GUID 4900

Exposure Draft: Guidance on Authorities and Criteria to be considered while examining the regularity and propriety aspects in Compliance Audit

INTOSAI

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INTRODUCTION

1) The ISSAIs define that compliance auditing may be concerned with regularity (adherence to formal criteria such as relevant laws, regulations and agreements) or with propriety (observance of the general principles governing sound financial management and the conduct of public officials). While regularity is the main focus of compliance auditing, propriety may also be pertinent given the public-sector context, in which there are certain expectations concerning financial management and the conduct of officials. Depending on the mandate of the SAI, the audit scope may therefore include aspects of propriety.

2

OBJECTIVE

2) The objective of this guidance is to provide support to auditors in identifying suitable regularity and propriety criteria in a compliance audit. The guidance explains the difference and relations between regularity and propriety concepts.

3

DEFINITIONS

3) This *Compliance audit* - one of the three types of public sector audit, independent assessment of whether a given subject matter complies with applicable authorities identified as criteria. Compliance audits are carried out by assessing whether activities, financial transactions and information comply, in all material respects, with the authorities that govern the audited entity.[1] Compliance audits may include **regularity** and/or **propriety**[2] criteria, depending on the mandate of the SAI and the jurisdiction.

4) *Authorities* – laws, rules, regulations, policies, established codes, agreed terms or general principles governing sound public sector financial management and the conduct of public officials, code of ethic etc. from which 'criteria' for verification of compliance is derived while carrying out a compliance audit.[3]

5) *Criteria* – benchmarks used to evaluate a subject matter. Each audit shall have criteria suitable to the circumstances of that audit. Criteria can be specific or more general, and may be derived from various authorities.

6) *Regularity* refers to adherence to formal authorities such as relevant acts or resolutions of the legislature or other statutory instruments, directions issued by public sector bodies with powers

[1] ISSAI 4000/2.
[2] ISSAI 400/13, ISSAI 4000/24.
[3] ISSAI 4000/19.

provided for in the law, with which the audited entity is obliged/bound to comply.[4] Binding terms for the auditee, for example agreements and contracts (contracts in the petroleum operations) may also be considered as formal authorities.

7) *Propriety* refers to compliance with general principles governing sound financial management and conduct of public officials.[5] In the context of public sector audit, this would include conventionally accepted standards of behaviour in public sector management and delivering of public services.[6]

8) *Subject matter* refers to the information, condition or activity that is measured or evaluated against certain criteria.[7]

9) *Sound financial management* means generally accepted principles governing conduct of public officials in executing financial transactions.

10) *Conduct of public officials* refers to an ethical behaviour and wisdom where norms and moral in a society is followed.

[4] ISSAI 400/13, 32, 24
[5] ISSAI 400/13.
[6] Oxford English dictionary (OED).
[7] ISSAI 100/26.

4 SCOPE OF THE GUID

11) This GUID provides supplementary audit guidance in relation to the compliance auditing standard, ISSAI 4000, and does not contain any further requirements for the conducting of the audit.

12) This GUID is aimed at auditors who need guidance on how to perform compliance audit with regularity criteria as well as propriety criteria. It will depend on the mandate of the SAI and the terms and circumstances of the individual engagement, whether it is relevant to consider propriety criteria when performing a compliance audit. Auditors who make use of this GUID in the context of a compliance audit that does not include propriety criteria should disregard any guidance provided in relation to propriety.

5

SOURCES FOR CRITERIA IN COMPLIANCE AUDIT

13) Suitable criteria are required in order to ensure a reasonably consistent measurement of a subject matter by using professional judgement. Without the frame of reference provided by suitable criteria, any audit findings or audit conclusions are open to individual interpretation and misunderstanding.

14) Authorities are the sources for criteria and serves as a fundamental element in compliance auditing, since their structure and content provide the audit criteria and form the basis of how the audit is to proceed under a specific constitutional arrangement.[8]

15) Criteria are considered to be formal, where they are derived from formal authorities – laws, rules, regulations and agreements, while propriety criteria are considered to be principle-based, where they derive from general principles governing sound financial management and the conduct of public officials.

Authorities as the source for regularity criteria

16) Regularity is usually concerned with compliance with authorities stemming from laws, regulations and agreements.

