

**AUDITOR-GENERAL'S AUDITING STANDARD 3
THE AUDITOR'S APPROACH TO ISSUES OF
EFFECTIVENESS AND EFFICIENCY, WASTE, AND A
LACK OF PROBITY OR FINANCIAL PRUDENCE**

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Introduction

Scope of this Standard

1. This Auditor-General's Auditing Standard establishes the Auditor-General's requirements on annual audits in relation to issues of effectiveness and efficiency, waste, and a lack of probity or financial prudence.

Application

2. Compliance with this Standard is mandatory for Appointed Auditors who carry out annual audits on behalf of the Auditor-General.
3. This Statement applies to audits of financial statements and/or performance information which has been prepared for reporting periods beginning on or after 1 April 2017.

Background

4. While carrying out the annual audit, the Appointed Auditor is expected to keep in mind the overall role and concerns of the Auditor-General as specified in the Public Audit Act 2001 (the Act), and also public and parliamentary expectations of the Auditor-General as they emerge over time.
5. There is overlap between the content of this Standard and other Standards and Statements. This overlap arises because this Standard requires the Appointed Auditor to maintain alertness for, and awareness of, matters that may be of interest to the Auditor-General, even though they may not affect the Appointed Auditor's responsibility to form an opinion on the financial and performance information.

Objectives

6. The objectives of the Appointed Auditor, in carrying out the annual audit, are to:
 - (a) maintain alertness for, and awareness of, issues and risks related to the Auditor-General's concerns over effectiveness and efficiency, waste, and a lack of probity or financial prudence;
 - (b) plan and audit areas of sensitive expenditure; and
 - (c) report in an appropriate manner on any matters identified in (a) and (b) above.

Definitions

7. For the purpose of this Auditor-General's Auditing Standard the defined terms have the meanings attributed:
- (a) in the Glossary of Terms issued by the New Zealand Auditing and Assurance Standards Board (the NZAuASB glossary) of the External Reporting Board (although where a term with a specific meaning in the New Zealand public sector differs from the NZAuASB glossary, the New Zealand public sector definition shall prevail);
 - (b) in the Auditor-General's Glossary of Terms; and
 - (c) in the following term.

Sensitive expenditure	means expenditure by a public entity that provides, has the potential to provide, or has the perceived potential to provide, a private benefit to an individual staff member of a public entity that is additional to the business benefit to the entity of the expenditure. It also includes expenditure by a public entity that could be considered unusual for the entity's purpose and/or functions.
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Requirements

Considerations to take into account when being alert and aware

8. The Appointed Auditor shall, when carrying out the annual audit of the financial and performance information of a public entity, take into account the need to maintain alertness and awareness for any indication that:
- (a) the public entity has not applied its resources effectively or efficiently;
 - (b) waste has occurred, either by the public entity itself or as a result of action or inaction on the part of the public entity; or
 - (c) there has been an act or omission that shows or appears to show a lack of probity or financial prudence on the part of the public entity or one or more of its members, office holders, or employees.

Maintaining alertness for and awareness of issues and risks

9. As part of developing the overall audit strategy and audit plan, the Appointed Auditor shall ensure that they maintain alertness and awareness for issues and risks related to effectiveness and efficiency, waste, and a lack of probity or financial prudence.
(See paragraphs A1 - A3)

10. The Appointed Auditor shall ensure that their overall audit strategy and audit plan reflects any guidance on issues or risks identified by the OAG in the applicable audit brief.
11. The Appointed Auditor shall document the processes used to ensure that they have maintained alertness for, and awareness of, issues and risks of effectiveness and efficiency, waste, and a lack of probity or financial prudence.
12. In carrying out the annual audit, the Appointed Auditor shall note that the Act permits an examination of effectiveness and efficiency as long as that examination takes into account any applicable government or local authority policy.

