should be established by some means, particularly if many invoices must be routed for approval to operating officials. The detailed checking of the invoices involves a comparison of the descriptions, prices, quantities and terms with the information on the purchase order and, where applicable, the receiving report. Typically, extensions and footings are verified and account distribution is entered on the invoice or covering voucher. Supervision over the clerical processes of checking is exercised by review and approval of transactions by a responsible individual.

4. Recording (Recording in Accounts and Subsidiary Ledgers) — Once invoices have been authorized, the recording process consists of: First, recording the transaction as a liability and an expense or asset at the correct amount in the proper account and period. Second, posting the amount in the accounts payable and inventory subsidiary ledgers. Controls over. Recording process includes assigning voucher numbers to the invoices, accounting for the sequence of the numbers, and periodic review of open files of items awaiting processing. Discipline over the recording process is provided by supervisory review of reconciliations of control accounts with detailed records and open file follow-ups. Segregating the duties of those who prepare invoices, approve them, post the detailed records, maintain control accounts, and make the reconciliations and follow up also enhances discipline.

5. Processing and Recording Payments (Cash Disbursements) — Accounting controls over the cash disbursements process assures that no unauthorized payments are made and accurate records are made of each payment. Basic controls to prevent unauthorized payments consist of requiring valid support for all requests for payment and cancellation to prevent reprocessing of documents a second time. Persons who prepare checks should not have conflicting duties such as originating requests for payment. Signed checks should be processed and kept out of the hands of unauthorized persons and unissued checks should be safeguarded. Complete and accurate recording of payments is controlled by maintaining numerical sequence of unused checks, maintaining a detailed check register, accounting for the numerical sequence of checks entered in the register, and comparing paid checks returned by the bank with the check register as part of the periodic bank reconciliation. Discipline over the cash disbursements process is provided by the check signer's review of supporting documentation.

6. Summarization and Recording in the General Ledger (Classification and Summarization in the General Ledger and Trial Balance) — Summarization and posting of transactions represent the last stage in the cycle. Basic control is provided through the reconciliation of totals and accounting for the completeness of standard and non-recurring journal entries. Discipline over the summarizing and posting process is provided by supervisory review of summarization entries and trial balances.

b. Production cycle

The control objectives in the production cycle are explained in terms of the processing and controls over the inventories. The inventory system is comprised of two separate but closely related systems, one involving the physical movement of good (control over physical movement of raw materials, work-in-process and finished goods) and the assignment of cost to inventories. Controls over the physical movement of goods cover the point where raw materials are received from vendors, issued to production and converted into finished goods, up to the point where finished goods are shipped to customers. The controls over the receipt of raw materials, including payroll cost, form part of the expenditure cycle. The shipment of finished goods to customers is part of the revenue cycle. The internal transfer of goods from the point where raw materials are requisitioned for issuance to production to the point where the manufactured product is completed and transferred to storage is addressed in the production cycle. Control is provided in this area through the following:

1. Authorization, use of numerically controlled inventory movement documents, and verification of physical movement by counting, weighing or measuring of issues and returns of materials and supplies; also the basis for charging labor and overhead to production, and transfers from work in process to finished goods.

2. The use of perpetual inventory records which include controls over the:

— Validity of entries in the stock records

— Accounting for all inventory movement documents

— Inventory record-keeping

— Reconciliation of control accounts

— Other inventory accounting entries

— Physical control including the periodic inventory-

taking procedures

c. Revenue cycle

The Revenue Cycle describes the typical transaction system and internal control applicable to these transactions:

— Assessment/Billing

— Collections

— Remittance/Deposit, and

— Accounting

1. Assessment is the official action of a person authorized by law to ascertain the amount of tax or fee, due under the law, from a taxpayer. Assessments are not recorded in the books of accounts until collected.

Billing is the giving of a formal notice to a payor/client that payment is due on a certain date for goods provided or services rendered.

2. Collection — is the act of receiving payments by authorized collecting agents of the government of taxes, fees imposed, and all other receipts which come into the possession of government agencies. It involves the issuance of official receipts or its equivalent in the form of postage, documentary stamps, cash tickets, and the like.

3. Remittance/Deposit — means to send collections to the proper treasury for safekeeping, whereas deposit generally refers to the placing of all collections in a government depository bank for safekeeping. Generally, collections of national government agencies and some corporations are remitted to the Bureau of Treasury which is the central custodian and depository of government funds although some receipts, like trust receipts, may be deposited directly to authorized depository banks.

4. Accounting — Accounting for revenue starts from the recording of bills rendered or of official receipts issued. It involves the process of classification and summarization of the nature of revenues and receipts through the books of accounts, and the reporting thereof through the financial statements.

a. So that only valid revenue transactions are processed, authorization control should ensure that receipts are accepted only from those authorized parties; that the amounts of receipts are authorized; that adjustments of accounts are authorized and that receipt processing are established and maintained in accordance with laws, regulations and management's policy.

b. To ensure that transactions pertaining to the revenue cycle are economical, efficient and effective, the results should be in accordance with laws, rules and management's policy and plans; collection methods and receipt processing should be done in an economical and efficient manner.

c. For physical safeguards, access to cash and cash items, receipts and receivable records, critical forms should be permitted only in accordance with management's criteria until control is turned over for asset management.

d. Over revenue transaction processing, the following control objectives should be achieved by adequate internal control techniques: each receipt should be accurately and promptly prepared; and accountability for cash items should be established.

e. Adequate controls over the recording of the revenue cycle transaction may be achieved if the following control objectives are met: cash items received are accurately and promptly classified, summarized and reported; adjustments to receipts, receivable and other accounts are accurately and promptly classified, summarized and reported; receipts, collections on account and related adjustments are accurately applied to the proper receivable accounts; journal entries are prepared each accounting period for receipts and related adjustments; and revenue journal entries summarize and classify receipts in accordance with management's plan.

d. Non-cycle

The control objectives in the non-cycle deal with events caused by the passage of time rather than individual transactions. The controls are generally applied periodically to groups of transactions. The activities in the non-cycle may be performed on a monthly basis (reconciliation of bank balances), a quarterly basis (as the identification of obsolete inventory items), or a yearly basis (physical inventory counts).

The non-cycle deals with custodial activities like the comparison of accounting data in the books with evidence generated outside the books (e.g., confirmation of bank balances and physical existence of other assets). These custodial activities aim to detect accumulated errors. For example, errors that have accumulated since the last reconciliation or count are identified through the bank reconciliation or physical inventory count.

The non-cycle also includes activities relating to the valuation of assets like receivables, inventories and investments.

Finally, the non-cycle includes the reporting process, controls over the adjusting and closing process, and the preparation of trial balances.