[8] ISSAI 400/28, ISSAI 4000/24.

17) Authorities as the sources for regularity criteria may include:
- Parliamentary plenary resolutions, including policies;
- Laws and regulations, rules, other legislative acts;
- Internal rules, procedures and processes issued by audited entity (applicable depending on jurisdictions);
- Constitutional budgetary laws and resolutions, the annual budgetary laws;
- Regulations with financial effect in the public management; and
- Public procurement rules.

18) The sources of regularity criteria can be broadly described as follows:
- Primary Legislation - These authorities may include the country's constitution, formal acts and laws, rules and regulations governing a subject matter, which together could be categorized as primary legislature framework
- Secondary Legislation – The authorities may also be codal provisions, orders issued by regulatory authorities in government or by regulatory bodies. These may be categorized together as Secondary Legislation governing an activity or information, which is subject matter of audit
- Contractual Provisions - The authorities could also be treaties, agreements, contracts etc. relating to the subject matter under audit, which are contractual in nature and are legally enforceable in a country

19) There is a hierarchical relationship between different types of authorizing legislation. The constitution of the country is normally the highest formal authority, followed by laws, rules, regulations and other legislative acts. An authority that is lower in this hierarchy or is a part of secondary legislation cannot be *ultra vires*[9] of the authority that is higher in hierarchy. For instance, if the laws governing a social welfare scheme in a jurisdiction lay down eligibility requirements for social benefits, subsequent rules or orders issued under these laws cannot change these eligibility requirements. In a compliance audit the auditor must ensure that the criteria derived from secondary legislation comply with the above requirement. Dependent on the national legal system this hierarchy may also include certain general legal rules or principles of law, which have not been codified into a written constitutional or legal act. For instance, a government agency which decides on social benefits may be subject to the general rule that all

[9] The Oxford English Dictionary (OED) definition: beyond the powers or legal authority.

eligible persons should be treated in an equal way even if this rule is not explicitly stated in any legal act governing the scheme (legal principle of equality). In a compliance audit the auditor may therefore sometime need to consider unwritten as well as written law when deriving regularity criteria.

20) Most authorities originate from the basic premises and decisions of the national legislature, but they may be issued at a lower level in the organizational structure of the public sector for instance as statutory instruments etc.[10] At the same time, rules and regulations derived at a lower level must be traceable to rules and regulations issued by national legislature.

21) Established codes and agreed upon terms may also be considered as authorities – sources of regularity criteria. This includes international treaties, such as:

- Treaties establishing international or supranational organizations;
- Treaties with biding fiscal or budgetary content;
- Legal rulings issued by the competent effect in the legal order of each member state, for example international agreements/treaties on subjects of climate change and sustainable development when adopted by a country; and
- other agreements and contracts relating to the subject matter of audit, being contractual in nature and legally enforceable in a country.

22) Authorities may be the sources for regularity criteria in cases, where the audited entity is obliged/ bound to comply with them.

23) Most countries have worked out policies for certain sectors of national economy. Such policies may be approved/sanctioned by the parliament/government. Policies are *metarules* (rules that governs other rules) in this context. Policies should relate to all legal instruments that regulate the particular sector, and the legal framework should be in accordance with the policies. Hence, policies can be directly relevant as criteria when SAIs evaluate or ascertain compliance in implementing the policies contents and intentions.

24) When deriving regulatory criteria from the authorities and describing them, auditor uses the articles, paragraphs, sections, chapters, etc. of the authorities, which are relevant to the specific subject matter under the audit.

[10] ISSAI 4000/113.

Authorities as the source for propriety criteria

25) Whereas regularity is concerned with compliance with authorities stemming from rules and regulations etc, propriety is concerned more with expectations from the three parties[11] and standards of conduct, behaviour and corporate governance. Depending on the jurisdiction, it may include values and principles generally accepted such as fairness and integrity, the avoidance of personal profit from public business, even-handedness in the appointment of staff, avoid nepotism by not giving opportunities to family and friends, open competition in the letting of contracts and the avoidance of waste and extravagance.

