**Concept Paper**

**on**

***Enhancing the Scope of Financial Audit using IT Audit Techniques***

In the public sector financial management domain Financial Audit primarily deals with attestation of the Financial Statements of the entity/organization through the auditor according a reasonable assurance that the statements under review are free from material errors or have the same under different scenarios. ISSAI 200 defines Financial audit as “…. an opinion by the auditor as to whether the financial statements are prepared in all material aspects in accordance with an applicable financial reporting framework or in the case of financial statements prepared in accordance with a fair presentation financial reporting framework, whether the financial statements are presented fairly, in all material aspects, or give a true and fair view, in accordance with that framework”

The key element here is “numbers”. Auditor’s analysis and focus is on the numbers. Aspects of the organization beyond the numbers such as, what events are leading to the formations of these numbers, the framework in place in the organization for maintenance and use of these numbers etc, is a secondary focus area for the auditor, as quantification of non-number based observations is complicated. For example if segregation of duties of data center employees of an organization is vague , ad-hoc based and not well documented, it is unlikely to have a bearing on the results of financial audit; Whereas weak controls in a data center may provide opportunities’ for significant fraudulent activities putting the credibility of the statements being produced, in doubt.

The question then arises whether the financial attest audit activity should concern itself with affairs outside the domain of numbers and whether looking at potential aspects of financial frauds should be part of the financial audit domain based on pre-defined parameters. The answer lies in review of the Financial Environment of the organization that the auditor has to make himself/herself familiar with.

Information technology is continuously effecting the business/operational environment of an organization. In a reasonably short period of time newer and more complex financial transaction options become available to an entity/organization. Added to this, is the global nature of the transactions where it becomes difficult to establish a paper trail of the financial transactions taking place. It is therefore important for the auditor to know the flow of such transactions and to be able to make a “mental map” of the information system infrastructure of the organization. Such a map may be necessary for the auditor to ask the right questions while trying to understand the working of information system in an entity/organization.

In any organization using information technology to implement its core business activities, there are two broads aspects to consider. First, is the economy, efficiency and timeliness in the business output that has been facilitated by the information technology. Second is the set of new business risk areas that have been introduced by the use of the new IT system. The risk areas may further be classified into two broad categories. One being Information Systems security maintenance and allied protocols; the other being data availability and credibility aspects.

During the course of a routine Financial Attest audit of an organization having a financial information system the auditor is likely to use Computer Aided Audit Techniques to review the financial data of the organization. Doing so, the auditor knowingly or unknowingly reviews the business risk areas of data availability and credibility. However the second category of business risk areas stated above is generally not probed by the audit during the financial attest audit exercise.

A reason for this approach by the auditor is that review of information systems and related aspects are beyond the scope of the financial attest audit exercise. An argument can be that IT Audit, Compliance Audit or Performance audit are more suited for such type of an audit exercise. This is the precise point where a change of perspective is needed. All such events and processes which have a direct or indirect impact on the financial credibility of the organization or on the mandate of operations given to the organization should fall under the financial attest audit review.

However, before such an approach to financial audit can be envisaged a primary baseline question needs to be answered. That is whether or not detecting fraud should be the responsibility of the financial attest auditor.

Presently it is responsibility of the entity itself to investigate and declare frauds. Onus for detecting the fraud while examining the accounts of the organization does not rest with the auditor. This is indeed a well-considered principle and has allowed public sector auditors to maintain their impartiality and credibility over the years. Traditionally speaking the auditor is the watch dog, not a blood hound.

Nevertheless a realization needs to be introduced that information technology has changed and is rapidly changing the financial information environment of public sector entities. Paper trials of financial transactions or their e-audit are scarce and not comprehensive. During the use of manual financial systems by organizations, scrutiny of manual record by audit had far more impact on the credibility of the financial transaction. Full paper trial would invariably be available and therefore a comprehensive financial audit would significantly reduce the chance of fraudulent activities by the organization.

Information technology has changed all this. There is now a greater risk of the auditor not identifying material financial fraudulent activities by using the traditional financial audit approach. With time this potential weak auditing area may become even more exposed.

The stakeholders require a confidence from the auditor assertions that things are going well in an organization. If this purpose gets defeated and auditors’ take shelter under their traditional non fraud based approach, the value of their assertions would diminish gradually. Therefore a paradigm shift is needed to embrace this change in a structured manner.

The way forward may include the following:

* Defining Fraud in context of the financial information system. It may be important to segregate between operational irregularity and financial frauds.
* Defining the scope of fraud detection. This is important because all kinds of frauds cannot be covered in any kind of audit. The effort here is to link those key areas of information systems which have a direct bearing on financial transactions and look for control weaknesses and fraudulent activities within these areas.
* Identifying and creating a list of “audit limitations” regarding fraud detection. Audit would have to limit itself to the information available from within the information system of the organization. Externalities would have to be identified as beyond the audit scope. Such as Bank Account details of the employees, number of cars of the Chief Internal Auditor and similar forensic accounting areas.
* Classifying information system areas having direct or indirect impact on the maintenance of financial information.
* Classifying the types of financial transactions and the non-IT and IT risks associated with each type.
* Creating a link between information systems controls and their impact on the financial statements. The concept of materiality would have to be enhanced in this case. A system control which impacts the credibility of financial information may lead to a material observation on the financial statements.
* Reviewing the definition of Financial Audit to include aspects of fraud detection in context of defined audit limitation.

It would be an understatement to say that the area of enhancing Financial Audit’s scope requires extensive brainstorming and research. The Financial Auditor may need to go beyond numbers and it is apparent that IT Audit techniques may have a significant role in this change of perspective as and when it happens. The above submissions are a mere starting point or a crude assessment of a large policy discussion. The submissions have been made to highlight the current challenges being faced by auditors and to ponder on ways of sustaining their efficiency and credibility.

**Muhammad Ali Farooq Gheba**

**Deputy Accountant General**

**Department of Auditor General of Pakistan**