Reporting instances of effectiveness and efficiency, waste, or a lack of probity or financial prudence

13. The Appointed Auditor shall immediately advise the OAG if they identify an instance of effectiveness and efficiency, waste, or a lack of probity or financial prudence. The Appointed Auditor, in consultation with the OAG, shall then decide what further steps shall be taken, if any, to address the issue.
14. The Appointed Auditor shall formally report to the OAG on issues and risks related to effectiveness and efficiency, waste, and a lack of probity or financial prudence identified during the annual audit as part of reporting the results of the annual audit.
15. As part of advising the OAG in paragraph 13, the Appointed Auditor in consultation with the OAG shall determine the appropriate external reporting action to be taken. External reporting actions may include:
 - (a) reporting in the audit report;
 - (b) reporting to management or those charged with governance in the management letter; and/or
 - (c) reporting to another party. (See paragraphs A4 - A5)

Auditing sensitive expenditure

16. The Appointed Auditor shall follow any directions that are issued by the OAG to audit specific areas or types of sensitive expenditure.
17. The Appointed Auditor shall audit sensitive expenditure irrespective of whether the OAG issues any directions, although the Appointed Auditor shall apply their judgement in determining what sensitive expenditure is to be examined. The

Appointed Auditor shall do this by having regard to the Auditor-General's concerns over effectiveness and efficiency, waste, and a lack of probity or financial prudence as well as their understanding of the entity and its environment, including its internal control.

18. The Appointed Auditor shall take into account the results of any external reviews or a consideration of any risk factors that may have been identified by the OAG.
19. The Appointed Auditor shall ensure that their overall audit strategy and audit plan clearly document the types of sensitive expenditure to be examined and the nature, timing, and extent of the audit testing to be carried out. (See paragraph A6)
20. In meeting the requirements of paragraph 19, the Appointed Auditor shall audit areas of sensitive expenditure by obtaining an understanding of the attitude of management and those charged with governance towards sensitive expenditure, assessing the public entity's policies against current good practice, and performing tests on a sample of expenditure to evaluate whether the public entity has complied with its policies and that the expenditure:
 - (a) has a justifiable business purpose;
 - (b) preserves impartiality;
 - (c) has been made with integrity;
 - (d) is moderate and conservative, having regard to the circumstances;
 - (e) has been made transparently; and
 - (f) is appropriate in all respects. (See paragraph A7)

Reporting issues of sensitive expenditure

21. If the Appointed Auditor identifies an issue of sensitive expenditure, they shall immediately advise the OAG. As part of advising the OAG, the Appointed Auditor shall specifically consider whether the sensitive expenditure should be publicly reported in the audit report.
22. If the issue raises the potential that a fraud has been committed, the Appointed Auditor shall follow the specific requirements and guidance in AG ISA (NZ) 240: *The auditor's responsibilities relating to fraud in an annual audit*.
23. The Appointed Auditor shall report separately on sensitive expenditure issues, including any assessments made as to the appropriateness of the public entity's policies where deficiencies were noted in those policies that were identified during the annual audit:
 - (a) to the OAG, normally as part of reporting the results of the annual audit; and

- (b) to management or those charged with governance in the management letter.

Separate engagements on sensitive expenditure

24. A public entity, or another party, may request an Audit Service Provider (ASP) to carry out a separate engagement on sensitive expenditure. Where there is possible media or political interest in the engagement subject matter, or the matter is generally of a sensitive nature, the ASP shall consult with the relevant OAG sector manager before accepting the engagement or finalising the terms of reference. ASPs should refer to AG PES 1 (Revised): *Code of ethics for assurance practitioners* for further guidance surrounding the acceptance and reporting of engagements of this nature. (See paragraph A8)

Application and other explanatory material

Maintaining alertness for and awareness of issues and risks (See paragraphs 9 - 12)