26) Authorities for propriety criteria are normally general in nature and therefore the criteria can be harder to identify compared to the criteria stemming from authorities governing regularity criteria. Forming audit conclusions based on propriety criteria can be more subjective compared to regularity criteria that are more objective. Hence, the need to rely on the professional judgment of the auditor is also likely to be higher in the case of propriety criteria than in the case of regularity criteria.

27) Furthermore, propriety criteria may refer to conventionally accepted normative behaviour in public sector financial management and in the conduct of public officials. The written norms for this acceptable behaviour can vary between jurisdictions depending on social norms, business practices etc. There is no universally accepted propriety criteria and hence the auditor has to give due consideration to the written norms prevailing in the jurisdiction in which audit is conducted. These norms may be expressed in documents dealing with general expectations of behaviour from public officials in public sector financial management and delivery of public services.

28) Due to different legal frameworks, SAIs may interpret the concepts of regularity and propriety differently. This lead to a significant difference between SAIs in the way the two concepts are being used. Propriety is generally understood as the principles governing sound financial management[12] and the conduct of public officials[13], but in some jurisdictions SAIs may also assimilate into it concepts such as financial prudence, public interest, prevention of wasteful

[11] ISSAI 100/25.
[12] Spending funds in accordance with the principles of economy, efficiency and effectiveness (see also ISSAI 300 Performance Audit Principles /11).
[13] ISSAI 400/32.

expenditure, constitutional legitimacy and integrity, expand on the system of law, equity (even or just) and discipline.

29) Some of the common authorities from which propriety criteria can be derived, include:

- General guidance for public officials in incurring expenditure on public goods and services;
- Codes of conduct laying down broad principles to guide the conduct of public officials, etc.

30) Predictability is vital for acceptance of criteria, both from the auditee and stakeholders. The above canons of financial propriety are evidently broad in nature and the auditor will have to exercise professional judgment to assess whether a particular transaction complies with such a broad and general propriety criteria. The auditor may do so after gathering information pertaining to similar transactions that may have occurred in the past under identical circumstances in same, identical or similarly placed organizations. The auditor can benchmark the transaction against this information to form an opinion on whether the expenditure incurred was within the limits that the particular occasion demanded. An example of this is when constructing an airport in a jurisdiction where norms for determining the size of the airport like volume of passenger traffic and corresponding size and number of terminals does not exist. The auditor while carrying out the compliance audit of the expenditure relating to construction of the airport, will have to use the professional judgment to form an audit conclusion on whether the size of the airport constructed is justified by the present or predicted future level of air traffic in the area. The auditor can also use standards available in other countries to form a conclusion since these standards normally have general applicability. If the auditor finds material deviation, the auditor may conclude that the size of the airport was more than what the occasion demanded.

31) Another example of propriety criteria derived from a code of conduct for public officials is that public officials recuse themselves from transactions involving conflicts of interest. The term conflict of interest, may be codified in some jurisdictions in terms of the nature of relationship or degree of kinship between the public official and the contracting party. In some jurisdictions, criteria to judge the nature of relationship that constitutes conflict of interest may not exist. Where such specific criteria do not exist, the auditor will have to rely on professional judgment to form a conclusion on whether a particular relationship constitutes a conflict of interest and therefore a breach of the propriety criteria. For instance, in most jurisdictions, the criteria of conflict of interest is likely to be applied to public transaction with the spouse of the public official, unless the same

is specifically permitted by rule or is an 'arm's length'[14] transaction. The auditor can adopt this general principle to conclude whether there was any conflict of interest.

32) Propriety is linked to the fiduciary duty of those who have been entrusted with public management. The person who holds a legal or ethical relationship of trust with one or several other parties. This includes the duty to act in good faith, and with the highest standard of care, honesty and loyalty. It represents a legal obligation of one party to act in the best interest of another. The fiduciary duties of public officials are usually described in legislation, Parliamentary instructions or code of conducts. Therefore the propriety is usually concerned with expectations[15] stemming from codes of conduct, behaviour and corporate governance.

33) Authorities as the sources for propriety criteria are general principles, codes of conduct and/or national or international good practices.