- A1. It is not the role of the Auditor-General to set standards, or to make judgements in the absence of generally accepted understanding of what is allowable practice or behaviour. However, where the Auditor-General identifies an absence of standards and a need for guidance as a result of issues that have arisen during audits of public entities, the Auditor-General may issue a “good practice guide” that outlines the principles applicable for appropriate practice or behaviour. The Appointed Auditor should maintain alertness for and awareness of:
- any accepted standards promulgated by third parties; and
 - any applicable “good practice guides” that may be issued by the Auditor-General.
- A2. Existing standards of conduct which have substantive authority in New Zealand for various aspects of public entity behaviour include:
- the State Sector Act 1988, which, among other things, places a responsibility on chief executives of public entities subject to the Act to operate "good employer" principles and to ensure that all employees maintain proper standards of integrity, conduct, and concern for the public interest;
 - the Local Authorities (Members' Interests) Act 1968, which regulates the behaviour of members of some public entities in relation to contracts in which the members are “concerned and interested” and when voting on matters in which they have a “pecuniary interest”;

- State Services Commission publications, including “codes of conduct” or “board appointment and induction guidelines”;
- the ethical standards and guidelines of professional bodies, as relevant;
- any government policy statements on behaviour, such as Cabinet Minutes or Cabinet Office Circulars;
- financial reporting standards, which require the disclosure of related party relationships, transactions, and balances;
- the Companies Act 1993, which requires directors’ interests to be disclosed in an interests register that is available for inspection by shareholders; and
- the Local Government Act 2002, which requires the remuneration of chief executives to be disclosed in the financial statements.

A3. The Appointed Auditor should, when maintaining alertness and awareness of the standards expected of public entities, consider the following:

- whether the public entity has acquired resources in an economical manner, with due regard to probity;
- whether the public entity has applied its resources in an effective and efficient manner, and there is no evidence waste has occurred; and
- whether employees and members of the public entity have acted with proper regard to probity and financial prudence.

Reporting instances of effectiveness and efficiency, waste, or a lack of probity or financial prudence (See paragraphs 13 - 15)

A4. One aspect of advising and/or consulting with the OAG will be about whether it is appropriate to report the matter in the audit report and, if so, whether to include an emphasis of matter or other matter paragraph in the audit report.

A5. If a significant issue is identified, the following steps should be taken:

- brief the Assistant Auditor-General – Parliamentary Group or the Assistant Auditor-General – Local Government immediately on any significant issues of effectiveness and efficiency, waste, and lack of probity or financial prudence; and
- agree with the Assistant Auditor-General – Parliamentary Group or the Assistant Auditor-General – Local Government the next steps (if any) to be taken.

Auditing sensitive expenditure (See paragraphs 19 - 20)

A6. As part of developing the audit strategy and audit plan, the Appointed Auditor needs to understand the purpose of the public entity and the likely extent to which sensitive

expenditure may be incurred to achieve its purpose. Such an understanding will assist the Appointed Auditor in determining the nature, timing, and extent of audit procedures to be carried out. The Appointed Auditor should also consider the appropriateness of the public entity's sensitive expenditure policies as part of sensitive expenditure testing.

A7. There are a number of areas of spending that are likely to generate significant interest with stakeholders and other interested parties because of their sensitive nature. The Appointed Auditor is expected to have a high-level understanding of the overall expenditure of each of these areas, and of the likelihood of impropriety.

Sensitive expenditure may include:

- board and senior management pay, travel, and expenses;
- management of large contracts;
- tendering processes used for large dollar value purchases;
- payments to or from related parties; and
- payments to or from other countries, particularly those with a history of different ethical standards or where bribery is more prevalent.

Reporting issues of sensitive expenditure (See paragraph 24)

A8. If the sensitive expenditure issue reasonably falls within the scope of the annual audit, further action might involve:

- pursuing the issue within the existing audit engagement agreement;
- obtaining agreement with the public entity for both the performance and funding of a specific extension of the audit scope; or
- obtaining approval from the OAG for undertaking and funding the extension of the audit scope.