34) Depending on jurisdiction, this may include conventionally accepted values and norms, such as fairness and integrity, and exercising of prudence. Criteria relating to propriety may also relate to expectations regarding behaviour, for example what may be considered acceptable in regard to class of travel or levels of hospitality and entertainment at government expense if such limits are not explicitly stated by regulations.

35) In some cases propriety criteria may be uncodified, implicit or based on overriding principles of law.[16]

36) While regulatory criteria are legally binding for audited entities, the sources of propriety criteria are conventionally accepted norms of a moral and ethical nature, and are closely linked to the values and social conventions in a society to which there is a broad support among citizens.

37) Propriety is a wide concept capable of varying interpretations and influenced by multiple factors including cultural differences. In respect of propriety, legislator's intentions has a broader meaning – its expectations about the way in which public business should be or should not be conducted; its expectations about the way public officials should or should not behave when

[14] This valuation principle is commonly applied to commercial and financial transactions between related companies. It says that transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest. OECD, 2006, Annual Report on the OECD Guidelines for Multinational Enterprises: Conducting Business in Weak Governance Zones, OECD, Paris.
[15] ISSAI 100/25.
[16] ISSAI 400/32.

managing public funds.

38) Best practices or good conduct may change over the time because of new knowledge, but obligation of public officials to follow the best practice does not change. An example may be environmental issues, where the best practice changes through time by increased knowledge of environment and new technological solutions. Then the criteria for compliance of actions by public officials change along with that development.

39) The authorities and criteria pertaining to propriety are also more context-sensitive than those relating to regularity. This aspect needs to be considered when evaluating audit evidence and reporting on propriety aspects in compliance audit.

40) When determining propriety criteria, SAIs may consider applying some canons of propriety in public expenditure and have in mind if the management used their senses, for example:

- The expenditure should not *prima facie*[17] be more than what the occasion demands;
- Every public officials should exercise the same vigilance in respect of expenditure incurred from public money as a person of ordinary prudence would exercise in respect of expenditure of his/her own money;
- No authority should exercise power of authorizing the expenditure, which will be directly or indirectly to own advantage;
- Compliance with “arm’s-length” principles in transactions with related parties;
- Primacy to the benefit of the majority over that of an individual;
- Fairness, integrity, the avoidance of personal profit from public business, like even-handedness in the appointment of staff;
- Safeguarding resources belonging to the country’s population (natural resources).

If there are no prescribed procedures for incurring public expenditure under certain special circumstances e.g. during an emergency like flood, the propriety criteria to be followed could be whether the public official exercised the same level of prudence that a man of ordinary prudence would exercise in incurring such expenditure. A man of ordinary prudence is likely to deviate from prescribed procedures such as inviting bids for procurement etc. in order to save lives or property in an emergency. The auditor should therefore use his professional judgment based on the expected behaviour of a man of ordinary prudence to arrive at audit conclusion on whether

[17] The Cambridge Dictionary.

the deviations from procedures to procure relief material, expected to be followed were warranted under the emergency circumstances.

41) Consideration of propriety criteria in a compliance audit differs from criteria in a performance audit. A compliance audit aims to determine compliance with authorities, while a performance audit examines whether government programs are economically, efficiently and effectively prepared and implemented, and whether taxpayers or citizens have received value for money.

6 PROCESS OF DERIVING THE CRITERIA FROM SOURCES (incl. characteristics and benchmarks)

42) The ISSAIs require the auditor to identify relevant audit criteria prior to the audit to provide a basis for a conclusion/an opinion on the subject matter.[18] The criteria should be made available to the intended users and others as appropriate. They should also be communicated to the responsible party.[19]

43) Each audit shall have criteria appropriate to the scope and circumstances of that audit. While planning the audit, based on the audit scope and the risk assessment, the auditor derives the criteria from formal authorities or conventionally accepted norms, and applies them for the assessment of compliance of the subject matter.

44) In order to arrive at suitable audit criteria, the auditor needs to derive the criteria from the authorities and describe the criteria as relevant to the subject matter. The description is an interpretation of paragraphs and sections of the authorities made for the specific subject matter under audit. In the interpretation of both – regularity and propriety criteria the intentions and premises set out in developing the law may be taken into consideration.

45) Determining compliance audit criteria is an important process, which requires considerable professional judgement by the auditor and knowledge both of the relevant authorities and its sources of interpretation. To assess compliance with authorities in the public sector, it is necessary to have sufficient knowledge of the structure and content of the authorities themselves.

46) Communicating the criteria with the audited entity is crucial to allow the auditee to give feedback on the criteria. It is also important that the audited entity can relate the criteria to its work. The

[18] ISSAI 4000/110.
[19] ISSAI 4000/97.

criteria are deriving specifically from the authorities governing the auditee or conventionally accepted norms, and the criteria cannot be used automatically from one subject matter to the next. In cases where the auditee does not agree with the criteria, the auditor considers whether the disagreement is due to the criteria not being suitable or that the auditee does not want to be measured using these criteria.

47) Suitable audit criteria either regularity or propriety, should exhibit the characteristics listed in ISSAI 4000.[20] This is especially important when determining propriety criteria, and in communicating and explaining to the auditee. In determining suitable audit criteria, the following may be taken into account.

- Criteria must be appropriately 'operationalized' for the particular circumstances of the audit so as to be able to reach meaningful audit conclusion(s).
- In many compliance audits, the applicable authorities will be clearly identifiable. For regulatory audits, for example, in some cases a law or regulation (or its article, paragraph, section, chapter, etc.) could be sufficiently clear to be used directly as a criterion. If situations arise where there may be doubt as to what is the correct interpretation of the relevant authority, public sector auditors may find it useful to consider the intentions and premises set out in developing the authority (e.g. law), or to consult with the particular body responsible for the legislation. The auditors may also consider relevant decisions made by judicial authorities.[21]
- In some cases, provisions of relevant authorities may be unclear, for example, where a legislative act states that more specific provisions should be set out by the relevant administrative body and these provisions have not yet been developed. In such cases, public sector auditors clearly state in the audit report what they believe the relevant legislation requires, or that the scope of the audit has been limited and the reasons for this limitation. For example, in this case the report may state that insufficient clarity of law has limited the audit criteria applied and that there is a need for remedial measures to be taken.
- In some cases subordinate authorities may not be consistent with the requirements. In these cases the lack of consistency can be a finding in itself. However, the provisions of primary legislation should prevail over those in subordinate legislation. For instance, if the law governing public procurement mandates compulsory bidding process, while the rules framed there under provide an exception, audit should adopt provisions of the law as an appropriate authority. As a result, to assess compliance with authorities in the public sector it is necessary

[20] ISSAI 4000/118.
[21] ISSAI 4000:117.

to have sufficient knowledge of the structure and content of the authorities themselves.[22]

- The audit approach may also be broken down into parts, or the scope narrowed, so that clearly identifiable criteria may be applied.

[22] ISSAI 400:30.

7

THE DIFFERENCE BETWEEN REGULARITY AND PROPRIETY CRITERIA

48) Due to differing jurisdictions legal frameworks there can be a significant difference between the ways the SAIs use the two concepts; the sources of criteria for propriety in one jurisdiction could be the same as that for regularity in another jurisdiction. There could also be a thin line between regularity and propriety, and impropriety may not be easily established.

For example a contractual agreement may turn out to be wasteful and in contravention to the applicable law. To establish impropriety the auditor will look for indicators/evidence that public authority acted with a deliberate bias and chose incorrect options. Hence, criteria for propriety audit will be transparency or procedures followed by the public authority in awarding the contract.

49) It is probable that some of the general principles governing sound financial management and conduct of public officials which are inherently propriety criteria in nature are formally codified into a set of laws, rules, regulations or procedures which those charged with governance are expected to comply with while performing their responsibilities with regard to use of public funds and assets. In such cases, those codified criteria can be considered as regularity criteria while planning, executing and reporting on compliance audits. Where, however, such general principles of sound financial management and conduct of public officials have not been codified into laws, rules, regulations or procedures etc., but are stated merely as general principles of sound financial management and conduct of public officials prevalent in a jurisdiction, they should be considered as propriety criteria to be verified in compliance audits and further determined/explained by the auditor.

For example, public officials are universally expected to observe sound financial judgment while carrying out public procurement. If in a particular jurisdiction, there are specific rules, regulations and procedures etc. to be followed in the procurement processes, for instance requiring an appropriate bidding process, the evaluation of bids and the award of a contract based on prescribed parameters, the nature of these specific criteria makes them regularity criteria. If however, this expectation to follow principles of sound financial management in public procurement, are not codified in any jurisdiction, or there are shortcomings in such codification, the audit criteria to be adopted would be the generally accepted principles governing conduct of public officials in executing financial transactions in that jurisdiction. These general principles could be reasonable expectations of transparent procurement procedures, expectations of accountability of public officials in public transactions, and expectations of reasonable quality in goods procured, works executed or services delivered. Such criteria can be termed as propriety criteria.

Another example of criteria inherently of the nature of propriety criteria but may be treated as regularity criteria is as follows. In some jurisdictions, general principles of financial management state that an allowance drawn by a government employee should not be a source of profit to him. This is inherently a propriety criterion. However in the same jurisdiction, there may be specific rules and regulations stipulating the kind of allowances admissible, the amount of such allowances admissible and the conditions subject to which such allowances are admissible. In case such rules etc. exist the criteria that are inherently of a propriety nature become regularity criteria due to further elaboration of the general principle into rules. Where, however, there are no specific rules governing admissibility of any particular type of allowance, the auditor will have to exercise his professional judgment to conclude whether the allowance paid resulted in any profit to the individual. For instance, in respect of a travel expenditure where there are no specific guidelines on entitlement, the auditor may examine if there was profit by comparing the actual payment to that which would be admissible as per standard fares of travel by actual mode of travel used and the standard rates of room tariff for hotel where the official stayed.

50) Each SAI has to take into consideration the system of laws, regulations and agreements, it is a part of, and thus being the sources of regularity criteria, as well as observance of the general principles governing sound financial management and the conduct of public officials in the context the particular jurisdiction.

51) There may be SAIs that are not permitted to adopt criteria of propriety, either because of the legislation or their mandate, while there may be others where propriety becomes important because the audit mandate of the SAI as well as auditing conventions require examination of compliance with authorities governing propriety. Neverthless, this does not change the need for suitable criteria. In fact, it increases the need for them. The social conventions and context in countries can differ a lot that makes it important to look upon this document as a guiding tool for using regularity and/or propriety criteria.

8

DISCLOSURE OF SOURCES/CRITERIA IN AUDIT REPORTS

52) Criteria need to be available to the intended users to allow them to understand how the underlying subject matter has been measured or evaluated. The requirement states that the criteria are listed in a separate paragraph of the audit report.[23]

53) Communicating the criteria with the audited entity is crucial to allow the auditee to give feedback on the criteria.

54) The compliance audit report determines the applicable criteria against which the underlying subject matter was measured or evaluated so the intended users can understand the basis for a conclusion. It may be relevant in the circumstances, to disclose:

- The source of the applicable criteria, and whether or not the applicable criteria are embodied in law or regulation, or issued by authorized or recognized bodies of experts that follow a transparent due process, that is, whether they are derived criteria in the context of the underlying subject matter (and if they are not, a description of why they are considered suitable);
- Measurement or evaluation methods used when the applicable criteria allow for choice between a numbers of methods;
- Any significant interpretations made in applying the applicable criteria in the engagement circumstances;
- Whether there have been any changes in the measurement or evaluation methods used;
- Where appropriate, a description of any significant inherent limitations associated with the measurement or evaluation of the underlying subject matter against the applicable criteria;
- Jurisprudence, unlawful law.

[23] ISSAI 4000/210.

55) When the applicable criteria are derived for a specific purpose, the audit report may include a statement alerting readers to this fact and that, as a result, the subject matter information may not be suitable for another purpose.

56) Where the audit mandate requires an audit with propriety criteria, the principles outlined in these guidelines may be applied as appropriate in the circumstances. The form and content of reports on propriety may vary depending on the mandate of the SAI and the particular circumstances.

57) Public sector auditors ensure that the criteria adequately reflect the topic subject to audit in its entirety. In rare cases, where the audit may be of limited scope and may only cover certain parts of a law or regulation, this limited scope must be clearly stated in the auditor's report.

It may also be necessary to elaborate on instances of conflicting criteria in the auditor's report.